Tax Competition and EU Law

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CHAPTER 4 - NON-LEGALLY BINDING RULES AND HARMFUL TAX COMPETITION: THE CODE OF CONDUCT AND THE OECD REPORTS

4.1 Introduction

This chapter deals with the politics of (harmful) tax competition in the EU. Consistently with the changed strategy in direct tax policy and the move towards coordination through non-legally binding acts rather than harmonisation through legally binding directives (see especially in Chapter 1, section 1.4), EU Member States agreed in 1997 on a far-reaching political approach on the (harmful) tax competition issue laid down in a resolution approved by the Council and containing inter alia a Code of Conduct for Business Taxation. This document will be analysed together with subsequent documents released at EU level as a result of its application, namely the so-called Primarolo Report of 1999 and its blacklist of harmful tax regimes, and the follow-up documents adopted by the Council.

An evaluation of selected tax regimes implemented by Member States and potentially constituting harmful tax competition within the meaning of the Code of Conduct (and the Primarolo Report) follows. These regimes are grouped into different categories based on the taxpayers, the business activities, or the kind of income they target. The evaluation is based not only on the principles contained in these non-binding documents, but more in general on international and EC tax law principles, which are fundamental in assessing the actual harmful character of such regimes and their blacklisting. The regimes analysed here have been selected on the basis of their relevance and widespread use by multinational companies; a number of them have already been evaluated under the Treaty rules on state aid (see Chapter 3).

The last part of this chapter deals with the parallel project to counter harmful tax competition undertaken by the OECD in 1996 and consisting of three main Reports released in 1998, 2000, and 2001. Also these documents are not legally binding towards the OECD (and EU) countries but merely contain an analysis of harmful tax competition and a number of recommendations on what to do about it. Given the limited practical relevance of the OECD documents for EU Member States, which is a consequence of their more limited substantive scope than the EU documents and the more limited political support surrounding the OECD project, there will not be a detailed analysis of their actual impact on Member States’ tax regimes. However, the main aspects of the OECD attempt will be explained and commented on as well as the likely future developments. Finally the EU and OECD projects are compared, highlighting their strengths and weaknesses and their likely outcome.

4.2 The EU “Package” to tackle harmful tax competition and the Code of Conduct

4.2.1 Historic overview: the three parts of the “Package”

The EU project to counter harmful tax competition materialised in the second half of the 90s mainly due to the impulse and initiative of the Commission, and in particular of the Internal Market Commissioner Mr. Mario Monti. His Memorandum of March
1996 (see in detail Chapter 1, at 1.4.3) called for an urgent need to increased coordination in Member States’ direct tax policy, setting out that the Commission, "fully respecting the subsidiarity principle", would "put forward ...appropriate solutions" to solve the discussed problems, if necessary requiring also harmonisation measures rather than promoting coordination among Member States’ legislation. The subsequent Report of October 1996 (see also Chapter 1, at 1.4.3) stressed the need to curb unfair tax competition by applying more stiffly the EC state aid rules and to achieve greater coordination in the area of tax incentives granted by Member States so as to reduce the negative effects of tax competition. In this respect, this Report set out the need to involve (another) group of high representatives of Member States to discuss about the relevant issues and find a consensus on the tax measures to be considered “harmful in the Community context” as well as on the common criteria to identify such measures to be transposed into a “code of good conduct.” This effort culminated in the adoption of a comprehensive “Package to Tackle Harmful Tax Competition in the European Union” (hereinafter: “Package”), approved by the ECOFIN Council on 1 December 1997 and largely based on the proposals put forward by the Commission. The broad goal of the Package is the need “to tackle harmful tax competition in order to help achieve certain objectives such as reducing the continuing distortions in the single market, preventing excessive loses of tax revenue or getting tax structures to develop in a more employment-friendly way.” To this end, the Package is composed of three linked elements: a Code of Conduct on business taxation (see below in this section), a set of guidelines in the area of taxation of savings concerning a directive to be proposed by the Commission, and a call for a Commission proposed directive on cross-border interest and royalty payments between associated enterprises.

As for taxation of savings, the Package stresses the need to implement a directive meant to ensure a minimum level of taxation on interest income from savings received by residents of a Member State in a country other than that of their residence (see also in Chapter 1, especially at 1.2.4). This directive is aimed at preventing harmful tax competition in the form of exemption of this interest income earned by non-residents by most (EU) source countries, which effectively leads to non-taxation of this income mainly as a result of failure to report it by the recipients in their country of residence. Following the so-called ‘interim agreement’ on the Package of November 2001, the most recent version of the proposed Directive on taxation of savings provides for a


2 The proposals were contained in the Commission Communications COM (97) 495 final, Towards tax co-ordination in the European Union – A package to tackle harmful tax competition, 1/10/1997, and COM (97) 564 final, A package to tackle harmful tax competition in the European Union, 5/11/1997.

3 The so-called ‘interim agreement’ is contained in the 2312th ECOFIN Council Meeting, Council Conclusions, 13861/00 (Presse 453), 27/11/2000, also explained below at 4.3.2. See also J. M. Weiner, ECOFIN makes significant progress in adopting EU savings tax package, Worldwide Tax Daily, 2000, 231-3.

generalised automatic exchange of information between the tax authorities of the EU country in which interest is paid and the recipient’s EU country of residence. The new proposed directive also allows the three EU countries reluctant to information exchange (i.e. Austria, Luxembourg, and Belgium) to apply a withholding tax of 15% for a period of three years and of 20% for a period of four years without having to provide information on the recipients of interest to their country of residence. Under the proposed Directive, the revenue collected from the withholding tax by these three countries will be apportioned between them, entitled to retain 25%, and the country of residence of the recipients, entitled to receive the remaining 75%. The ‘interim agreement’ makes clear that the approval of this Directive by all Member States as required by Arts. 94 and 95(2) (see Chapter 2, Section 2.2) is conditional on the extension of its scope to, or to the adoption of similar measures by, dependent and associated territories of Member States (e.g. the Netherlands Antilles and the UK Channel Islands) as well as key non-EU countries (e.g. USA, Switzerland, Liechtenstein, Monaco, Andorra and San Marino) within the agreed deadline of 31 December 2002. A failure in this respect would mean not only failure of approval of this proposed directive, but also that the other elements of the Package would be jeopardised, including the Code of Conduct.5

The third element of the Package concerns, somewhat paradoxically, the repeal of withholding taxes on intra-group payments of interest and royalties. This is necessary to avoid distortions to the internal market caused by international economic double taxation on these payments. As a result of unanimous agreement by Member States in this area, the Commission has released a Proposed Directive on intercompany payments of interest and royalties6 covering these payments made between associated companies and relying on the principle of taxation in the residence country of the recipient company. Among the various anti-abuse provisions contained in the proposed directive, the one that seems to stem directly from the Package is the denial of the benefits of its application (thus allowing the levy of withholding taxes in the EU source country) on payments to recipient entities enjoying a low tax rate deviating from the ordinary rate in their country of establishment or a reduction in the tax base not normally available in their country of establishment.7 Indeed, this provision indirectly aims at limiting harmful tax competition in the form of special tax regimes providing for nil or lower corporate tax rates or tax base reductions. Apart from this, there seems to be not much connection with the objectives of the Package as the main goal of this directive is the elimination of tax obstacles to the correct functioning of the common market.8

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7 See in particular Terra & Wattel, cit., at 438-440.
8 In this respect, Terra & Wattel, cit., at 440, refers to the opinion of commentators asserting that to counter harmful tax competition withholding taxes should not be repealed but increased to the level of the corporation tax, at least for payments deductible from the corporate tax base, such as interest and royalties: see A. Easson, Fiscal degradation and the inter-nation allocation of tax jurisdiction, EC Tax Review, 3/1996, p. 113.
Last but not least, the Package acknowledges the commitment by the Commission to apply the Treaty state aid rules in direct tax matters against harmful tax competition (see Chapter 3, especially at 3.6.6).

4.2.2 The Code of Conduct: legal nature, scope, and criteria to identify harmful tax regimes

The main document of the Package specifically meant to tackle harmful tax competition is the Code of Conduct for business taxation (hereinafter: the “Code of Conduct” or the “Code”).²⁹ The preamble of the Code acknowledges “the positive effects of fair competition and the need to consolidate the competitiveness of the European Union ... at international level, whilst noting that tax competition may also lead to tax measures with harmful effects.” As for its legal nature, the Code of Conduct has been adopted by the Council as a resolution, which is a non-legally-binding instrument part of EC ‘soft’ law. This is also laid down in its preamble, in which Member States emphasise that the Code “is a political commitment and does not affect the Member States’ rights and obligations or the respective spheres of competence of the Member States and the Community resulting from the Treaty.” As a result, its rules may not be enforced before the ECJ by the EU institutions or the Member States in case of failure to comply with them. The scope of the Code concerns corporate taxation as a whole, including activities performed within groups of companies, and does not include measures concerning individual taxation. Tax measures covered by the Code encompass not only laws, but also regulations and administrative practices:¹⁰ in principle all Member States’ (special) tax regimes fall within its reach regardless of the act through which they are implemented. Also their mechanism is irrelevant for the purpose of the Code of Conduct, which covers measures affecting tax rates, tax base, or other any relevant factors for the determination of taxable income, such as depreciation schedules, tax treatment of reserves and provisions, and the like.¹¹

More specifically, the Code of Conduct covers “potentially harmful tax measures” (hereinafter: “PHTM”) singled out by reference to an objective and a subjective aspect. As for the latter, the Code catches tax measures “which affect, or may affect, in a significant way the location of the business activity in the Community.”¹² With regard to the former, the Code endorses the criterion of the deviation of these tax measures

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¹⁰ Code of Conduct, Para. A (3).

¹¹ Code of Conduct, Para. B (2).

from a Member State’s ‘benchmark’ tax system, i.e. those providing “for a significantly lower level of taxation, including zero taxation, than those levels which generally apply in the Member State in question.”\textsuperscript{13} From this one may infer that in the absence of a clear definition of “harmful” tax competition, the Code endorses a combination of subjective and objective elements to map out PHTMs, which approach is consistent with the concept of harmful tax competition and its distinction from desirable tax competition explained above (see Chapter 1, at 1.2.3, 1.2.4, and 1.2.6).

By and large, the scope of the Code seems broad enough to catch all Member States’ special tax incentives directed at both foreign direct investment generating active income and mobile investment generating passive income. However, there are two main interpretative issues linked to the Code’s scope. The first has to do with the subjective aspect linked to companies’ locational decisions and the motives on where to invest, which are close to impossible to determine with certainty given the many factors influencing investment decisions and the lack of a scientific methodology for this purpose (see Chapter 1, at 1.3.4 and 1.3.5). The second doubt is linked to the objective aspect and the absence of any clarification as to what “significantly lower” effective level of taxation means. The first issue is what deviation in terms of percentage points between a PHTM and a Member State’s ordinary tax system should be considered sufficient for this purpose (e.g. 5 or 10 points), or whether there should be a different comparison standard (e.g. a tax burden of the PHTM lower than 1/3rd or 1/4th of the ordinary tax burden). A second issue is what is meant by “effective level of taxation”, or in other words what methodology should be applied (e.g. the King & Fullerton) and what assumptions should be used, as well as what level of taxation should be considered the statutory one in case of more than one corporate tax rate (see Chapter 1, at 1.3.4 and 1.4.5.4).

The Code tries to overcome these shortcomings by listing a number of criteria to assess which of the PHTMs are actually harmful and are thus caught by the provisions of the Code of Conduct.\textsuperscript{14} These criteria are:\textsuperscript{15}

\begin{enumerate}
  \item availability of a tax measure only to non-resident taxpayers or to transactions concluded with non-resident taxpayers;
  \item no repercussions of a tax measure on the domestic tax base of the country granting it due to its insulation from the domestic economy (i.e. ring-fencing);
  \item availability of a tax measure to investors regardless of their having an actual economic presence or carrying on a real economic activity in the Member State concerned;
  \item availability of a tax measure relying on the computation of taxable income according to principles other than the internationally accepted ones (i.e. the OECD transfer pricing rules);
  \item lack of transparency of a tax measure, including where it is available according to an unpublished administrative practice of a country’s tax administration or where this practice departs from a country’s statutory tax principles.
\end{enumerate}

In addition to the above criteria, the Code contains other factors that need to be taken into account in the assessment of the actual harmful nature of PHTMs:\textsuperscript{16}

\textsuperscript{13} Code of Conduct, Para. B (1).
\textsuperscript{14} See on this also H. Nijkamp, Landmark agreement on EU tax package: new guidelines stretch scope of EU Code of Conduct, EC Tax Review, 3/2001, p. 147.
\textsuperscript{15} Code of Conduct, Para. B (3), No. (1) through (5).
vi) their spillover effects, i.e. the impact they (are likely to) bring about with respect to other (neighbouring) Member States' economies, also taking into account how the activities concerned are commonly taxed in the EU;

vii) the underlying policy objectives linked to the support of economic development pursued by a Member State's tax measure, which should in any event be proportional and targeted, but could justify PHTMs in the "outermost regions and small islands, without undermining the integrity and coherence of the Community legal order."

While criteria i), ii), iv), and v) are linked to the objective aspect of PHTMs deviating from a country’s benchmark system, criteria iii), vi), and vii) are needed to ascertain the main policy goal(s) for their implementation, and in particular the prevalence of the desirable versus the harmful ones for the influence of firms' investment decisions. Focusing on some of them, criteria i) and ii) must be read in conjunction as they target tax regimes mainly available for foreign-based multinational companies or 'offshore' regimes ring-fenced from the rest of the economy, which apply to transactions concluded with non-resident and usually benefit foreign-owned multinational companies. One must also consider that ring fencing seems a misnomer, as every tax incentive has by definition an impact on the domestic base of the country concerned. In fact, offshore incentives effective in attracting mobile foreign-based companies imply a likely increase in tax revenue on the fees from services performed to them by local taxpayers (e.g. financial services, consultancy, turnover taxes etc.), on the income earned by employees hired by them, and on the return on capital invested within the country (if not exempt).

As for criterion iii), the test of availability of a tax incentive regardless of a local substantial presence by its beneficiary clearly shows that a company has invested in that country merely or preponderantly because of that incentive, and at the same time that the country granting it is trying to attract mainly (mobile) business activities at the expense of other countries rather than to pursue a sound domestic fiscal policy. Criterion iv) is directed at special regimes relying on notional methods for the computation of taxable profits such as the cost-plus or resale-minus at odds with OECD transfer pricing principles (see also Chapter 3, Section 3.8). This implies that the use of these methods is allowed and is considered harmful only if it departs from the OECD Transfer Pricing Guidelines with regard e.g. to the items taken into account for the application of the notional methods. The test under v) targets hidden tax incentives granted by way of favourable administrative practices of Member States' tax authorities and encompasses two subcategories. The first includes non-transparent (i.e. unpublished or secret) practices granting corporate tax reductions on a case-by-case basis, which are probably the most dangerous forms of harmful tax competition because they are difficult to be detected and distort competition in the internal market by favouring certain companies only. The second refers to the granting of rulings according to published practices in which tax authorities do not merely interpret statutory tax law but enjoy a high degree of discretion on the tax treatment of a certain transaction or taxpayer and go beyond the boundaries of statutory law.17 They are

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16 Code of Conduct, Para. G. These criteria are indicated as additional practical tools to be used in the assessment of harmful tax measures and are contained in the section of the Code dealing with the review process (see below in the text).

17 This criterion is very similar to the 'specificity' criterion with regard to tax authorities' practices for the purpose
caught by the Code due to the potential inequalities of treatment between taxpayers as well as possible ‘manipulations’ of the statutory tax system by a country’s tax authorities escaping judicial and ultimately democratic control.

Criteria vi) and vii) are closely linked as they both have to do with the subjective aspect of (harmful) tax competition and involve an assessment of the intentions and policy objectives pursued by Member States through the implementation of PHTMs. The former calls for an evaluation of the spillover effects of these measures on other Member States’ economies. If it turns out that these effects are mainly negative, then there is a strong presumption that the main intention of that country was to attract mobile activities at the expense of other Member States. Interestingly, the Code requires that this evaluation take into account the prevalent tax treatment of similar activities and income throughout the Community. This suggests that if a certain PHTM is in line with several other Member States’ tax measures, it will not have to be considered harmful but rather justified on the grounds that it constitutes ‘passive’ tax competition and Member States have been forced to implement it as a response to other Member States’ practices (see Chapter 1, at 1.2.5). This criterion presupposes a thorough comparative analysis of the common or prevalent tax treatment of several groups of activities in the EU, or in other words the mapping out of an EU ‘benchmark’ for each such group against which to assess the various specific PHTMs. It may also be seen as similar to the mechanism of Art. 96 and 97 of the Treaty, which require a (tax law) disparity as compared to the (tax) laws of the majority of other Member States (see Chapter 2, at 2.4.2). As will be seen, due to the complexities involved by such comparative analysis an assessment of PHTMs in this light has hardly been carried out in the drawing up of the black list.

Given its wording and aims, criterion vii) must be interpreted in the light of the Treaty state aid rules, and in particular of the exemptions for regional fiscal aid measures and those relating to the “outermost regions” (see Chapter 3, Section 3.7). As a result, if a PHTM meets one or more of the other criteria laid down in the Code but is nevertheless justified by the policy objective to boost the development of depressed EU areas and is well-targeted and proportionate to such objective, it will not have to be considered caught by the Code. For this purpose, to ensure consistent decisions it may be reasonably assumed that the same criteria and analysis laid down with regard to the Treaty state aid rules (i.e. the Art. 87 (3)(a) and (c) exemptions and relevant Commission soft-law documents) must be used. This is also implicitly confirmed by Para. J of the Code, which anticipates that the Commission will assess a number of Member States’ PHTMs also caught by the Code under the Treaty state aid rules and calls for “ensuring that the rules and objectives of the Treaty are applied consistently and equally to all.”

4.2.3 Consequences of the application of the Code of Conduct and implementation rules

The consequences for Member States’ harmful tax measures covered by the Code of Conduct are laid down in its ‘standstill’ and ‘rollback’ provisions. According to the former, “Member States commit themselves not to introduce new tax measures which
are harmful within the meaning of this code” and “will therefore respect the principles underlying the code when determining future policy.” Under the latter, “Member States commit themselves to re-examining their existing laws and established practices” and “will amend such laws and practices as necessary with a view to eliminating any harmful measures as soon as possible.”

The procedural rules for the actual implementation of the standstill and rollback provisions are contained in Paras. E through I of the Code. Para. H requires the establishment by the Council of a group in charge of the identification of the PHTMs falling into the scope of the Code and their assessment in the light of all the criteria explained above. The Code clarifies that this process should culminate with a report to be submitted to the Council containing a final list of Member States’ actual harmful tax measures subject to repeal or amendment in accordance with the rollback provision.

Paras. E and F of the Code contain additional procedural rules for the functioning of the group in charge of the assessment. The former refers to the basic principles of transparency and openness for the discussion on the various PHTMs and provides for the duty by Member States to (i) inform each other of their existing or new tax measures able to fall into the scope of the Code and (ii) submit any relevant information in case of request by other Member States. Para. F of the Code allows each Member State to raise discussions or make observations on other Member States’ tax measures capable of being caught by the Code’s standstill and rollback provisions.

Lastly, it is interesting to evaluate the role of the Commission within the group. Under para. I of the Code, “the Council invites the Commission to assist the group in carrying out … preparatory work and to facilitate the provision of information…” (emphasis added). Apparently, the Commission’s task would be confined to coordination between Member States to render the groups’ works smoother and ensure compliance by Member States’ representatives with the (procedural) rules of the Code. In other words, the Commission would be the ‘external’ and impartial party sitting in the group mainly to speed up the implementation of the Code and solve any potential procedural or substantive conflict that might arise among the Member States in the very sensitive implementation phase. This provision, far from what in practice had been the Commission’s contribution to the whole process to tackle harmful tax competition in the EU, seems concerned with stressing once again the sovereignty of Member States and the subsidiarity principle in the direct tax area and ultimately the mere political nature of the Code, with as little Commission interference as possible in its actual implementation.

4.2.4 Evaluation of the Code

The above analysis of the Code of Conduct calls for some remarks on its strengths and weaknesses. Starting with its political nature, one might be tempted to conclude that this is a major weakness in the fight against harmful tax competition due to the impossibility to enforce the principles laid down in the Code. Member States may maintain that the Code is a mere political commitment and that they are not legally

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18 Code of Conduct, Para. C.
19 Code of Conduct, Para. D.
bound by it. Alternatively, they may interpret its principles and criteria with respect to their own harmful tax measures such that these are not deemed to be caught by the Code. In other words, the absence of any enforcement mechanism and of (interpretative) jurisdiction by the ECJ could render the Code ineffective due to its nature.

However, further considerations lead to the opposite conclusion that the non-legally binding nature of the Code may be considered a major strength rather than a weakness. In the first place, if the other two parts of the Package, two legally binding directives, are adopted (see at 4.2.1), Member States may feel more compelled to comply with the Code, also on the basis of the loyalty principle enshrined in Art. 10 of Treaty (see also Chapter 2, at 2.2.3). Another useful legal mechanism in this respect would be Art. 96 (and 97) of the Treaty, which might provide the Council, under cooperation and impulse by the Commission, with an enforcement tool against Member States reluctant to implement the Code rollback provision, especially if there were only one or two such reluctant Member States (see Chapter 2, at 2.4.4 and 2.4.5). Moreover, the effectiveness of the Code of Conduct must be evaluated in the light of the changed Commission’s approach in the direct tax area promoting coordination rather than harmonisation of Member States’ tax systems in accordance with the subsidiarity principle. The underlying idea is that ‘soft law’ embodying political commitments may turn out to be even more effective than legally-binding acts, as the peer pressure exercised by other Member States to ensure their implementation may be even more compelling than the threat of resorting to the ECJ available with regard to the latter.

The Commission has explicitly acknowledged this in its 2001 Communication on the future of tax policy in the EU, stating that “the use of non-legislative approaches or ‘soft legislation’ may be an additional means of making progress in the tax field” and that “peer pressure, which is the basis of the Code of Conduct for business taxation, could be applied in other areas” as they “could be particularly effective in cases where they have a firm legal foundation, based on the Treaty and the case law of the Court of Justice.”20 This has also proven true in practice, as Member States have taken the Code of Conduct seriously and amended most of their measures to comply with it regardless of its lack of binding force and of the approval of the other two elements of the Package (see Sections 4.4 through 4.7). All in all, one must agree on the effectiveness of the Code of Conduct approach and more in general on the fact that coordination in certain aspects of the direct tax area covered by it seems appropriate, as it preserves (certain) Member States’ tax sovereignty and leaves them with enough flexibility as to the actual remedies concerning their harmful tax regimes in this sensitive area, while at the same time being backed by Member States’ peer pressure and other Treaty provisions reinforcing its application (e.g. the state aid rules, the internal market distortions provisions, and the loyalty principle).

A weakness of the Code already stressed is the absence of a clear definition of harmful tax competition and some interpretative doubts on its scope (see at 4.2.2). Another weakness is that its scope is limited to corporate taxation and leaves out special tax regimes for individuals (e.g. expatriates), which may turn out to be just as harmful as

certain corporate tax regimes. One also notes that the scope of the Code does not cover generalised corporate tax regimes of Member States, such as a very low tax rate (e.g. the 12.5% Irish corporate tax rate as from 2003) or the non-application of withholding taxes on passive income (e.g. interest and royalties) remitted abroad. However, one should also consider that the line between harmful tax measures targeted by the Code and those outside its reach had to be drawn somewhere and that it seems to have been drawn consistently with the borderline between ‘good’ and ‘bad’ tax competition. Furthermore, the situations not caught by the Code are limited (so far) and they are still subject to other Treaty constraints, such as the internal market distortions provisions or the EMU rules (see Chapter 2, sections 2.4 and 2.5).

The above considerations support that overall the evaluation of the Code of Conduct must be a positive one. First, it is remarkable that Member States have acknowledged for the first time the existence of harmful tax competition in the EU and the need to do something about it. Second, it is to be welcomed that the principles of Member States’ tax sovereignty and of desirability of tax competition have been restated, confirming that this is the norm in the EU (legal) context and that only harmful tax competition needs to be tackled by this coordination effort. Third, the Code contains appropriate instruments (i.e. the standstill and rollback provisions) to be consistently applied with the other two components of the Package as well as with the Treaty fiscal state aid rules, and more in general it contemplates an evaluation of the various circumstances concerning each Member State’s PHTM and its underlying policy objective(s). The absence of legally binding force and the (disputable) lack of legal remedies do not seem sufficient to lead to a negative overall evaluation of the Code, especially in the light of the above considerations related to its overall effectiveness towards Member States.

4.3 Follow-up to the Code of Conduct: The “Primarolo” Report and the “2000 Guidelines”

4.3.1 Establishment of the “Code of Conduct Group” and its work

In compliance with the Code of Conduct, the Council established in March 1998 a group chaired by the then UK paymaster general Ms. Dawn Primarolo (hereinafter: the “Code of Conduct Group” or the “Group”), composed by high-level experts of each Member State and representatives of the Commission. The Council mandate clarified that the Group was in charge of the assessment of Member States’ PHTMs under the Code of Conduct without prejudice to their sovereignty and stressed that its work was of political importance. Under the procedural rules on the functioning of the Group, its work should be confidential and the final report to be submitted to the Council would “reflect either the unanimous opinion of its members or the various opinions expressed in the course of the discussion.” The former rule proved ineffective as due to a number of leaks by the Group’s members its work was made known to the public, as was the outcome later (i.e. the final report). The latter rule also proved ineffective as the Group decided to adopt its decisions based on majority

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22 See the Communiqué 2072, at., paras. 12-13.
voting rather than unanimity, which was necessary for the adoption of the final report and the blacklisting of harmful tax measures without the consensus of the Member State concerned.

During the year and a half of its existence, the Code of Conduct Group met 18 times and divided itself into sub-groups in order to speed up the process to draw up the black list. The Commission submitted a draft “Initial indicative list of measures that might fall under the scope of the Code of Conduct” on 16 July 1998, which was revised and resubmitted on 25 September 1998 after the comments and discussions of the Member States’ representatives. Member States with associated and independent territories also submitted a list and detailed reports on the PHTMs of the territories caught by the Code of Conduct in November 1998. At this stage, the Commission singled out 85 potentially harmful tax measures and broke them down into five categories: intra-group services (17 measures), financial services and offshore companies (13 measures), other sectoral regimes (15 measures), regional measures (17 measures), and other measures (23 measures). A sixth category encompassed PHTMs of Member States’ dependent and associated territories. The Group assessed through its sub-groups each PHTM against the criteria of Para. B of the Code of Conduct and in particular their lower tax burden and deviation from the benchmark tax system. With regard to regional measures, the Group also considered whether they were proportionate and targeted to the aims sought by the Member States in accordance with Para. G of the Code of Conduct (see at 4.2.2).

An additional list of PHTMs was drawn up on the basis of the lists submitted in January 1999 by several Member States pinpointing other fellow States’ PHTMs, as provided by Para. F of the Code. The Netherlands submitted a thick list of 80 such PHTMs using a different approach from the one adopted until then by the Group in that it focused on the effective tax burden in each Member State (rather than the statutory one) on the basis of three independent studies using different methodologies and assumptions (see Chapter 1, especially at 1.4.4 and 1.4.5.4).

4.3.2 The “Primarolo Report” and the “2000 Guidelines”

After an evaluation of all PHTMs submitted, the work of the Code of Conduct Group culminated in a final report submitted to the Council on 23 November 1999 (hereinafter: the “Primarolo Report” or the “Report”). It contained a ‘black list’ of 66 Member States’ harmful tax measures within the meaning of the Code divided into 6 categories (i.e. 5 categories plus a residual category of miscellaneous measures). The Primarolo Report has never been formally approved by the Council. The main reason is the disagreement of several Member States on the blacklisting of their own measures as well as the fact that the Primarolo Report, as regards the criteria to be applied, in some instances seems to go beyond the scope of the Code of Conduct and the mandate the Council gave to the Group (see below at 4.3.7 and 4.3.8). However,
Member States decided not to formally reject the Report and its black list in this ‘interim agreement’ on the Package reached in November 2000 (see at 4.2.1). As a part of the agreement, the Council adopted three sets of guidelines (hereinafter: the “2000 Guidelines” or the “Guidelines”) containing general criteria based on those set out in the Primarolo Report with respect to 3 of its 6 categories, which take into account some Member States’ criticisms concerning the Report and represent its follow-up.25 Below there will be a general analysis of the criteria contained in the Primarolo Report and in the 2000 Guidelines with regard to the categories of measures as set out in these documents, which will serve as the basis for the assessment of specific Member States’ tax regimes in the following sections of this chapter.

4.3.3 Financial services and royalty income

The first category of harmful tax measures contained in the Primarolo Report is composed of three subcategories concerning income from financial services and from intra-group financing, and royalty income. The common characteristic is the high mobility of this income, which can be easily shifted within multinational groups from one country to another (mainly) as a result of (favourable) tax considerations.

The first subcategory encompasses regimes applying to income from financial services rendered to unrelated parties. The criterion laid down for the blacklisting is their providing for a full exemption or a substantial reduction of the tax burden on this income as compared to that country’s standard tax regime. This requirement represents nothing new or different from the main objective criterion contained in the Code of Conduct and thus does not require further comment.

The second subcategory concerns tax regimes for the provision of intra-group financial services between related entities mainly within a multinational company. The Primarolo Report indicates that the blacklisting is based on the following criteria (also) linked to transfer pricing issues:

(i) a reduced nominal rate of tax;
(ii) fixed margins for pass-through financing without a regular review of such margins against commercial criteria;
(iii) creation of tax-free reserves in excess of the real underlying risks of financing activities;
(iv) formulaic way to allocate profits between the group’s headquarters and a branch resulting in a low effective tax burden on this income.

as the views expressed in each of the papers contained in that issue. See especially M. J. Ellis, The Code of Conduct in 2000: Cracking the Code or coating the crack?, at 414.

25 For an explanation of the ‘interim agreement’ and of the 2000 Guidelines, see Nijkamp, cit. The relevant documents are: (i) Conclusions of the 2312th ECOFIN Council of 26-27 November 2000, cit.; (ii) Presidency note, Doc. 13555/00 FISC 190, 20/11/2000; (iii) Presidency note, Doc. 13898/00 FISC 207, 20/11/2000; (iv) Primarolo Progress Report, Doc. 13563/00 FISC 193, 20/11/2000; (v) Annex to the Primarolo Progress Report, Doc. 13563/00 FISC 193, 20/11/2000. Unfortunately, only documents (i) through (iii) are public. Documents (iv) and (v) on the Primarolo Progress Report and its Annex, which contain the 2000 Guidelines, are not public. Our request to the Council to obtain a copy under Council Decision 93/731/EC on public access to Council documents has been rejected. Therefore, the analysis contained in this chapter is based on the limited available documents and on the article by Ms. Nijkamp, cit., which contains the criteria of the 2000 Guidelines. I apologise for any imperfection in the analysis due to this circumstance.
These criteria reflect the basic transfer pricing principles meant to ensure that transactions concluded between related parties reflect the arm’s length principle so as to avoid the erosion of the tax base in high-tax jurisdictions. They concern two broad subcategories of special regimes for intra-group financial services: ‘finance company’ regimes and ‘finance branch’ regimes. Criterion (i) is common to both subcategories and targets tax measures providing for a low or nil tax burden on interest arising from intra-group loans and other financing activities. It is also expression of the general criterion of Code of Conduct that special tax measures providing for a nil or very low tax burden on these activities must be considered harmful tax competition.

The second and third criteria specifically concern the so-called ‘finance company’ regimes. Criterion (ii) catches measures providing for fixed taxable spreads on back-to-back loans between group companies where they are not constantly reviewed and do not reflect the current market interest rate charged between unrelated parties. These arrangements are available in a few EU countries pursuant to administrative practices under which small fixed margins between incoming and outgoing interest on intra-group back-to-back loans must be reported for tax purposes by intermediate pass-through finance companies. The third criterion covers tax regimes allowing finance companies to create tax-free provisions in connection with relevant business risks borne on intra-group financing where these risks are not objectively present or are not such to justify the formation of these provisions. It targets regimes providing for a fixed portion of interest income from intra-group loans and other financial activities to be allocated to these provisions before taxation so that the deferral enjoyed is arbitrary considering the purpose for their creation.

The last criterion deals with regimes for foreign finance branches. These regimes provide for an allocation of finance profits between a multinational head office and a foreign finance branch through a fixed formula. The Report targets arbitrary allocation methods at odds with the OECD arm’s length principle resulting in a low tax burden on intra-group interest income. They mostly apply pursuant to administrative practices of Member States’ tax authorities under which only a small portion of such interest income (e.g. 10%) is allocated to the headquarters and the remaining significant portion (e.g. 90%) allocated to the branch is exempt either on the basis of an applicable tax treaty or of domestic tax law. The 2000 Guidelines further clarify the criterion contained in the Primarolo Report with regard to finance branch regimes. They explicitly state that the use of fixed formulas for the allocation of profits between headquarters and finance branches entails harmful tax competition within the scope of the Code of Conduct only where it deviates from international (i.e. OECD) transfer pricing principles. Moreover, the application of the exemption method with regard to the branch’s profits by the country of the headquarters is considered a harmful feature only where (i) the tax burden on the finance branch’s profits is significantly lower than that applicable on the headquarters’ profits, and (ii) there are no adequate anti-avoidance clauses preventing (multinational) companies from abusing these regimes.26

26 It is also worth noting that Belgium has stated that it interprets the feature under (i) as referring to the lowest general tax rate applicable in the Member State with the lowest rate rather than with regard to the headquarters’ Member State only. The Irish delegation contests this interpretation as inconsistent with the Code of Conduct, which requires a comparison of tax burdens within the same Member State and not with regard to all the other Member States. For a critique on the 2000 Guidelines and the EC law aspects of their implementation, see
The third subcategory of this group includes Member States’ regimes for royalty income. The main criterion indicated in the Report for their blacklisting is the exemption or a significantly reduced tax burden on this income. Although not expressly stated in the Report, it seems that transactions between both unrelated and related parties are covered. The remaining two criteria, which must be read in conjunction, refer to the possibility to calculate taxable royalty income by using fixed spreads which do not reflect commercial conditions. These indicators aim at catching intra-group back-to-back royalty arrangements and are harmful only to the extent that the spreads between incoming and outgoing royalties of (intermediate) group companies are not set at arm’s length. The considerations on the finance company regimes are also valid for this category.

4.3.4 Insurance activities

The second category of PHTMs included in the Primarolo Report regards insurance activities. It encompasses all regimes directed at income from insurance, reinsurance, and captive insurance activities, which present features similar to the financial activities as described above. The criteria for their blacklisting are mainly two:

(i) the possibility to form provisions out of before-tax (insurance) income by contributing disproportionate amounts exceeding the real and usual business risks stemming from insurance activities, which lead to a substantially long tax deferral on insurance profits;

(ii) a special exemption or reduced tax burden (e.g. through notional tax bases) on insurance income.

These criteria are consistent with the Code of Conduct’s ones, as they are meant to catch only measures providing for a significant lower tax burden on insurance income as opposed to the standard tax burden. This lower burden is achieved through measures allowing tax deferral through the formation of tax-free reserves, or relying on notional methods for the calculation of the tax base of insurance companies. While the former criterion targets all kinds of insurance activities and transactions, between related or unrelated parties, the latter targets captive insurance income stemming from transaction with related parties, as in this case the arm’s length principle may be infringed by the use of a notional method.

4.3.5 ‘Headquarter company’ regimes: the ‘centres’ and intra-group services

The third category of harmful measures encompasses ‘headquarter company’ regimes covering income from intra-group activities performed by the so-called ‘centres’ (see also Chapter 3, Section 3.8). It targets Member States’ regimes not complying with the OECD transfer pricing arm’s length principle for the computation of income from transactions between related parties. The criteria laid down in the Primarolo Report, which stem from the Code of Conduct criterion of the deviation of tax measures from

Nijkamp, cit., at 150.

27 In this respect, the Report stresses that some of the regimes blacklisted in the category of financial services also cover insurance activities, in which case there is no need to evaluate them also in this category.
Internationally accepted transfer pricing principles, covers Member States' measures implying:

(i) a deviation from the comparable uncontrolled price (CUP) method to set the transfer prices for transactions between related parties where this, if used, would lead to reasonable results;

(ii) the absence of a thorough examination of all the relevant facts and circumstances on a case-by-case basis by the local tax authorities or of a regular review of the fixed mark-ups for the use of the cost-plus or resale-minus methods against the normal market criteria;

(iii) the requirement for eligible companies to be part of a multinational group;

(iv) the exclusion from the relevant base of significant items of expenses borne by the eligible centres for the purpose of the cost-plus method.

These criteria aim at labelling as harmful Member States' special tax regimes providing for a very low tax burden on income earned by intra-group centres through the use of notional methods for the computation of profits such as the cost-plus or resale-minus, especially those granted through rulings of the tax authorities, where they do not reflect the arm's length principle because they provide for an artificial reduction of the taxable base or set artificially low mark-up margins. This category comprises a range of headquarters centre regimes implemented by Member States which have the effect of almost exempting their income. The 2000 Guidelines also deal with 'headquarter company' regimes. While restating criteria (i), (ii) and (iv) of the Primarolo Report, they also specifically refer to the OECD Transfer Pricing Guidelines as the benchmark transfer pricing rules to consider when making the assessment of harmfulness of these regimes. With regard to criterion (iii), the Guidelines state that features such as the restriction of these regimes to (transactions with) non-residents or their 'ring-fencing' are also relevant for their being considered actually harmful, substantially specifying the criterion set out in the Primarolo Report.

4.3.6 Holding and offshore company regimes

The fourth category of harmful tax measures is divided into two subcategories on holding company regimes and exempt and offshore company regimes. The issues relating to holding companies are more thoroughly addressed in an unreleased report containing a comparative study with a cross-country review of the treatment of holding companies in the Member States in accordance with Para. G (1) of the Code of Conduct. The key point stressed by the Report is the distinction between holding companies set up for a genuine business reason and those merely used for tax reasons. While the former are mostly entities with certain local substance and active management, the latter have little or no economic substance and are highly mobile companies easily movable from one jurisdiction to another. The Report focuses at length on the so-called 'participation exemption' (or affiliation privilege), i.e. the exemption by the Member States' holding company of dividends received from, and capital gains realised on, shareholdings of affiliated group companies in which a certain interest is owned. As will be seen below (in Section 4.6), the underlying idea of the participation exemption is to prevent international economic double taxation stemming from the taxation of the same income first at the level of the subsidiary and
then at the level of the parent company, and to recognise the tax sovereignty of the 
source State.

The main criterion laid down in the Report for the blacklist of participation 
exemption regimes is their application even in cases in which the subsidiary’s profits 
are subject to very low or nil taxation in the source country. The reason is that in this 
case the participation exemption is pointless as there is no or very little economic 
double taxation to relieve, whereas if it is granted the subsidiary’s profits wind up 
untaxed altogether. In order to avoid being considered harmful, the Report requires 
that participation exemption regimes be conditional on a ‘subject-to-tax’ clause with 
regard to the subsidiary’s income or be coupled with extensive controlled foreign 
company (i.e. “CFC”) legislation in the holding company’s Member State. As for 
capital gains, the Report considers harmful participation exemption regimes with an 
asymmetrical treatment exempting capital gains and at the same time allowing a 
deduction of capital losses in favour of the holding company. The 2000 Guidelines 
substantially endorse the same criteria contained in the Primarolo Report with regard 
to participation exemption regimes, with a clarification. They restate the two 
cumulative criteria to be considered harmful of their applicability even in cases where 
the subsidiary’s profits are subject to a significantly lower tax level in its country and 
of the absence of effective CFC legislation but also add that any other equivalent anti-
abuse regime able to neutralise the differences in the levels of tax in the country of the 
subsidiary and its parent company is sufficient to avoid the blacklisting.28

The second subcategory singled out by the Primarolo Report includes specific tax 
measures for exempt and offshore entities enacted by independent or associated 
territories of the Member States which provide for a complete exemption or a very 
low tax burden on these entities’ profits. The criteria laid down in the Report for their 
blacklisting are:

(i) the benefits are restricted to companies with non-resident shareholders (i.e. 
ring-fencing);
(ii) no business with residents is permitted for the exemption or the low tax burden 
to apply;
(iii) the measure is mainly targeted at mobile capital.

The above criteria target the special offshore regimes of Member States’ associated 
and dependent territories offering an exemption or a very low tax burden on profits of 
companies mainly or exclusively owned by non-residents and with activities mainly 
or exclusively outside the jurisdiction concerned. These criteria are based on the 
general ring-fencing criterion included in Para. B of the Code of Conduct and on Para. 
M calling for the extension of its scope also to Member States’ associated and 
dependent territories, known as ring-fencing, or insulation of the said entities from the 
rest of the economy of those jurisdictions. The reason behind this is that there is the 
need to avoid or limit special tax regimes granting exemptions to foreign taxpayers 
without substance, which result in no taxation of this mobile income and thus erodes 
the tax bases of high-tax jurisdictions, causing harmful effects on their economies.

28 Like with regard to finance branch regimes Belgium interprets these criteria as meaning that the tax level to take 
into account is the lowest generally applicable in the Member State with the lowest rate, giving rise to the same 
objection by Ireland (see at 4.3.2). With regard to the asymmetrical treatment of capital gains and losses the 
interpretation by the Netherlands considers this requirement not met where the deductibility of capital losses 
covers liquidation of a subsidiary (see also at 4.3.8 and 4.6.2).
4.3.7 The Member States' reactions to the Primarolo Report

The reactions of the Member States on the Primarolo Report may be found in its footnotes. They contain not only the views and reservations by Member States on their blacklisted measures, but also more general comments on the work of the Code of Conduct Group and on the Report as a whole. While the former will be explained when analysing specific regimes of Member States (see Sections 4.4 through 4.7), the latter will be summarised here.

The first observation by the Netherlands delegation is that the Primarolo Group did not completely fulfil its mandate as it failed to carry out a thorough cross-country study on the tax treatment of the activities encompassed into each of the categories singled out in the Report as required by Para. G (1) of the Code of Conduct.\(^29\) Furthermore, it stressed that the Report was missing an in-depth analysis of the impact of the tax measures scrutinised on firms' locational decisions as well as their actual spillover effects on the economies of other Member States, which was also required by the Code (see at 4.3.2).

At the same time, the Netherlands delegation made the opposite remark that the Primarolo Group went too far and beyond its mandate in laying down certain criteria used in the assessment of PHTMs.\(^30\) The criticism was based on the grounds that some of the Report's criteria were neither contained in the Code of Conduct nor did they directly stem from its criteria, and that the entire category of holding company regimes was not targeted by the Code and outside its scope altogether. In other words, the Netherlands' (and other Member States') feeling was that the Code of Conduct Group had created new criteria on its own initiative, which was not tolerable given the sensitive area and interests at stake and the lack of political support and a specific mandate to this effect.

The Irish delegation noted that the Group failed to compare the effective tax burden of each PHTM with the general level of taxation applicable in the country concerned.\(^31\) This is indeed a fundamental step in the assessment on their harmfulness, as the Code of Conduct considers this the main indicator, and the Group did not do what the Netherlands authorities did by presenting three independent studies in this respect (see at 4.3.1 and Chapter 1 at 1.4.4). Furthermore, the Netherlands and the Luxembourg delegations stressed the rigid application by the Group of the Code's criteria especially with respect to PHTMs included in the category of financial services as opposed to a less strict approach followed in the assessment of measures in other categories.\(^32\) While these statements are probably due to the fact that most of the blacklisted measures included in these categories happen to be contained in the Netherlands or Luxembourg legislation, it is true that the Primarolo Report focuses specifically on regimes for financial services despite the Code of Conducts targets corporate taxation as a whole. This is understandable, though, as harmful tax competition mainly stems from tax measures directed at passive income and highly mobile intra-group services.

\(^{29}\) See footnote No. 2 of the Report.
\(^{30}\) See footnote No. 7 of the Report.
\(^{31}\) See footnote No. 4 of the Report.
\(^{32}\) See footnote No. 5 of the Report.
A last more general statement of the Netherlands delegation welcomed the work and overall the results achieved by the Primarolo Group while at the same time calling for additional work to refine the outcome of the Report, pointing out that pursuant to the follow-up process envisaged by Para. N of the Code of Conduct, the Tax Policy Group (i.e. the Code of Conduct Group) should be in charge of this. The Netherlands’ delegation recommended the issue of more general guidelines based on the criteria contained in the Report agreed on by all Member States and containing principles on whose basis the Report’s black list should be updated. To this end, this Group should re-evaluate all blacklisted measures and assess any new tax measure implemented by Member States under the proposed guidelines, also in the light of the overall competitiveness of the EU in the international arena and of the effective tax burden in each Member State in compliance with the Code of Conduct.

4.3.8 Comments on the Primarolo Report and the 2000 Guidelines

The Primarolo Report is a fundamental step in the fight against harmful tax competition in the EU. Not only does it blacklist Member States’ harmful tax measures under the Code of Conduct, but it also sets out the specific criteria used for this purpose. The Report does not stand on its own, but it stems from the Code of Conduct and aims to implement its rules through the blacklisting of measures falling within its scope. This also entails that the (political) significance of the Report is linked to the outcome of the Code of Conduct, and ultimately of the whole Package to tackle harmful tax competition. Most Member States confirm this link and stress that failure to agree on the other parts of the Package will automatically undermine the actual implementation of the Code and the Report.

Another pattern emerging from the Report’s footnotes is that almost all Member States disagree on the blacklisting of their own tax measures (see in the following sections). However, this has a limited impact on the Report as the decisions on the blacklisting were based by the Group on the majority rather than the unanimity voting rule. This might be the first step towards the use of Art. 96 of the Treaty to adopt legally-binding acts in this area (see Chapter 2, at 2.4.5) or towards an extension of the qualified majority rule in the direct tax area as advocated by the Commission. In this regard, the Netherlands delegation explicitly “regrets that elements of the report appear to suggest that Member States should aim for majority voting and pseudoharmonisation,” but it “cannot agree to using new criteria which have not been discussed in depth and would in effect lead to pseudoharmonisation.”

The scope of the Report seems to be consistent with that of Code of Conduct. Some direct tax areas have explicitly been left out, such as guarantees and tax credits linked to employment, as well as the tax treatment of collective investment vehicles. The

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33 See footnote No. 6 of the Report.
34 See footnote No. 1 of the Report, containing a statement by the Belgian, German, French, Italian and Netherlands delegations.
36 See footnote No. 2 of the Report.
37 See footnote No. 7 of the Report.
Report also leaves out special tax treatments for high-skilled expatriates available in a number of Member States (see Chapter 3, at 3.6.3), even though it acknowledges that they might constitute harmful tax competition as envisaged in the original Commission proposal to include them in the scope of the Code of Conduct.\(^{38}\) The Report states that all these tax measures should be discussed in the framework of the Tax Policy Group, possibly finding a compromise to preserve the competitiveness of the EU at international level and prevent a massive capital flight from the EU.

As for the mandate of the Primarolo Group, by and large the comments by the Member States, especially The Netherlands delegation, seem appropriate and well-founded. As far as the criteria set out in the Report for the blacklisting of Member States' PHTMs in the five categories are concerned, most of them are not innovative but rather they stem from, or are in line with, those of the Code of Conduct. In this respect, the Report explains that "the Group considered that a literal interpretation of the criteria as set out in the Code could make some of the criteria of little or no significance. It agreed that, in addition to a literal interpretation, the Group should also take account of a wider interpretation of some of the criteria."\(^{39}\) By contrast, it seems true that some criteria are not based on the Code but have been created by the Primarolo Group on its own initiative and beyond its mandate. The feeling is that these criteria have been elaborated by the Group 'backwards', i.e. as a consequence of the blacklisting of certain Member States' tax measures for which there seemed to be uncertainty as to the satisfaction of the criteria of the Code of Conduct. In other words, it seems that the Group in the first place singled out the harmful tax measures to blacklist, and only thereafter it formulated specific criteria in a general way to justify their blacklisting.

The next question is whether this deductive rather than inductive way of laying down general criteria for the assessment of harmful tax measures, which seems to have been adopted also for the criteria set out in Para. B of the Code of Conduct, is justifiable in the light of the purpose of the fight against harmful tax competition and the lack of a consistent theoretical framework and economic methodologies for this purpose. The Primarolo Report exercise should probably be welcomed as an attempt to overcome these difficulties, though some of these criteria seem imprecise and need more refinement or are not exhaustive. However, this conclusion is valid only to the extent that the Report's new criteria are within the boundaries of those contained in the Code of Conduct. If this is not the case, one must share the view of Member States that the use of new criteria or the targeting of certain categories of measures (e.g. holding company regimes) requires political backing by the Council (and the Member States' representatives) and is not justifiable on the grounds of the absence of an adequate framework to counter harmful tax competition.

Unfortunately, the 2000 Guidelines do not solve these issues but rather create new ones. On the one hand, they are incomplete as they only deal with three of the five categories singled out in the Primarolo Report and do not add much with respect to the category of 'headquarter company' regimes. On the other hand, they go even further than the Primarolo Report with respect to the categories of finance branch and holding company regimes by laying down new criteria. Under the new criteria, these

\(^{38}\) See COM (97) 495 final and COM (97) 564 final, \textit{cit.}

\(^{39}\) See the Primarolo Report, para. 14, at 5.
regimes would be considered harmful within the meaning of the Code of Conduct if they also cover underlying income earned by foreign finance branches or holding companies' foreign subsidiaries subject to a low local tax burden and are not coupled with adequate domestic anti-avoidance legislation (e.g. CFC rules). Not only do these criteria not stem from the Code of Conduct or are outside its scope, but they are also able to interfere with Member States' sovereignty to decide on their benchmark tax systems and are potentially in breach of EU law (e.g. the Parent/Subsidiary Directive) and tax treaties, next to posing a number of interpretative issues for their application (see in detail at 4.4.5 and 4.6.2). One must hope that the revision of the Primarolo Report and of the 2000 Guidelines will solve these issues.

4.4 Financial services regimes

4.4.1 Overview

The first category of PHTMs as laid down in the Primarolo Report concerns the provision of financial services. It encompasses special tax regimes applying to income from financial activities rendered to third parties or from transactions between related entities part of a multinational group. This distinction matters as tax regimes (also) applicable to third-party services usually rely on an exemption or a low tax rate on (part of) the eligible income, whereas regimes only covering intra-group financial services mostly concern transfer pricing issues. The following paragraphs analyse certain blacklisted regimes in the light of the Code of Conduct and the Primarolo Report as well as the 2000 Guidelines (where applicable) taking into account this distinction.

4.4.2 Financial services performed to third parties: the Irish IFSC and the Madeira ZFM

The most common type of favourable tax regimes for income from financial services rendered (also) to third parties relies on nil or very low tax rates as compared to the general corporate tax rate applicable in a Member State. Often, there are also other tax and non-tax incentives offered to entities performing these financial services, such as special tax allowances for investments in business assets, reduced taxation or tax credits for employees of these entities, and financial grants at favourable conditions. These features are all present in two regimes discussed below, the Irish International Financial Services Centre (hereinafter: “IFSC”) regime (for its detailed description and analysis under the Treaty state aid rules, see Chapter 3, Section 3.5) and the Portuguese archipelago of Madeira Zona Franca Madeira (hereinafter: “ZFM”) regime (for its description and analysis, see Chapter 3, at 3.4.6 and 3.7.5). As already seen, a common characteristic is that they both apply in limited areas within their countries and that the main reason for their introduction was to favour the development of these depressed areas, which meant a thorough scrutiny by the Commission under the Treaty state aid rules. Here these regimes will be evaluated exclusively in the light of the Code of Conduct and the Primarolo Report.

In short, the Irish IFSC features a significantly lower tax burden on eligible financial activities (i.e. banking, international financial services, insurance and reinsurance,
treasury and global fund management, leasing and factoring) of 10% versus the much higher standard corporate tax rate applicable in Ireland. Furthermore, the IFSC regime deviates from the benchmark system in that it is available exclusively to resident entities belonging to multinational groups established in the Centre and it applies exclusively to eligible income from activities performed within the Centre. Other special incentives are the exemption from withholding tax on dividends and interest paid by IFSC companies to non-resident recipients, double deduction for rents of eligible buildings located in that area, and accelerated depreciation on certain business assets.

The Portuguese ZFM (also) features a ‘financial services centre’ for entities performing a number of financial and banking activities as well as trusts services. This regime provides for a corporate tax exemption on income from eligible activities performed in the ZFM versus a much higher corporate tax burden normally applied in Portugal (i.e. 32% in 2002) and features a number of other direct and indirect tax incentives, such as exemption from withholding tax on passive income distributed by ZFM entities. The ZFM regime is also ‘ring-fenced’ as it applies to entities belonging to multinational groups only for their offshore activities and transactions not involving mainland Portugal and Portuguese residents.

These features have caused the blacklisting by the Primarolo Report of both the IFSC and the ZFM regimes, given their low tax burden and deviation from the benchmark tax system (as well as the ring-fencing for the ZFM) within the meaning of the Code of Conduct. Furthermore, their ability to significantly affect the decisions to locate firms performing financial services (also) to third parties as required by the Code of Conduct is shown by some figures. With regard to the IFSC, the Primarolo Report indicates that at the end of 1997 there were more than 100 IFSC projects employing more than 4,500 people, to increase to 6,000 in the following years. The effectiveness of the ZFM in attracting entities performing financial services is supported by the data shown in the course of the investigation under the Treaty state aid rules (see Chapter 3, at 3.7.5).

However, what the Primarolo Report seems to neglect in the blacklisting of these regimes is Para. G (in conjunction with Para. J) of the Code of Conduct, which provides for the possible existence of a valid justification for implementation of harmful tax regimes in the light of the Treaty state aid rules (see at 4.2.2). This is explicitly lamented by the Portuguese delegation, which stated in the Primarolo Report that the ZFM regime “was not assessed under the provisions of paragraph G of the Code” and that “no Member State has expressed its opinion either on the concept of proportionality ... or on the assessment ... in face of the outermost condition of Madeira, or on the contents of the report presented by Portugal on this matter...”41 Surprisingly, Ireland did not make any specific statement with regard to the assessment of the IFSC regime under para. G of the Code, despite it had been approved by the Commission several times under the Treaty State aid rules on the grounds of the need to encourage the development and employment in the Dublin area (see Section 3.5). Probably the reason for this lies in the political compromise

40 See Primarolo Report, Measure B001, p. 48, which also indicates that the origin of IFSC projects at the end of 1997 was 23% from Ireland, 37% from the EU, and 40% from non-EU countries.
41 See footnote No. 8 of the Primarolo Report. See also A. C. Santos, Point J of the Code of Conduct or the primacy of politics over administration, European Taxation, 9/2000, p. 417.
reached with the Commission on the approval of the new Irish corporate tax regime and in the fact that the IFSC regime was already being phased out in order to meet the 2003 the deadline contained in the Code of Conduct. This seems confirmed by the statement of the Irish delegation with regard to the blacklisting by the Primarolo Report of the “manufacturing relief”, which also encompasses the IFSC regime, expressing its disagreement *inter alia* because “it is being phased out over an agreed period (State aid E/2/98 Ireland).”

This brings us to the more general issue of the relationship between the Code of Conduct and the Treaty State aid rules, as the assessment required by Para. G of the Code seems to reflect the Treaty provisions relating to the justifications for State aid measures to encourage the development of depressed areas in the EU contained in Art. 87 (3) (a) and (c). It is true that the Primarolo Report ignores this assessment in the blacklisting of both the IFSC and the ZFM regimes and in particular any analysis of their proportionality and targeting with regard to the aims to favour the development of the respective areas, as well as any consideration relating to Madeira being an “outermost region” of the EU (see on this Chapter 3, at 3.7.2 and 3.7.5). A coherent application of EC law, both ‘hard’ (i.e. the Treaty) and ‘soft’ (i.e. the Code of Conduct) would require an analysis of both regimes on the basis of the Commission’s decisions regarding the *Irish corporation tax* case and the ZFM, as well as the Treaty rules on the “outermost regions” (i.e. Art. 299(2)) with regard to Madeira, as Para. J of the Code requires. As a result, the blacklisting of the IFSC and the ZFM regimes should be based on a thorough assessment of: (i) the real aim(s) for their introduction; (ii) the proportionality to achieve such aim(s), and (iii) their appropriateness in this respect. Furthermore, with regard to the “outermost” region of Madeira a more ‘lenient’ approach should be followed in consideration of its significant handicaps.

Based on this, the blacklisting of the Irish IFSC does not seem to pose any issue, mainly because in practice the agreement between the Irish authorities and the Commission under the state aid rules is fully compatible with the Code of Conduct as to its phasing out within the deadline of the Code’s rollback provision. With regard to the ZFM, it is regretful that the Primarolo Group blacklisted it without discussing the detailed report submitted by the Portuguese authorities on the basis of Para. G of the Code of Conduct. From the Primarolo Report it seems that the Group endorsed the Commission view that this regime was not proportionate to its aims, as the granting of tax incentives in favour of such income from mobile financial services was not deemed sufficient to alleviate the local handicaps suffered by these regions. Instead of its blacklisting, it would have been more appropriate to wait for the conclusion of

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42 See Chapter 3, Section 3.5. In this respect, it is true that the IFSC regime will in certain instances still apply up till 2005, and thus it would seem to infringe the Code’s deadline of 2003. However, the ‘interim agreement’ has formalised the granfathering of harmful tax regimes applying before the year 2000 until 2005, which would justify the exclusion of the IFSC from the black list. Furthermore, once the Irish reform enters in effect the fact that active financial activities would also benefit from the lower 12.5% would mean that there would be no significantly lower taxation provided by the IFSC, as a difference of a mere 2.5% does not seem sufficient for the basic criterion laid down in the Code to be considered met.

43 See footnote No. 38 of the Primarolo Report.

44 This seems indirectly confirmed by the Primarolo Report, which in the description of the IFSC specifically focuses on the phasing out of this regime under the agreement between Irish authorities and the Commission (see Measure B001, at 49-50).

45 See the Primarolo Report, para. 67, at 14, and also Santos, cit., at 419.
the state aid procedure on the ZFM and rely on its findings for the final decision on the blacklisting under the Code of Conduct.

Pending the Commission investigation on the ZFM regime, at this stage it seems that this regime should probably be considered harmful under the Code of Conduct even in the light of Para. G (and J). The ZFM’s tax incentives in favour of ring-fenced financial activities would seem not proportionate to stimulate a genuine development of the archipelago as most eligible finance entities (entirely) lack local substance and conclude transactions with non-Portuguese residents. In other words, the main effect of the ZFM would be to drive mobile capital to Madeira unduly eroding other Member States’ tax bases while at the same time failing to make up for the handicaps of this outermost region. This is also supported by the Commission decisions on the Irish corporation tax case as well as the handling of the Canary Islands ZEC regime, which was approved only on the condition that financial activities would be excluded from its application as targeted and proportionate to the archipelago’s ZEC regime, (see Chapter 3 at 3.7.4). This distinction is also endorsed by the Primarolo Report, which states that the blacklisting of the ZFM “related only to the financial services activities permitted within Madeira” and not to the ‘industrial free zone’ and the international business centre (IBC).

It remains to be seen whether the proposed reform of the ZFM applying a corporate tax burden of 7.5% to 12.5% on income from financial services will be considered compatible with the Treaty state aid rules, also in the light the new principles concerning the “outermost” regions, which is still debatable at the moment especially as the ZFM is still ring-fenced (see at 3.7.5). A positive evaluation of compatibility would automatically mean that the ZFM regime would have to be taken off the blacklist on the basis of Para. G (and J) of the Code of Conduct, also based on the priority of the Treaty state aid rules over the Code in the hierarchy of EU law sources.

4.4.3 Intra-group financial services: the Luxembourg and Netherlands ‘finance company’ regimes

The second category of PHTMs concerns regimes for finance companies usually part of a multinational group. The tax issue in this category has to do with transfer pricing and the (non-)compliance with internationally accepted standards as required by Para. B No. (4) of the Code of Conduct. The evaluation of finance company regimes is difficult as the transfer pricing standards in this area involve difficult and most of the times highly discretionary assessments by taxpayers or tax authorities. The main issue regards the application of the arm’s length principle with regard to the setting of interest rates on inter-company loans granted by (intermediate) group finance companies especially in back-to-back situations.

The Primarolo Report includes in the black list of harmful tax regimes the Luxembourg and the Netherlands finance company regimes, both granted pursuant to administrative practices providing for the issuance of ‘finance rulings.’ The Luxembourg regime was in effect until 1996, with expiration of the latest rulings granted in 2001, and has also been object of the 2001 Commission large-scale investigation under the Treaty state aid rules (see Chapter 3, at 3.8.3). The Netherlands

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regime has been in effect until April 2001, with finance rulings expiring up to 2005, and has been replaced by a comprehensive reform (see below and at 4.7). The common feature of these administrative practices is the possibility to fix in advance the taxable spread on back-to-back loans granted by intermediate finance companies to other group companies. The spread between incoming interest from group companies financed and the outgoing interest repaid to the provider of funds (either a third-party financial institution or more often another group company located in a tax haven) is usually set either at 0.125% - 0.25%. Under the Luxembourg practice, the lower spread applies if there is a collateral for the loan (i.e. the Luxembourg finance company bears no default risk) and there is a requirement that the finance company be part of a multinational group present in at least two countries. Under the Dutch practice the lower spread applies if the funds are provided by another group entity and on the condition that the Dutch finance company bears no default risk or currency risk. In both cases the fixed spread contained in the ruling is subject to ordinary corporate tax rate (i.e. 35% in the Netherlands and 37.4% in Luxembourg in 2001). The relevant criterion of the Code of Conduct applicable to both finance company regimes is contained in Para. B No. 4, since the determination of the taxable interest under the Dutch and Luxembourg practices presumably occurs without complying with the OECD transfer pricing rules. The application of this criterion with regard to these regimes is better explained in the Primarolo Report, which refers to the use of fixed margins agreed on by a country’s tax authorities without constant review against commercial margins set between unrelated parties (see at 4.3.3). The Primarolo Report blacklisted both finance company regimes on the basis of these criteria. The evaluation on the blacklisting (i.e. on the actual harmful character) of the Dutch and Luxembourg finance company regimes must be based on their compliance with the OECD arm’s length standard and the possible justification(s) for these practices. As a matter of fact, the taxable spread between incoming and outgoing interest of intra-group finance companies accepted by the Netherlands and the Luxembourg tax authorities is objectively a low one. This leads to a very reduced taxable base in such countries, which in turn means an insignificant overall tax burden on interest income from intra-group transactions (see also the example below). Even in the absence of specific data in the Primarolo Report, the widespread use of these regimes by multinational companies suggests that they have been able to significantly affect their decisions on where to establish intra-group finance companies within the meaning of the Code of Conduct. Furthermore, in the light of the Primarolo Report the fact that the taxable spreads are fixed regardless of the characteristics of each intra-group loan concluded by eligible finance companies and that the rulings are granted for a relatively long period (4 or 5 years) would support the non compliance with the

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47 The Netherlands also featured a regime similar to the finance company regime with regard to back-to-back royalties channelled through intermediate Netherlands companies, which has also been blacklisted by the Primarolo Report (with regard to royalty income, see the criteria at 4.3.3). The same remarks and analysis with respect to the finance company regime are also valid with regard to the tax practice on back-to-back royalties, which has also been object of the reform of the Netherlands ruling practice (see below in the text and at 4.7).

48 Under the Netherlands practice, in principle the tax authorities agree to the application of this fixed spread on the assumption that there is no possibility to find a comparable arm’s length indicator for similar transactions and that the spread agreed between the parties be based on market indicators for similar transactions. Furthermore, the 0.125 and 0.25% spreads slightly vary according to a sliding scale depending on the principal amount of the intra-group loan: for more details see the Primarolo Report, Measure A010, p. 34.
OECD transfer pricing rules for the purpose of Para. B No. 4 of the Code of Conduct and consequently their blacklisting.

This conclusion calls for further considerations on the actual harmful character of the Luxembourg and Netherlands regimes. It is indisputable that that they both entail a low tax burden on income from intra-group financing activities due to the low spreads accepted by the tax authorities. It is also true that these spreads are not constantly updated with regard to current market conditions. However, the decisive point for their assessment is whether these spreads, however low and fixed for a certain period of time, comply with OECD standards or not.

The premise is that in all situations covered by finance rulings the determination of the correct arm’s length interest is extremely difficult due to the absence or the low significance of comparable transactions between unrelated parties. This is also confirmed by the circumstance that the Dutch tax authorities are only willing to issue finance rulings on the condition that there is no comparable indicator in the market for similar transactions. As for the objectively low taxable spreads accepted by the Dutch and Luxembourg tax authorities, one must consider that: (i) finance companies incur little or no risk on these loans, as the conditions for the issuance of the rulings are that the risk of default in the payment of interest or of the principal of the loan is not borne by them (i.e. through a collateral or ‘non-recourse’ loan agreements) and in the Dutch practice that there is no currency risk (i.e. both loans must be in the same currency), and (ii) the finance companies have little local substance, if any. These considerations support the conclusion that the little taxable spreads applicable under these regimes, far from being in breach of the OECD arm’s length principle, do comply with it and might even turn out to generate higher taxable revenue for these countries than that yielded by a more accurate application of this principle if one considers the actual business risks borne by eligible finance companies and their little or no substance (on this point, see further below). Furthermore, the fact that back-to-back financing transactions eligible to the rulings in practice are similar with each other seems to justify the use of fixed spreads for a relatively long period and do not need to be reviewed often. This suggests that the Netherlands and Luxembourg regimes do not meet the Code of Conduct criterion of providing for a significantly lower taxation than the ordinary tax burden through an artificial reduction of finance companies’ taxable base stemming from a breach of the OECD transfer pricing rules.

What may then have been the underlying reason for their blacklisting other than the erroneous interpretation and application of the Code of Conduct criteria? In all likelihood, this was due to the analysis of the potential harmful effects ultimately caused by the common use of Luxembourg and Netherlands finance companies by multinational groups. The end result of tax planning techniques relying on these regimes is an (almost) total exemption from tax on interest income generated by these financing transactions with a significant erosion of the taxable base of their operating companies located in high-tax jurisdiction. An example may better clarify this point.

Assume a Dutch finance company with a finance ruling granted by the Dutch tax authorities borrows € 400,000 from its tax haven parent company located in the Netherlands Antilles pursuant to a non-recourse loan agreement at an arm’s length interest rate of 5% (i.e. an unrelated bank would charge this interest rate for a similar loan). Assume that this finance company relends the same amount in the same
currency at an interest rate of 5.125% to an operating group company located in a
high-tax EU jurisdiction having a tax treaty with the Netherlands providing for 0%
withholding tax on outgoing interest. As a result, the EU operating group company
will pay € 20,500 per annum of interest, which will be normally deductible against its
active income earned in the high-tax jurisdiction (i.e. if no domestic thin capitalisation
legislation applies) and will not be subject to withholding tax pursuant to the tax
treaty. Under the ruling, the Dutch finance company is required to report 0.125%
spread in the Netherlands, or € 500, which will be subject to 35% Dutch corporate tax,
for a total tax of € 175. The Dutch company will then pay € 20,000 interest per annum
on to its Antilles parent company, which is not subject to withholding tax in the
Netherlands under domestic tax law, and is subject to little or no taxation in the
Antilles.49
This example, also valid for the use of Luxembourg finance companies, shows that the
use of these regimes may be abused by multinational companies in situations where
the financing would not be needed from a business perspective but is merely used to
artificially create deductions in high-tax jurisdictions. In these cases, Dutch and
Luxembourg finance companies are used exclusively as part of a greater scheme to
erode the tax base of other countries, which is also easy and cheap to use as there are
no or little substance requirements for the Dutch (or Luxembourg) finance
companies.50 Is this sufficient to justify the harmful characterisation of these regimes
by the Primarolo Report? We believe not. Indeed, the main reason for the erosion of
(EU) high-tax countries’ taxable bases by using Dutch and Luxembourg finance
companies purely for tax-related considerations is the result of successful tax planning
by multinational companies giving rise to (legal) tax avoidance. This occurs as a result
of the inconsistency between different tax systems and in particular of the
combination of four main factors: (i) non-existence or inapplicability of thin
capitalisation rules in the (EU) high-tax country where the operating company is
located and existence of a tax treaty with the Netherlands or Luxembourg providing
for a nil or low interest withholding tax; (ii) a finance ruling granted under the Dutch
or Luxembourg finance company regimes; (iii) absence of withholding tax on
outgoing interest under domestic tax laws of both Netherlands and Luxembourg; and
(iv) little or no taxation in the tax haven where the provider of funds is located (unless
the finance company borrows funds from a third-party financial institution). This
means that the Dutch and Luxembourg finance company regimes only cause the said
harmful effects in combination with the other factors, which are a result of other
countries’ tax sovereignty out of the Netherlands’ or Luxembourg’s control (i.e. the
high-tax jurisdiction and the tax haven in factors (i) and (iv)) or of their own tax
sovereignty concerning the non imposition of withholding tax on outbound interest
(i.e. factor (iii)).
The only question left is why both finance company regimes lack anti-avoidance
clauses to prevent the said abusive situations, or in other words whether these

49 In the Netherlands Antilles, pursuant to so-called ‘cocktail’ ruling a company is eligible to substantially reduce
the amount of taxable interest income through a fictitious deduction, and it only pays 2.4 to 3% corporate tax rate
on this reduced taxable base.
50 In our example, the multinational company is able to obtain a deduction of € 20,500 in the high-tax country
(worth e.g. € 6,150 in tax savings assuming the local corporate tax rate is 30%), while paying a substantially lower
tax burden on the interest income and incurring very low costs for using this structure.
regimes should be considered harmful merely because the Netherlands and Luxembourg are not as aggressive against these situations as other Member States. One would doubt that this circumstance would be sufficient to reach this conclusion, especially since there is no provision in the Code of Conduct containing an obligation, a recommendation, or a political commitment that Member States must aggressively fight (the improper use of) tax regimes to achieve legitimate tax savings. It is true that Para. L of the Code mentions anti-abuse provisions and countermeasures contained in domestic tax laws or tax treaties as a fundamental tool in counteracting tax (avoidance and) evasion and that Para. M calls for Member States to pressure their independent and associated territories (e.g. the Netherlands Antilles in the above example) to comply with the Code. It is also true that the Primarolo Report and the 2000 Guidelines would seem to go into the direction to require Member States to be stricter against international tax avoidance relying on the (ab)use of their own regimes, as will be seen for ‘finance branch’ (see at 4.4.6) and ‘holding company’ (see in Section 4.6) regimes. However, Member States are still sovereign to implement the policy they deem most appropriate to counter tax avoidance and evasion and to deal with their dependent and associated territories, as well as a fortiori to decide on general measures contained in their tax laws, such as the imposition of withholding taxes on outbound interest. Furthermore, the country of the borrower is able to apply anti-abuse measures itself, in the form of thin capitalisation rules. These reasons support the conclusion that the Dutch and Luxembourg finance company regimes should not be considered harmful and blacklisted, as, considered in themselves, they are neither in breach of the Code of Conduct nor of international (and EU) tax law principles. Interestingly, the reform of the Netherlands ruling practice, which also affects the finance company regime, seems to confirm this conclusion (on this reform, see in detail at 4.7). Following the codification of the arm’s length principle and the application of the OECD Transfer Pricing Guidelines, the tax authorities can no longer issue rulings for intermediate Dutch companies engaged in back-to-back finance activities if they lack substance in the Netherlands and do not bear any (substantial) business risk. Furthermore, the granting of rulings is conditional on the taxpayer agreeing that the tax authorities exchange information with the tax authorities of the foreign jurisdiction(s) concerned. As a result of these changes, even though the finance company regime as blacklisted by the Primarolo Report is no longer available in the Netherlands, there is still the possibility for intermediate Dutch finance companies to survive. In practice, resident companies with certain substance and business risk may either apply with the tax authorities for an advance pricing agreement (“APA”) complying with OECD transfer pricing principles, or they may set the transfer prices themselves provided there is underlying support that the methodology used also complies with such principles. The level of protection in the latter case varies depending on the supporting evidence, which ranges from a documentation study to a comparability/valuation study usually relying on public databases and evidencing what the price set between unrelated parties for similar transactions would be.51

As a result of the new rules, even though passive finance companies are no longer entitled to apply for a ruling and may be unwilling to apply for an APA to avoid

51 Needless to say, the lower the level of protection, the more likely the Netherlands tax authorities would challenge it under the transfer pricing rules.
agreeing on the clause allowing the exchange of information, they may still engage in back-to-back financing transactions applying an appropriate spread between incoming and outgoing interest as justified by the said underlying supporting evidence. Apparently, it turns out that in practice finance companies previously eligible to finance rulings with the mentioned low fixed spreads are able to apply in the same situation the same or even lower spreads than those previously allowed, as they do reflect the arm’s length principle according to accurate independent transfer pricing studies. This confirms *a posteriori* that the Dutch (and the Luxembourg) finance rulings were not to be considered harmful under the Code of Conduct.

4.4.4 The Netherlands ‘CFM’ Regime

Another finance company regime limited to intra-group services is the Netherlands ‘CFM’ regime (for its description and analysis under the Treaty state aid rules, see in detail Chapter 3, at 3.8.3). This regime was also included in the black list of the Primarolo Report as harmful tax measure within the meaning of the Code of Conduct. The analysis below focuses on whether this inclusion was justified.

The CFM regime provides for a significantly reduced level of taxation on profits from eligible intra-group financial services contributed to the ‘financial risk reserve’ (hereinafter: “FRR”), as the ultimate tax rate borne by such profits can be as low as 7% as opposed to the ordinary 35% Dutch corporate tax rate. The actual final tax burden on these profits depends on the type of release of funds from the FRR. A ‘tax-free’ release, which occurs mainly where the CFM uses the funds to finance acquisitions of new companies or group investments exceeding the ordinary risk (i.e. investments undertaken in areas politically unstable or subject to high currency fluctuations), leaves the total tax burden on eligible profits at 7%. A ‘voluntary’ release takes place at the discretion of the CFM upon its election and entails an overall effective tax burden of 15% in addition to the tax deferral enjoyed by these profits for the years in which they stayed in the FRR and to the payment of the reduced 10% tax rate on five yearly instalments. ‘Mandatory’ releases, which occur when the CFM is liquidated, emigrates, or no longer fulfils the prescribed conditions, trigger full Dutch taxation at 35%, but since there is no recapture provision the profits contributed to the FRR still enjoy a significant tax deferral. These features show that the criterion of the Code of the significantly lower taxation is met, as is the indicator that the CFM regime is able to significantly affect the location of intra-group finance entities in the Netherlands, which is supported by its use by a number of large multinational companies (see Chapter 3, at 3.8.3). Furthermore, the fact that the amount contributed to the FRR is not dependent on the actual risk born and that the FRR is not available for every taxpayer but is only granted upon the fulfilment of certain conditions concerning the taxpayer (i.e. a multinational company active in at least 2 continents or 4 countries) and the eligible income (i.e. income from intra-group financial services) support that it constitutes a ‘deviation’ from the Dutch benchmark corporate system within the meaning of Para. B of the Code of Conduct.

As for the Primarolo Report, the CFM regime is caught by the criterion of a measure allowing the creation of substantial reserves exceeding the real underlying risks. Apparently, the blacklisting implies that the Primarolo Group considered the
significant reduction of 80% of taxable profits through the contribution to the FRR under the CFM regime disproportionate considering the real commercial risks from international operations for which the FRR is meant. A comparison with other tax-free provisions allowed under the general Netherlands tax system is helpful for a better understanding of whether this conclusion is appropriate. First, there is the possibility to create a reinvestment reserve (see Art. 3:54 of the Netherlands Income Tax Act of 2001) allowing deferral for proceeds received by a company to replace damaged business assets, provided they are reinvested within a certain period of time. The reason for the deferral in this case is to avoid taxation on the capital gains in the assets to be replaced. More significant is the possibility to form general provisions (i.e. voorzieningen, see Art. 3:53 of Netherlands Income Tax Act of 2001) on the basis of the prudent businessman principle covering *inter alia* doubtful or bad debts or environment-related costs. The amounts of before-tax income eligible for these provisions are in the overwhelming majority of cases not as substantial as the 80% amount of eligible income under the CFM regime. Moreover, compliance with the prudent businessman principle requires a careful assessment of all the facts and circumstances of the situation for which the funds are set aside in these provisions, which case-by-case assessment is not required also for the contribution of funds to the FRR.

With more specific regard to the CFM regime, the reason for the formation of the FRR and the subsequent special tax treatment of releases of funds is to allow multinational companies to set aside funds to cover risks from international investments. As for the tax-free release, it seems that a mere investment in a foreign company by a multinational group is not *per se* a valid reason to grant a tax deferral of such a substantial amount of income in the first place and a tax-free release of funds subsequently. In normal circumstances, one may presume that the acquisition of a foreign company does not imply any extraordinary financial risk or any other business reasons justifying this double tax benefit under the general prudent businessman principle required for the formation of other tax-free provisions. Moreover, in most cases these international acquisitions do not imply higher business risks than investing domestically or making the same or similar international investment by domestic companies not being part of a multinational group entitled to the CFM regime. The situation would certainly be different if the formation of the FRR were conditional on the presence of special circumstances like the ones giving rise to the tax-free releases of funds concerning investments in high-risk areas because politically or financially unstable. In these cases, the FRR might be justified in consideration of higher financial risks than normal, but in any event a detailed assessment of the specific risks borne should be carried out also in accordance with the prudent businessman principle, which does not seem to justify in any event the double benefit provided by the CFM regime. Also the tax treatment of 'voluntary' releases of funds eligible to the special 10% tax rate stretched over a 5-year period represents a suspect factor underscoring the harmful character of the CFM regime. In these cases, there is no special financial risk whatsoever justifying this special treatment, which further supports the blacklisting of the CFM regime.

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52 For this purpose, the hidden reserve is carried over to the replacing asset, which must be entered into the financial accounts at its purchase price minus the reserve.
The last issue to consider is the possible presence of a justification for the implementation of the CFM regime linked to the objectives pursued by the Netherlands government with its introduction. Apparently, the main such objective was the need to improve the competitiveness of the Netherlands as a location for finance companies and to induce mainly Dutch-based multinationals to bring back to the country entities performing these intra-group activities in the meantime shifted to other favourable EU countries as well as non-EU tax havens.\(^{53}\) This is explicitly confirmed by the statement of disagreement on the blacklisting of the CFM regime by the Netherlands delegation contained in the Primarolo Report, which lamented that the evaluation of “the effects that tax measures have on other Member States, *inter alia* in the light of how the activities concerned are effectively taxed throughout the Community ... has barely been done by the [Code of Conduct] Group” and that “it is justified to have tax measures for intra-group financial services which counteract beneficial tax systems of third countries outside the EU.”\(^{54}\) The fear of capital flight to other (non-EU) countries appears justified by the fact that multinational companies apparently moved their intra-group finance facilities out of the Netherlands, namely to Switzerland.\(^{55}\)

In principle, one has to agree with the position of the Netherlands authorities that the Code of Conduct Group did not make a comparative study of the taxation of intra-group finance activities as required by Para. G of the Code of Conduct. However, one cannot agree with the conclusion that the CFM regime should not have been blacklisted, as there seems to be no ground in the Code for a justification based on other Member States having similar harmful tax regimes for intra-group finance activities. Instead, the Code of Conduct endorses the opposite principle that these competing harmful tax systems must be dismantled (simultaneously) altogether, which is what the Primarolo Group did by blacklisting also other EU States’ regimes such as the Irish IFSC and the Belgian coordination centre regimes. In other words, the clear violation by the CFM regime of the principles of the Code of Conduct rules out the possibility of it being justified on the basis of other Member States’ harmful tax regimes also in breach of the Code, since the comparative evaluation required by Para. G only helps where there is a widespread favourable taxation of certain activities throughout the EU pursuant to general or at least defensible principles of international taxation, or where there is the need to prevent massive capital flight from the EU as a result of the blacklisting of certain regimes. This does not seem to be the case with regard to the CFM and its competing intra-group (and third-party) finance company regimes, which represent the exception rather than the rule in the EU. The same line of reasoning also rules out the viability of the argument that the CFM regime would be justified as a tool to fight the existence of non-EU tax havens offering similar regimes, which is exactly what the Code of Conduct aims to prevent. The Code does encourage such a fight, but through the enactment of appropriate anti-avoidance provisions and countermeasures contained in Member States’ domestic tax laws and tax treaties (i.e. pursuant to Para. L) or through the geographical extension of


\(^{54}\) See footnote 11 of the Primarolo Report.

\(^{55}\) See Chapter 3, at 3.8.3.
the Code through negotiations with third countries and Member States’ dependent or associated territories meant to have these repeal their own harmful tax regimes (i.e. pursuant to Para. M).

4.4.5 ‘Finance branch’ regimes and the 2000 Guidelines

A last category of PHTMs concerning income from financial services are the so-called ‘finance branch’ regimes. Once again, the main issue in these cases is the application of generally accepted transfer pricing rules, as well as the method to prevent international double taxation laid down in domestic law or bilateral tax treaties. Like for finance company regimes, the Primarolo Report targets two regimes available in the Netherlands and Luxembourg, blacklisting both of them. Their evaluation must take into account not only the criteria of the Code of Conduct and the Primarolo Report, but also the specific principles contained in the 2000 Guidelines (see at 4.3.3).

The main transfer pricing issue of finance branch regimes concerns the allocation of profits between a (finance) company headquarters and its foreign finance branch, which in most cases renders intra-group financial services (e.g. grants, loans, engages in factoring and leasing activities, etc.). The branch’s finance profits are in principle taxable in both the branch’s and its headquarters’ country given that the branch is not a separate legal entity, with a double tax relief provided in the latter country. If this country adopts the exemption method under domestic tax law or a tax treaty, the profit allocation between the headquarters and the foreign branch becomes crucial to determine the overall tax burden on (finance) profits. Usually, this profit allocation is based on the so-called ‘direct method’, which means that the branch’s profits have to be calculated as if it were an independent legal entity with separate accounting.

As for the Netherlands and Luxembourg finance branch regimes, the favourable tax treatment for multinational companies stems from a combination of ruling practices with the exemption method to prevent double taxation under domestic tax law or an applicable tax treaty. Under these regimes, only a small percentage of the finance branch’s profits is allocated to, and taxable in the hands of, the domestic headquarters (i.e. 10% in Netherlands, 5% in Luxembourg), provided the branch has enough substance and is actively involved in the production of such income from financial services. The remaining finance profits (i.e. 90% or 95%) are therefore tax-exempt in the Netherlands or Luxembourg. Multinational companies take advantage of these regimes especially using Swiss finance branches of Dutch or Luxembourg companies. Provided the Swiss branch has sufficient substance, its (intra-group) finance profits are subject to a reduced tax burden in Switzerland (e.g. 5-10% depending on the canton) and is almost entirely exempt from tax in Luxembourg or the Netherlands under the local administrative practices and the tax treaty with Switzerland (i.e. only 10% are taxed in the Netherlands at 35% and only 5% in Luxembourg at 37.4%).

The evaluation of the harmful character of the Luxembourg and Netherlands finance branch regimes within the meaning of the Code of Conduct must focus first on

56 It is worth noting that with regard to the Netherlands practice the Dutch tax authorities are no longer willing to grant a ruling unless a ‘safe harbour’ provided in the tax legislation applies under which finance branches are truly active, or are located in countries with a tax treaty having a stringent limitation on benefit clause. If the safe harbour rules are not met, the credit method rather than the exemption method applies on the branch’s (finance) income, resulting in taxation at the standard Dutch corporate rate of 35% with a credit for the local taxes paid.
whether they provide for a significantly lower tax burden at odds with the OECD transfer pricing principles. Furthermore, one has to assess these regimes in the general framework of the Dutch and Luxembourg tax systems and their underlying tax policy as well as in the light of international tax principles. Both regimes rely on advance rulings fixing the percentage of profits derived from the foreign finance branch allocated to the headquarters’ country. The percentage is based on the actual contribution of the branch’s activities and of the headquarters’ management and activities to the accrual of the finance profits, which involves mainly factual assessments of the actual activities performed by each entity. The Luxembourg and Netherlands practices are based on foreign branches having enough local substance and skilled management to carry out the profitable financial activities independently.

As a result, the allocation of 5% or 10% of its profits to the headquarters does not seem at odds with OECD transfer pricing principles and also seems consistent with the OECD Model Convention and its commentary, which specifically accept this allocation method. This conclusion is supported by the fact that if the foreign branch does not have enough substance, the ruling is not granted and usually a higher portion of its profits is allocated to the Dutch or Luxembourg headquarters. Moreover, after an amendment in Netherlands tax law the credit rather than the exemption method applies for foreign finance branches unless strict safe harbour rules are met, resulting in full Dutch tax on the branch’s profits. These considerations are also sufficient to prove that the criterion set out in the Primarolo Report of a “formulaic way” of allocating profits between a head office and its branch “contrary to the arm’s length principle that can lead to a reduced effective rate of tax for the company as a whole” is not met by the Luxembourg and Netherlands practices.

To sum up, the above suggests that the Netherlands and Luxembourg finance branch regimes do not meet the criteria of the Code of Conduct of providing for a significantly lower taxation on the branch’s (intra-group) finance profits and of not complying with the OECD transfer pricing principles. Neither does the Code’s requirement that a PHTM be able to significantly affect companies to locate finance entities in the Netherlands and Luxembourg seem met. In fact, the Luxembourg and Netherlands practices have at most the effect of inducing companies to locate their headquarters in these countries, as the finance branches are by definition located outside their territory, possibly in low-tax countries (e.g. Switzerland). Fundamentally all of the (financial) activities and possibly most of the capital used to carry them out is located in the foreign country (e.g. Switzerland) rather than in the headquarters’ country. In other words, it appears that it is mainly the favourable tax regime in the finance branch’s country (e.g. Switzerland) and the access to tax treaties via the headquarters’ country rather than the Luxembourg or Netherlands tax practices that affect the location of the branches within the meaning of the Code in combination with the exemption method adopted by these countries, not of the rulings containing the said formulas.

The analysis of the new principles contained in the 2000 Guidelines with regard to finance branch regimes hints at the reason why the Luxembourg and Netherlands regime were considered harmful tax competition by the Primarolo Report. As mentioned above (at 4.3.3), the Guidelines restate the general criterion that such

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57 See Art. 7 of the OECD Model Convention and relating Commentary, especially paras. 25-28.
regimes are harmful where they do not comply with the arm’s length principle, which *may* be the case where fixed formulas for the allocation of profits between headquarters and branch are used. More striking is the other criterion of the adoption of the exemption method in the headquarters’ country with respect to finance branch’s profits where these profits are subject to significantly lower taxation in the branch’s country and there are no effective anti-avoidance measures or countervailing measures to undo this lower taxation. Belgium has stated that it interprets the first criterion as referring to the lowest general tax level applicable in the Member State with the lowest rate rather than referring to its own tax burden, and that both criteria should be applied consistently with double tax treaties.

The adoption of these criteria by the Guidelines tells us that most probably the reason for the blacklisting of the Netherlands and Luxembourg finance branch regimes was their abusive use by multinational companies to achieve an overall reduced tax burden on income from intra-group financing. As these tax planning techniques may be harmful also for other (EU) high-tax countries through the artificial creation of deductions reducing taxable profits of operating companies (i.e. interest payments to the finance branch), the Report probably considered the Netherlands and Luxembourg regimes harmful tax competition on the same grounds as it did finance company regimes (see in detail at 4.4.3). The new criteria laid down in the Guidelines suggest that Member States using the exemption method to relieve international double taxation on foreign finance branch’s profits must be more aggressive against the use of abusive techniques by adopting strict anti-abuse measures that deny the exemption where the branch’s country has a significantly lower corporate tax burden than their own tax burden. This should be done either by using the credit method or any other appropriate measure (e.g. denial of rulings with fixed profit allocation or allocation to the headquarters’ of a much higher percentage of the branch’s profits).

The criteria laid down in the 2000 Guidelines call for a few closing comments on the issue of finance branch regimes. The first criterion of the need to respect the OECD arm’s length principles on profits allocation between headquarters and branch, whether on the basis of a fixed formula or of the ‘direct method’, is nothing new compared to the Code of Conduct. The second combined criteria looking at the tax burden borne by the branch’s profits and the absence of anti-abuse legislation, on the other hand, do not stem from the Code of Conduct. Similarly to what happens in the case of finance company regimes (see at 4.4.3), the finance branch regimes are in themselves only a minor element in the tax structure to achieve low overall taxation of intra-group finance profits by multinationals, especially if they comply with OECD transfer pricing rules. The more relevant factors in this structure are: (i) the low or nil taxation in the branch’s country, and (ii) the exemption method applied by the headquarters’ country either unilaterally, or through (iii) access to its tax treaties. The Guidelines seem to target these elements, which are outside the reach of the Code of Conduct or the Primarolo Report, *via* targeting the finance branch regimes, which in themselves are not harmful within the meaning of either document. In other words, the Guidelines aim at undoing the low taxation in the branch’s country and also at interfering with sovereign choices on fundamental direct tax principles by the headquarters’ country, namely the choice between the exemption versus the credit method to relieve international double taxation, or between territoriality and
worldwide taxation, as well as the laying down of strict anti-abuse provisions in their domestic tax laws.

There are more flaws in the 2000 Guidelines with regard to finance branch regimes. First, they do not provide any definition nor clarification on what a finance branch is and whether branches carrying out mixed activities should also be targeted by the Guidelines. For this purpose, it would be desirable to have fixed criteria to determine targeted finance branches (e.g. if more than 50% of the branch’s profits are passive or more than 50% of its assets are used to produce passive income), in alternative or subject only their passive income to the anti-abuse rules, which would presuppose the branch to draw up accurate and complete financial accounts as if it were an independent entity. The Guidelines also fail to specify what is meant by ‘significantly lower level of tax’ and what tax rate should be taken into account in both the branch’s and the headquarters’ country. Moreover, as Belgium points out they do not take into account that the use of the exemption method on the branch’s profits is often laid down in tax treaties, and thus the Guidelines should not frustrate their application and the sovereignty of the countries party to the treaties until a bilateral solution (e.g. a renegotiation) is found between them. Lastly, the use of targeted countermeasures merely based on the tax level in the branch’s country and meant to undo the lower local taxation in another Member State may be at odds with the EU tax law and relevant ECJ case law if the finance branch is established in another Member State with significantly lower taxation (e.g. Ireland), as the Eurowings (and Centros) case(s) suggests (see in Chapter 2, at 2.3.3, and Chapter 5, at 5.3.2.7), although this case did not concern relate parties whereas the issue of finance branches regards by definition related entities. This suggests that the Guidelines should limit the use of this criterion (and thus the denial of the exemption method by the headquarters’ country) to finance branches benefiting from lower tax in non-EU countries and also that the interpretation by Belgium to compare the branch’s tax level to that of the Member State with the lowest tax rate is erroneous and incompatible with EU (case) law.

4.5 ‘Headquarter company’ regimes and intra-group activities performed by ‘centres’

4.5.1 Overview

This category of PHTMs concerns Member States’ regimes targeted at income derived by ‘centres’ part of a multinational groups (in general on the ‘centres’ see Chapter at 1.2.4). The activities covered by these regimes are often centralised by multinational companies in centres primarily in order to reduce overall costs, to foster efficiency and synergy, and to ensure uniform standards for all group entities. As mentioned above (at 4.3.5), the main tax issue relating to income earned by these centres is the transfer pricing for the services and transactions concluded with other group entities. It is often very difficult to find adequate comparable transactions concluded between unrelated parties. As a result, often notional methods for the computation of the

58 See also Nijkamp, cit., at 150-151.
59 See Nijkamp, at 151, also citing the issues concerning the compatibility of domestic anti-abuse rules such as CFC legislation with tax treaties (e.g. in France under the Swiss/French tax treaty) and the primacy of tax treaties over EC law and especially over non-binding principles like the ones contained in the Guidelines.
centres’ taxable income are used, not always complying with the OECD transfer pricing standards.
This section analyses the Belgian coordination centre and service centre regimes, and subsequently the French, Netherlands, and Belgian distribution centre regimes in the light of the Code of Conduct, the Primarolo Report, and the 2000 Guidelines (see also at 4.3.5). These regimes have been chosen as they are commonly used by large multinational companies and have already been analysed at length under the Treaty (fiscal) state aid rules (see in detail in Chapter 3, Section 3.8).

4.5.2 The Belgium regimes for coordination centres and service centres

The features of the Belgian coordination centre regime (hereinafter: “BCC”) and of the service centre regime (hereinafter: “SC”) have already been explained in detail above.\(^{60}\) The BCC regime seems in breach of the principles contained in both the Code of Conduct and the Primarolo Report as well as of the 2000 Guidelines, as it provides for a number of tax incentives leading to a tax burden significantly lower than the ordinary Belgian tax burden and not complying with the OECD Transfer Pricing Guidelines. Furthermore, it represents a departure from the Belgian benchmark tax system because the computation of BCCs’ taxable income is based on the cost-plus method rather than on the general tax accounting principles used by all other taxpayers. It is also ring-fenced within the meaning of the Code of Conduct in that BCCs must belong to multinational groups not based in Belgium and deriving most of their income from foreign sources.

The next question is whether the BCC regime complies with the OECD transfer pricing principles as required by Para B No. 4 of the Code of Conduct. One must note that the cost-plus method is explicitly endorsed by the OECD Transfer Pricing Guidelines as one of the methods reflecting the arm’s length principle for intra-group activities similar to those carried out by BCCs. One must also consider that the applicable mark-up of 8% could well be an accurate reflection of the arm’s length principle, especially given the low business risk borne by such entities.\(^{61}\) However, more relevant is the fact that certain significant costs borne by BCCs, namely personnel and financing costs, need not be taken into account in the computation of their taxable income, which is definitely not in compliance with the OECD principles. The end result of this exclusion is that the taxable income of BCCs is disproportionately reduced and their total tax burden is quite low due not to the application of the cost-plus method, but mainly to the exclusion of the said relevant costs from the mark-up base. This represents a clear departure from the OECD Transfer Pricing Guidelines, especially considering that (i) financing and personnel costs are the main items of costs borne by BCCs (and similar entities in comparable circumstances), and (ii) there is no reason for this other than granting a tax incentive to encourage the location of this type of entities in Belgium. The fact that many

\(^{60}\) See Chapter 3, at 3.8.1, and also the Primarolo Report, Measure A001, p. 23, and Measure A003, p. 27. For an analysis of the BCC and the other Belgian regimes under the Code of Conduct, see also J. Malherbe and O. Neiryck, Harmful tax competition: Belgian measures considered tax harmful, EATLP 2002 conference, cit., at 7 ff., available on the web site http://www.eatlp.org.

\(^{61}\) In practice, in similar situations even a lower mark-up of e.g. 5% could be considered to reflect the OECD arm’s length standard.
multinational companies have made use of these BCCs over the years (see at 3.8.2) confirms that this regime has been successful in influencing their locational decisions within the meaning of the Code of Conduct.

The above implies that the BCC regime is to be considered harmful under the Code, and therefore there is no need to analyse it in the light of the criteria laid down in the Primarolo Report. This is indirectly confirmed by the Belgian government, which did not raise any objection against its blacklisting by the Report, whereas it did object to the inclusion of the distribution centre regime (see next paragraph). Also the practice of the Belgian tax authorities after the blacklisting of the BCC regime confirms this. In particular, they included a savings clause in BCC rulings stating that in case the Belgian government would be forced to withdraw or amend the BCC regime in compliance with the Code of Conduct, these rulings would automatically cease to be binding on them.

The analysis of the Belgian service centre ("SC") regime is not as easy. The first difference with the BCC regime is that in principle the Belgian standard corporate tax system does apply to SCs and the cost-plus or resale minus method is resorted to only due to the absence of sufficiently comparable transactions between unrelated entities. Furthermore, there are two other main differences between the two regimes: (i) there is no tax incentive for SCs such as the exemption from withholding taxes on outbound payments or from capital duty granted to BCCs, and (ii) there is no requirement for a SC to be part of a multinational group mainly active outside Belgium (i.e. no ring-fencing). Therefore, unlike the BCC, the SC regime constitutes no deviation from the standard Belgian corporate tax system and is not ring-fenced from the Belgian economy. The main question becomes whether the application of the notional methods (i.e. the cost-plus and the resale-minus) represents a departure from the OECD transfer pricing principles that winds up artificially lowering the tax burden of eligible SCs. A first answer is that there is no such departure, as evidenced by the fact that the Belgian Circular letter containing the guidelines on the SC regime explicitly refers to the OECD Model Treaty for the interpretation of the 'preparatory and auxiliary' activities that can be carried out by SCs, and endorses different methods and applicable mark-ups depending on the actual activities and business risk borne by SCs, in line with the OECD Transfer Pricing Guidelines. However, under the SC regime personnel costs may be excluded from the cost base for the computation of profits upon approval by the Belgian tax authorities. This does constitute a deviation from the OECD Transfer Pricing Guidelines, but only with regard to the application of the cost-plus method. With regard to the resale minus, the costs borne by the SC are not relevant for the computation of the taxable base, which only depends on the total turnover of the SC and the applicable mark-down. 62

For a final assessment on the harmful character of the SC regime one must consider the criteria laid down in the Primarolo Report and the 2000 Guidelines. The regime relies on the cost-plus or resale-minus methods in a situation in which the standard CUP (i.e. the comparable uncontrolled price) method cannot be used due to the

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62 In this case, the costs are only relevant insofar as by the application of the resale minus method the total commission payable by the related company(ies) is lower than the costs actually borne by the SC, that is if there is no taxable profit in Belgium. According to the Circular on the SC regime, this is not acceptable and the SC must report a taxable amount of commissions received at least equal to the costs borne, which is in accordance with the OECD principles and does not seem to constitute an incentive for SCs.
absence of meaningful comparables between unrelated parties. The OECD Transfer Pricing Guidelines specifically allow the use of these methods for the provision of intra-group services and/or buy-sell activities. As for the other criteria of the Primarolo Report, there is no requirement that the SC be part of a multinational group. Nor is the criterion of the lack of thorough examination of the specific situation met as the method actually used (i.e. the cost-plus or the resale-minus) and the specific applicable percentage (the range of which range is as wide as 10 percentage points) depend on an analysis of the functions performed and the business risk borne by the SC on a case-by-case basis. The last criterion contained in the Primarolo Report is the exclusion of some expenses from the basis of the cost-plus method, which is allowed for SC with regard to personnel costs. The OECD Transfer Pricing Guidelines state that the actual costs to be taken into account for the application of the cost-plus method depend on the circumstances of each situation and may vary depending upon the functions performed and risks borne by the entity being remunerated on this basis. In this case, it seems that the SC regime is contrary to these OECD standards since there is no reason for allowing the exclusion of the said costs from the mark-up base. This would lead to the conclusion that this regime is indeed harmful within the meaning of the Code of Conduct in these situations, whereas it is not where the resale minus method applies or where the cost-plus method applies without the (discretionary) exclusion of personnel costs from the relevant base.

4.5.3 Distribution Centre Regimes

The Netherlands, Belgium, and France feature administrative practices concerning intra-group distribution centres (hereinafter: “DC”) (for a description of their features for and their assessment under the Treaty state aid rules see Chapter 3, at 3.8.1 and 3.8.2). These apply generally to local entities distributing group products and performing other auxiliary or preparatory services on behalf of group companies, with no or very little business risk borne by these DCs. Also the tax treatment is very similar under these administrative practices. In principle, eligible DCs are subject to the standard corporate tax system and to the ordinary rate. However, the computation of their taxable profit may be based on the cost-plus method with the approval of the local tax authorities.

Some (minor) differences exist in these administrative practices on distribution centres. In the Netherlands, the main condition for the application of the cost-plus is that there are no comparable unrelated transactions in the market. The actual mark-up of the costs for the determination of DCs’ taxable income varies between 5 and 15% depending on their actual risks and functions, and is usually set at 5%. For the purpose of the mark-up basis all costs, including financing and personnel costs, are taken into account, the only item not taken into account being expenses with a disbursement character. In Belgium, the cost-plus method applies with a 5% mark-up, and incurred by DCs are taken into account. Under the French DC regime, the taxable base is computed with reference to all their operating expenses, with exclusion of expenses incurred on behalf of other group companies or with a disbursement nature

63 See e.g. Paras. 2.24 and 2.32 of the OECD Transfer Pricing Guidelines.
64 See Para. 2.38 of the OECD Transfer Pricing Guidelines.
(i.e. débours). The mark-up applied on this base ranges between 6% and 12%, and is usually set at 8%.

The above features show that the Netherlands, French, and Belgian DC regimes are quite different from the Belgian coordination centre regime as well as partly different from the Belgian service centre regime (see at 4.5.2). However, all of them have been blacklisted by the Primaroló Report, meaning that they have been considered harmful like the Belgian CC and SC regimes. Further analysis is needed to assess whether this treatment is justified. In the first place, the Netherlands, Belgian, and French DC regimes do not deviate from these countries' benchmark corporate system, which is fully applicable to them as a matter of principle. Nor do eligible DCs enjoy other special tax incentives deviating from their tax systems. The only potential special feature is the application of the cost-plus method for the computation of DCs' taxable income which is justified, however, in the light of the generally accepted OECD transfer pricing principles in the absence of meaningful comparable independent transactions needed for the CUP method. Furthermore, in the DC regimes all the relevant costs are taken into account in the computation of their taxable base, including financing and personnel costs, and therefore there is no deviation from the OECD Transfer Pricing Guidelines. Lastly, there is no ring-fencing as they all apply regardless of whether DCs are part of a (mainly foreign-based) multinational group. The conclusion should therefore be that none of the DC regimes should have been blacklisted by the Primaroló Report.

One may think that the reason for their blacklisting lies in one of the criteria specifically contained in the Primaroló Report with regard to headquarter company regimes (see at 4.3.5). The only suspect criterion could be the lack of examination of each situation for the setting of the applicable mark-up and its regular review by the local tax authorities. It is true that the DC rulings usually contain fixed mark-ups (i.e. 5% in Belgium and Netherlands and 8% in France) accepted by the local tax authorities and that they are granted for a fixed period of time (i.e. 4 or 5 years), after which they are renewable. However, one needs to consider that in order to grant the ruling and fix the applicable mark-up the applicant DC must submit a detailed business plan with an explanation of the activities that will be performed in favour of other group companies. Subsequently, the tax authorities thoroughly review this plan and on the basis of the DC's functions and business risk agree on the applicable mark-up, which may vary within the range indicated above depending on the circumstances. Furthermore, the fact that, in principle, once DC rulings are granted, there is no review of the fixed mark-up against normal commercial criteria for their period of validity is based on the assumption that there are no substantial changes to the facts stated in the business plan by the taxpayer. This implies that if there is any such substantial change, the tax administration does review the situation and may

66 The only costs excluded under the Netherlands and French DC regimes are minor items such as disbursements incurred on behalf of other group companies and taxes paid.

66 Moreover, tax administrations are becoming increasingly strict in the assessment of DCs' business plans and in the setting of the appropriate mark-up depending on all facts and circumstances. A specific feature of the Belgian DC regime confirms this: the requirement that the 5% mark-up is applicable separately with respect to each entity of the group rather than on a consolidated basis in order to prevent the use of DCs to divert profits to tax-haven entities from high-tax countries' entities by charging the latter lower prices and the former higher prices with an overall average of 5%. This shows that (at least) the Belgian regime contains specific anti-avoidance provisions which should prevent an abusive use of DCs and therefore it does not encourage harmful tax competition.
change the applicable mark-up accordingly. Thus, the criterion laid down in the Primarolo Report does not seem to be met in this case and the period of application of the ruling (e.g. four years) seems appropriate. This is true especially if one considers that in the absence of a ruling the tax administration could initiate a transfer pricing proceeding and carry out the same assessment required for the granting of DCs rulings but ex post.

The above leads to the conclusion that the Netherlands, Belgian, and French DC regimes are not harmful tax competition within the meaning of the Code of Conduct (or the Primarolo Report). The statement by the Belgian delegation regarding its DC regime, which is also valid with respect to the Netherlands and the French DC regimes, clearly sums up why:

"the evaluation of this regime should be marked by an 'X' [i.e., it should not be on the Primarolo list of harmful tax measures] ... taking into consideration that:"
- the “cost plus” is applied on the total amount of the costs;
- the goal of the “cost plus” is only to ensure that the amounts invoiced by the distribution centres contain a normal profit...;
- the sole rate of 5% of this “cost plus” is justified through the fact that the activities performed by distribution centres are very limited.....;
- ...the “cost plus” does not allow to obtain the taxable net profit,...obtained through the application of all the rules concerning corporate income tax;
- there is no obligation imposed on these distribution centres to belong to a multinational group."

A closing remark must be devoted to the Netherlands DC regime, which is no longer available as a result of the change in the practice of the tax authorities as from April 2001 (see at 4.7). Under the new practice, compliance with the Code of Conduct and the 2000 Guidelines is ensured with the codification of the arm's length principle and the explicit endorsement of the OECD Transfer Pricing Guidelines for the setting of the transfer prices. Furthermore, standard rulings can no longer be issued with respect to activities like those performed by DCs, but APAs may be issued based on the OECD principles. In the absence of an APA, the taxpayer must in any event set the price for these intra-group activities according to the OECD transfer pricing rules and must support them with relevant documentation and studies, which depending on their accuracy, determine the level of protection against adjustments by the tax authorities (see also at 4.4.3). As a result, the new Netherlands practice fully complies with the Code of Conduct and the 2000 Guidelines while at the same time allowing taxpayers to continue using the old 5% cost-plus method for intra-group distribution (and similar) activities or even a lower percentage or another method, provided it is backed up by adequate transfer pricing studies in line with the OECD Transfer Pricing Guidelines.

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67 See footnote No. 17 of the Primarolo Report.
4.6 ‘Holding company’ regimes and the participation exemption

4.6.1 Use of holding companies and criteria to assess the harmfulness of their tax treatment

This category of PHTMs is probably the most controversial, as neither the Code of Conduct nor the Primarolo Report clearly deals with the issues surrounding the tax treatment of holding companies. Unfortunately, the study on holding companies used by the Code of Conduct Group for the decisions on the blacklisting of the different regimes scrutinised has not been published. At first one notes the inappropriateness of the reference by the Primarolo Report to a category of holding company regimes. Instead, a distinction should have been made between special regimes applicable to holding companies in derogation of a country’s benchmark system and general rules granting the ‘participation exemption’ to all companies, regardless of their activity and their ownership. Only the former may rightly be referred to as ‘holding company regimes’, whereas the latter are part of a country’s benchmark tax system not representing anything special. As will be seen, this is not only a matter of terminology or categorisation, but it is also important for the assessment on the actual harmful character of the various tax treatments of profits holding companies.

Holding companies are (and have always been) used by multinational companies to hold shares in other group companies and sometimes intangible assets owned by the group. They are often also used to hold smaller participations in other companies in which the group effects a portfolio investment but no control in their management. The use of holding companies is widespread for several genuine business reasons. The main such reason is that a centralisation of the various participations (and intangibles) in one single entity usually facilitates their management and ensures better results from a business perspective. One or more subholding companies are often needed to coordinate several functions relating to a certain geographic area in which the group is active or a certain line of business of the group. In addition to these genuine business reasons, there are often tax-associated reasons driving multinational groups to establish one or more group holding companies. The main tax advantage is the exemption from tax on dividends distributed by, or capital gains realised on the sale of, the various subsidiaries. This is important where the parent company’s jurisdiction taxes these dividends and/or capital gains, granting a direct tax credit for the (withholding) taxes paid on the dividends and possibly an indirect tax credit for the underlying corporate tax paid by the subsidiary. As for the holding of intangible assets, multinational companies aim to gain a favourable tax treatment on the royalties paid by the subsidiaries or third parties which license rights for their use. Given the possible existence of both business and tax reasons for the use of holding companies, the question arises as to what criteria must be used to assess the harmfulness of their tax treatments in the light of the Code of Conduct. There seem to be two main relevant criteria for this purpose. First, from a business perspective one has to weigh the real economic reasons for the establishment of one or more holding companies by a multinational group. If a favourable tax treatment (e.g. a participation...

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68 On the issues addressed in this section, see Schön, EATLP 2002 Report, cit., at 22-23.
exemption) applies to holding companies’ dividends and capital gains even where the only or preponderant reason for their use has been the avoidance of tax rather than an actual business need, this is a clear indicator of such treatment most probably being harmful. Secondly, from a Member State’s perspective one has to consider carefully the policy reason(s) for the adoption of that tax treatment of holding companies. If it turns out that there is no genuine policy generally accepted under international tax law (e.g. the need to avoid international economic double taxation) but rather the intention to attract capital from abroad by luring holding companies to establish in their territory at the expense of other (neighbouring) EU countries, there is a strong presumption of harmfulness of this treatment.

The next step is to identify practical indicators to use with regard to these two relevant criteria. As for the first, the Primarolo Report lays down an appropriate one by considering that holding companies “set up wholly or mainly for tax planning reasons ... as a tax efficient holding point for profits or ... conduit ... normally have little or no economic substance, and may be no more than brass plate companies.” Indeed, the lack of substance of a holding company points at the prevalence of tax-induced reasons for its use as a passive conduit vehicle, and a tax regime exempting its profits even under these circumstances would most probably have to be considered harmful (see above). With respect to the second criterion (i.e. the main policy goals aimed at by a Member State), the Report does not help as it refers to the harmful character of participation exemption regimes if they: (i) also apply to dividends distributed out of profits exempt in the country of the foreign subsidiary or subject to a very low tax burden therein, and (ii) are not coupled with comprehensive CFC legislation. As will be seen (at 4.6.2), these indicators contain a number of flaws and seem inconsistent with the Code of Conduct. A more appropriate approach to evaluate holding company regimes is to divide them at first into two subcategories depending on whether they are part of a Member State’s benchmark system (i.e. participation exemption regimes) or are special tax regimes deviating from it as they only apply to pure holding companies. Subsequently, one has to consider the underlying (tax) policy reason(s) for their enactment. With regard to participation exemption regimes, their harmful character may only be inferred if it is clear that the only reason for their adoption was to attract foreign mobile passive investment. By contrast, in case of special holding company regimes one has to compare the benchmark tax system’s tax policy with the policy reasons for the departure of these special regimes from it. In this case, one must be stricter in their evaluation and exclude their being harmful only if there is a compelling valid tax policy or an acceptable justification for their implementation.

4.6.2 The participation exemption: the Netherlands example and the 2000 Guidelines

General holding company regimes rely on a participation exemption applying to dividends and capital gains received by domestic companies (or domestic permanent establishments of foreign companies), whether or not these companies merely

69 See the Primarolo Report, Para. 47, and at 4.3.6.
70 See the Primarolo Report, Para. 48, and at 4.3.6.
perform holding functions or also operating functions, and whether or not their subsidiaries are resident or foreign companies. The participation exemption treats as a single (economic) entity separate legal domestic and foreign entities connected by shareholdings and engaged in the same or similar business activities. The underlying idea is that the subsidiary is an extension piece of the undertaking of the parent comparable to a branch. General participation exemption regimes covering dividends and (in some cases) capital gains are in place in the majority of Member States, such as The Netherlands, Luxembourg, Belgium, Austria, Denmark, Germany, and the recent trend is their proliferation (see below at 4.6.6). The granting of the participation exemption is usually subject to satisfaction of the following requirements:

i) a certain minimum shareholding in the capital of the subsidiary or a certain minimum acquisition price of the participation;

ii) a certain minimum holding period;

iii) additional requirements, such as that the subsidiary must be subject to (at least a minimum) tax or must have substance in its country of establishment.

The evaluation of the harmfulness of participation exemption regimes in effect in most Member States must focus especially the additional requirements under iii), as they are fundamental in assessing the taxpayers' motivation for the use of holding companies and the governments' main tax policy reasons for their enactment along the lines specified above (see at 4.6.1). Here the Netherlands participation exemption will be analysed in greater detail because of the widespread use by multinational companies of Netherlands (holding) companies entitled to it and of its blacklisting by the Primarolo Report.

The Netherlands participation exemption applies with respect to dividends provided a resident (holding) company owns more than 5% in the share capital of the (domestic or) foreign subsidiary, with no minimum holding period required. With regard to foreign participations, it is required that the foreign subsidiary be subject to tax in its country, even though the actual tax rate is immaterial for this purpose. This allows Netherlands holding companies to have subsidiaries even in low-tax jurisdictions and still enjoy the participation exemption on these shareholdings as long as the subsidiaries are not entitled to a special advantageous regime in their country. The last condition for the application of the participation exemption is the so-called 'non-portfolio' requirement, which does not apply to subsidiaries resident in EU countries and held for more than 25% by the Dutch holding company in compliance with the EC Parent-Subsidiary directive. This means that the participation must not be held as a passive portfolio investment, but rather as an investment in which the holding company is actively involved. For this purpose, the Dutch tax authorities usually consider whether the foreign subsidiary is active in the same line of business of the Group to which the holding company belongs. Alternatively, this requirement is met if the holding company is actively involved in the management of the foreign subsidiary by having e.g. one of its directors sitting also in the subsidiary's board of directors. Usually, the Dutch holding company must also have at least certain substance in the Netherlands (e.g. office facilities, personnel) in order to support that it is not a 'brass plate' company and does not merely hold the foreign participation(s) as a portfolio investment.
As for the evaluation of the harmful character of the Netherlands participation exemption, from a taxpayer perspective there usually is more than a business reason for choosing the Netherlands as a location for a holding company next to purely tax considerations. This country represents an ideal location especially for EU-wide business activities carried out by a multinational company due to its long tradition as a holding centre for multinational groups, the high-standard services and infrastructures offered, its international environment and attitude, an outstanding banking system, its multilingual population, and a very stable political system. This suggests that in the majority of cases both multinational groups and also smaller businesses do not choose the Netherlands mainly or exclusively for tax reasons as there are at least as many valid non-tax reasons.

Also from a tax policy perspective the Netherlands participation exemption does not seem to be harmful. The fact that the Netherlands opted for an exemption rather than a credit system for dividends distributed to a resident company from a (foreign) subsidiary is in line with the general policy of applying exemption for active income from abroad, in general does not support that the Netherlands’ goal was to attract mobile capital at the expense of other (Member) States. The Netherlands government has opted in general for the exemption method for the prevention of international economic double taxation pursuant to its fiscal sovereignty, also in the case of direct foreign investment of its residents through branches instead of subsidiaries (as well as domestic investments for dividends distributed by resident subsidiaries). In fact, also foreign profits derived through a branch established abroad are in principle tax-exempt in the Netherlands, as is individual active income from abroad (e.g. wages, professional income). In other words, this country (almost fully) pursues the goal of capital import neutrality, which is an accepted international tax policy standard and aims at treating branches and subsidiaries equally. This method is also a better method from an EU internal market perspective than the credit method, which seems at odds with the national treatment and mutual recognition principles of EU law and is protective (see in detail Chapter 5, especially at 5.4.2.1). This is also clearly (and rightly) stated by the Netherlands delegation in the Primarolo Report:71 "...there exist two schools of thought with regard to holding companies in the EU. One favours the exemption method, the other favours the credit method. The criteria of the Code of Conduct prescribe in no way a choice between these two different schools. Both systems are an acceptable way to treat the parent-subsidiary relation." This is confirmed by the Parent-Subsidiary Directive, which both in the Preamble and in Art. 4 explicitly leaves it up to the Member States to choose between a credit or an exemption on qualifying dividends distributed by EU subsidiaries to parents resident in another Member State. The EU Arbitration Convention also explicitly recognises both the exemption and the credit method, as does the OECD Model Tax Convention. This leads to the conclusion that the Netherlands participation exemption does not meet the Code of Conduct requirement of providing for a significantly lower tax burden (for holding companies), as it is part of its ‘benchmark’ tax system expression of its tax sovereignty exercised in compliance with international and EU tax principles. Furthermore, it is not ring-fenced since it is available for all resident companies with regard to both resident and foreign subsidiaries, and it is not the only

71 See footnote 26 of the Primarolo Report.
or main reason affecting companies’ decisions to locate holding vehicles in its territory within the meaning of the Code of Conduct.

There is more to this. The two main criteria laid down in the Primarolo Report for the blacklisting of participation exemption regimes are the absence of a ‘subject-to-tax’ requirement with regard to the income of the foreign subsidiary or the absence of adequate CFC legislation. As seen above, the former is present in the Netherlands participation exemption, even though the actual tax burden borne by the foreign subsidiary is not relevant, rightly so from a capital import neutrality perspective. One might conclude that this means that the participation exemption applies in any event also on dividends distributed out of profits subject to a very low tax burden in the source country. An example may better clarify this. Suppose a Dutch holding company owns 100% of the shares in a foreign subsidiary established in Gibraltar. This country has three main tax regimes for domestic corporations: the standard regime with a corporate tax rate of 32%, the “qualifying” company regime providing for a special low tax rate to be set by the Gibraltar tax authorities on a case-by-case basis, and the “exempt” company regime providing for a 0% corporate rate for eligible offshore companies (see on the Gibraltar regimes and their reform Chapter 3, at 3.8.4). Under the Netherlands participation exemption, a holding company with a Gibraltar exempt subsidiary is not entitled to it as this is not subject to corporate tax. By contrast, a Dutch holding company with a qualifying subsidiary is entitled to it even if the actual tax rate set by the Gibraltar authorities is very low (e.g. 6%), provided the subsidiary is not a portfolio investment, from which it might be concluded that the Primarolo Report criterion is not satisfied.

However, one must consider in more detail situations like the one in the example. In all the uncertain cases in which the foreign subsidiary is subject to a low tax burden, a Netherlands holding company is very likely to apply for an advance ruling confirming the application of the participation exemption as the amounts at stake are usually too high for a group to take any chance. The Dutch tax authorities have proven to be very strict in these situations, especially more recently (on the new ruling practice, see also below and at 4.7). In particular, only if the Dutch holding company has a compelling case will it be able to obtain a ruling from the tax authorities, provided it proves that: (i) the subsidiary is subject to at least a certain minimum tax rate; (ii) the subsidiary has been established for a genuine business purpose; (iii) the subsidiary has enough substance (i.e. office facilities and employees) in the country of its establishment; (iv) the holding company has itself sufficient substance in the Netherlands; and (v) the holding company is actively involved in the management of the subsidiary. From this interpretation and practical application of the requirements for the application of the participation exemption by the Dutch tax authorities it can be inferred that the Primarolo Report in all likelihood mistakenly blacklisted this regime. The feeling is that, had the Code of Conduct Group considered not the requirements as literally written in the law but as actually applied, it would have reached the opposite conclusion. This is true also in situations in which the holding company does not apply for a ruling, since the Dutch tax authorities will adopt the same approach, only in retrospect.

The absence of CFC legislation in Dutch tax law cannot be decisive either, as CFC legislation has a different anti-tax avoidance goal, i.e. the prevention of profit shifting.

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and tax deferral obtained by resident corporations through foreign passive entities under capital export neutrality (CEN). This is something entirely different from the denial of the participation exemption also on active income of foreign subsidiaries, which is mistakenly considered relevant only thinking in terms of CEN and indirect credit. Furthermore, one must take into account that Netherlands tax legislation does contain anti-avoidance rules against the use of foreign passive finance companies, which can be seen as a sort of CFC legislation. Under statutory tax law, the participation exemption does not apply on dividends paid by foreign passive finance companies, for which the indirect credit method applies instead. Furthermore, in the Netherlands there is current taxation at parent company level of the profits derived by these subsidiaries as their Dutch parents must adjust the value of these participations at the end of each fiscal year under the mark-to-market rule. This further suggests that the blacklisting of the Dutch participation exemption by the Primarolo Group is not backed by a thorough analysis of the Dutch tax regime. Interestingly, the recent proposals on the reform of the Dutch corporate tax system also address some of the above issues that have lead to the blacklisting of the participation exemption. First, it has been proposed to implement an anti-abuse provision under which the mentioned anti-avoidance rule on foreign finance companies relying on the mark-to-market principle would apply also where an intermediate EU subsidiary owned for more than 25% by the Dutch holding company would be interposed to circumvent its application. Closing this loophole would mean a more effective CFC-like anti-avoidance legislation able to prevent the abuse of holding companies purely for tax reasons in compliance with the Primarolo Report. Moreover, under the new ruling practice effective from April 2001 an advance tax ruling is issued to confirm the application of the participation exemption only on the condition that the holding company has sufficient substance in the Netherlands and that the taxpayer agrees on the exchange of information with the foreign jurisdiction(s) involved (see at 4.7). As a result, passive holding companies lacking substance may no longer be used as purely conduit vehicles, further showing a strict approach by the Netherlands against possible abuse by multinational companies in compliance with the Primarolo Report and the 2000 Guidelines. Further analysis is needed with respect to the application of the Netherlands participation exemption to capital gains (and losses) on the sale of participations in foreign subsidiaries. The conditions required for its application are the same as those laid down with regard to dividend distributions. In general, since capital gains are tax-exempt in the Netherlands, capital losses borne on the sale of participations in foreign subsidiaries are not deductible by the Dutch parent company. There is one

72 On CFC legislation and its policy goal(s), see in detail Chapter 5, section 5.4.1.
73 This anti-avoidance provision is contained in Art. 13 g of the Netherlands Corporate Income Tax Code. It is also worth noting that it does not apply with regard to foreign finance subsidiaries (i) resident within the EU, and (ii) held for more than 25% from the Dutch holding, i.e. where the conditions for the application of the Parent/Subsidiary Directive are met.
special feature, however, under which the holding company is allowed to deduct a loss sustained on liquidation of its subsidiary, just as losses made by a foreign branch can be deducted from the taxable base of a resident company even if the branch is closed down without ever having compensated for the losses with subsequent profits. The relevant criterion for the blacklisting by the Primarolo Report of the participation exemption in this respect is the asymmetrical tax treatment between capital gains and losses where the former are tax exempt and the latter are tax-deductible. While the general participation exemption system is perfectly symmetrical, to use the Report’s wording, the exception allowing the deduction of liquidation losses suffered by a Dutch holding company is certainly a case of asymmetrical treatment of capital gains and losses, in principle justifying its blacklisting (at least with regard to capital gains). However, one strongly doubts that this conclusion is correct. First, this rule has a non-harmful tax policy objective, that is to grant a tax relief to multinational groups terminating loss-making operations and consequently poor business results due to adverse market conditions. In this case, the holding company is not selling one of its subsidiaries to a third party at a loss, but is completely shutting down its operations. Under the Netherlands benchmark system, even though foreign branches’ profits are exempt from tax pursuant to the exemption principle, losses borne by them are deductible just the same as they are under credit systems. If the branch is shut down without ever having made compensating profits, the losses suffered permanently burden the tax base of the resident company as no recapture rule applies. Second, there are strict anti-avoidance rules in Dutch tax legislation preventing the continuation or the sale of the business of the subsidiary in a covert way by the Dutch holding company after the subsidiary’s liquidation at a loss. This confirms that the tax provision on the deductibility of liquidation losses is granted only in cases in which a company has experienced business difficulties and thus is forced to wind up part of its business for genuine commercial reasons. Third, one should consider that under the Dutch participation exemption any costs relating to the acquisition of foreign participations are not deductible in the Netherlands. The most important non-deductible item in this respect is interest paid by Dutch holding companies on loans taken out to finance the acquisition of the foreign participations or the development of their business activity. This is clearly a penalising provision for the taxpayer, which is more or less forced to finance the incorporation or acquisition of foreign subsidiaries with equity instead of loans.75

The above considerations show that by and large the Netherlands participation exemption with regard to capital gains is not to be considered harmful within the meaning of the Code of Conduct. The deductibility of liquidation losses is only a very limited exception to the general rule of non-deductibility of capital losses and is backed by equality considerations (comparing to foreign direct investments) and by strict anti-avoidance rules which make it very unlikely to be abused by taxpayers. Taking also into account the unsuspected tax policy objective underlying this exception, one would conclude that it is not enough to label the participation exemption regime as harmful. In this respect, it is regrettable that the 2000 Guidelines

75 It is worth noting that this provision is currently under the scrutiny of the ECJ, which is to rule on its compatibility with the Treaty freedom of establishment and capital: see Case C-186/01, Bosal Holding BV, pending, and the comments in Terra & Wattel, cit., at 92-94.
have merely restated with regard to holding company regimes the same general criterion of asymmetry contained in the Primarolo Report with no further specification on the case of liquidation losses. One is inclined to share the reservation concerning the 2000 Guidelines by the Netherlands authorities, which interpret the criterion of asymmetry as referring to asymmetrical measures in general and not to the specific case of losses upon liquidation of a foreign subsidiary.\textsuperscript{76} This is all the more so if these rules are clearly expression of genuine policy goals like the ones underlying the Dutch measure rather than an unjustified incentive for (multinational) companies representing harmful tax competition.

4.6.3 The Danish participation exemption and its recent changes

In 1998, the Danish government announced a change in tax policy in order to make the country a more attractive location for multinational companies investing into the EU. Unlike other Member States with special holding (or finance) company regimes, Denmark chose to amend its general tax system and to adopt a participation exemption also on foreign-source dividends and capital gains. This choice was likely due to the fact that the Code of Conduct had already been adopted at that time, so that opting for a special holding company regime would have been in breach of its principles.

The Danish participation exemption regime was introduced at the end of 1998 to become effective in January 1999.\textsuperscript{77} Two main requirements must be fulfilled for its application:

- A minimum ownership by the Danish company of at least 25% in the subsidiary’s share capital (no threshold is required for the exemption on capital gains), and
- A minimum holding period of at least 1 year (3 years for the exemption on capital gains).

The main feature of the Danish participation exemption is the absence of a ‘subject-to-tax’ requirement with regard to the income of the foreign subsidiary. As a result, also dividends distributed by a subsidiary located in a tax haven are entitled to the Danish participation exemption. Furthermore, the reform repealed the 25% withholding tax generally applicable on outgoing dividends distributed by Danish companies to foreign parents also resident outside the EU or in non-Treaty countries, provided they owned at least 25% of the share capital of the distributing Danish (holding) company for at least 1 year.

However, Danish tax law contains CFC legislation covering foreign corporations deriving mainly passive (i.e. financial) income abroad. The three main conditions for its application are:

- The Danish company holds at least 25% of the share capital or 50% of the voting rights in the foreign subsidiary;

\textsuperscript{76} See Nijkamp, \textit{cit.}, at 150.

\textsuperscript{77} The new Danish regime was introduced by Law No. 1026 of 23 December 1998. On this regime see e.g. B. M. Pedersen, \textit{The Holding Company Regime in Denmark}, International Bulletin for Fiscal Documentation 1/2000, p. 30. As will be seen below in the text, this version of the Danish regime has been amended as a consequence of its blacklisting by the Primarolo Report. For an evaluation of the Danish participation exemption under the Code of Conduct and the Primarolo Report, see N. Serensen, \textit{Tax competition in Europe - Danish national report}, EATLP 2002 Conference, \textit{cit.}, at II.2.2, available on the web site www.eatlp.org.
- The foreign subsidiary derives mainly financial income, i.e. more than 33.3% of its income is passive (i.e. dividends, interest, royalties, capital gains, rents, insurance or leasing income) or more than 33.3% of its assets are financial assets (i.e. shares, intangibles, receivables etc.);

- The foreign finance subsidiary enjoys a favourable tax rate of less than 75% of the Danish rate (i.e. less than 24% in the year 2000 as compared to the standard Danish corporate rate of 32%).

If the CFC legislation applies, the Danish parent company must include currently in its taxable income the income of the foreign subsidiary, regardless of a dividend distribution, and this will not be entitled to the exemption but will be fully subject to statutory 32% Danish taxation with a credit for the foreign taxes paid. Consequently, Danish holding companies cannot be used as a flow-through vehicle for passive income generated by tax-haven finance entities but only for foreign subsidiaries mainly active (i.e. deriving more than 66% of their income from active sources).

The assessment of the Danish participation exemption regime in the light of the Code of Conduct and the Primarolo Report is not easy. One should note that this regime entered in effect after the approval of the Code but before the release of the Primarolo Report, which means that in the Danish tax policymakers' view it was compatible with the Code. However, it has been blacklisted by the Primarolo Report. Considering the general remarks on the participation exemption and the Netherlands example one would be inclined to share the Danish authorities' view of its compatibility with the Code of Conduct. Denmark opted for a reform in its tax regime mainly based on the abolition of the 'subject-to-tax' requirement for the application of the participation exemption and the repeal of the 25% withholding tax on dividends distributed by Danish companies to their foreign parents. This choice seems to fall within Denmark's national fiscal sovereignty in tax matters as to whether to opt for a credit or an exemption system. Moreover, the Danish regime seems compatible with the Code of Conduct since it is a general system not deviating from the benchmark Danish system and not ring-fenced as there is no distinction between domestic and foreign participations, nor between Danish-based companies and foreign-based multinational groups. As for the criterion of the Code of the potential ability of a tax regime to affect firms' locational decisions, the new participation exemption made Denmark a quite attractive holding company location for multinationals. In practice, they are able to channel low-taxed profits arising within or outside the EU through a Danish holding company and repatriate them the (ultimate) group parent company located either in a tax haven or in a high-tax country (e.g. the USA) virtually tax-free.

Turning to the Primarolo Report, the Danish participation exemption is caught by its criterion of the absence of the subject-to-tax requirement, which potentially encourages the said conduit structures without substance. However, it does not meet the other criterion, given the presence of CFC legislation. The blacklisting of the Danish regime is probably due to the fact that the two criteria are cumulative or that

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78 The absence of the 'subject-to-tax' requirement makes the Danish participation exemption more attractive than the Netherlands one, in which the tax rate on the foreign subsidiary's profits is immaterial. The main difference is that Dutch statutory law does require that such profits be subject to a certain minimum taxation. On the other hand, the Danish participation exemption also covers the special (offshore) regimes granting a complete tax exemption to the foreign subsidiary, e.g. the Gibraltar 'exempt' company mentioned in the example on the Dutch participation exemption (see at 4.6.2).
the Danish CFC legislation was not considered adequate to prevent the abusive use of Danish holding companies. This is indirectly confirmed by the statement by the Danish delegation on the blacklisting that it “cannot accept the evaluation of the Danish holding regime... since a general holding regime without ring-fencing is outside the code. Denmark does not tax dividends from foreign subsidiaries, but has a CFC-taxation for protection against harmful effects of low tax jurisdictions.”

Furthermore, Denmark complains about the lack of a consistent assessment by the Report of similar participation exemption regimes (and CFC rules), since those of countries such as France, Germany, and Finland had not been blacklisted. The main question becomes whether that the Danish delegation is right in pointing out that domestic CFC legislation is tight enough to prevent a distorting use of the participation exemption at least for financial (i.e. passive) income earned in tax havens. One must consider that the criterion of ‘control’ for its application is set at a low ownership threshold of 25% of the foreign subsidiary’s share capital (or 50% of its voting rights) and is consistent with the 25% threshold for the application of the participation exemption. This is a strict requirement as compared to most CFC regimes requiring a minimum ownership of at least 50%, since the underlying idea is that only shareholders with sufficient decisional power may influence the decision to repatriate (passive) profits and thus should be subject to the CFC rules. Moreover, the definition of ‘finance’ company seems strict as compared to other CFC regimes, as a 33% threshold of passive income or financial assets is low enough to catch foreign passive subsidiaries located in tax havens and in any event lower than most regimes relying on a passive income threshold of 50% or more for their application. These features and the above considerations support that the Danish CFC legislation is able to prevent the abuse of Danish holding companies even in the absence of the ‘subject-to-tax’ requirement, and therefore that the Danish participation exemption should not have been blacklisted.

The Danish government was forced to change the participation exemption regime due to heavy criticisms for the said features labelling the country as the last EU tax haven and to avoid its blacklisting by the Primarolo Report. The first amendments were approved in 2001 and reinstated a withholding tax of 25% on outbound dividends distributed by Danish (holding) companies to parent companies resident in a non-EU country or in a non-treaty country. As a result of the amendment, currently it is no longer possible for multinational groups to distribute profits earned in a low-tax jurisdiction tax-free to group companies located in tax havens via a Danish intermediate holding company. In 2002, the participation exemption regime was further changed by lowering the 25% ownership threshold to 20%, whereas the 1-year minimum period was left unchanged for participation exemption on dividends, as was the 3-year minimum period for capital gains. Furthermore, under the 2002 amendments CFC legislation was relaxed as (i) it no longer applies to dividends received by subsidiaries held for more than 25%, including low-taxed subsidiaries, (ii)
interest expenses related to the CFC’s passive income are fully deductible against its profits caught by CFC legislation, and (iii) there is no need to calculate the fair market value of the CFC’s assets, but merely its income subject to CFC legislation. The relaxation of CFC legislation and of the participation exemption raise further doubt on the harmfulness of the Danish participation exemption, especially as no subject-to-tax clause with regard to the subsidiary’s profits has been introduced. The mere reinstatement of the withholding tax on outbound dividends could not be considered sufficient to avoid its blacklisting, especially in consideration of the Primarolo Report and the 2000 Guidelines.

4.6.4 Special Holding companies regimes: the Luxembourg “1929 Holding Company” (and the soparfi) regimes

The second subcategory of holding company regimes encompasses special regimes enacted for the very purpose of favouring the establishment of holding companies. As mentioned above, these regimes are not part of a country’s benchmark tax system but specifically deviate from it with regard to tax treatment of holding companies and often apply only to multinational groups mainly foreign-based and/or to their foreign participations.

The oldest special regime for holding companies was introduced by Luxembourg back in 1929, and earned this small country an excellent reputation for the establishment of these vehicles by multinational companies. The “1929 holding company” regime applies to Luxembourg entities engaged exclusively in the management of shareholdings in other companies (both domestic and foreign) and specifically prevented from carrying out normal commercial activities.82 1929 holding companies enjoy several tax advantages. They are exempt from Luxembourg corporate taxation as well as from the withholding tax on outbound dividends regardless of the receiving company’s country of residence. Furthermore, they are exempt from the municipal business tax on companies’ income and from the net worth tax normally paid by corporations resident in Luxembourg. Other tax benefits granted to 1929 holding companies include an exemption from tax on capital gains realised on qualifying shareholdings and an exemption from corporate tax upon their liquidation. The only tax 1929 holding companies are subject to is an annual subscription tax levied at a rate of 0.2% on the value of the shareholdings owned. In addition, they are liable to a tax on capital contributions equal to 1% of their value, which may be waived under certain circumstances.

The 1929 holding company regime clearly deviates from the Luxembourg benchmark tax system, under which there is a classical method of taxation of dividends.83 Outbound dividends are ordinarily subject to a withholding tax of 25%, unless the non-resident recipient is established tax treaty with a lower rate. Luxembourg also adopted a participation exemption for the so-called ‘soparfi’ (i.e. société de participation financière)84 provided the following conditions are met with

82 This special regime was introduced by Law of 31 July 1929, as subsequently amended by Law of 12 July 1977 and ministerial regulations.
83 In total, the standard corporate tax burden to which dividends are subject in the hands of the recipient is 37.45%.
84 On the soparfi regime, see e.g. the Primarolo Report, Measure AAM108, pp. 46-47. It is worth noting that the soparfi name is an abbreviation commonly used in Luxembourg mainly as an advertising tool, but it does not exist
regard to dividend distributions: (i) the soparfi holds for more than 1 year a participation of at least 10% in the subsidiary or whose acquisition price has been more than LUF 50 million (i.e. some € 1.2 million), and (ii) the subsidiary is subject to corporate tax on its profits in Luxembourg or, if it is not resident, to a tax rate of at least 15%.

From the above one may deduce that the 1929 holding company regime is caught by the Code of Conduct as it provides for an exemption from corporate income and withholding tax on outbound dividends as well as other tax benefits in deviance with the benchmark Luxembourg tax system. This is true whether one compares this regime to the ordinary classical system or to the soparfi/participation exemption regime. In this latter case a number of conditions must be met, including the said subject-to-tax requirement, which are not required for the application of the 1929 holding company regime. Furthermore, while the 1929 holding company regime is limited to companies not allowed to carry out business activities in Luxembourg, the soparfi’s are ordinary corporations allowed to carry out any (business) activity both in Luxembourg and abroad. The fact that substance requirements are almost entirely for the benefits of the 1929 holding company regime to apply further supports the blacklisting by the Primarolo Report.

The above also shows why the soparfi regime has not been blacklisted by the Report. The main reason is that this it features a general participation exemption not distinguishing between domestic and foreign holding companies and applying regardless of the activity(ies) of the soparfi. Furthermore, the participation exemption on dividends distributed by foreign subsidiaries only applies if their profits have been subject to a tax burden of at least 15%. This feature makes the Luxembourg participation exemption different from both the Netherlands and Danish participation exemptions, under which the tax rate is immaterial with regard to the foreign subsidiary, or there is no subject-to-tax requirement whatsoever. Based on this, it seems safe to conclude that the soparfi regime does not constitute harmful tax competition within the meaning of the Code of Conduct since it complies with the Primarolo Report and the 2000 Guidelines, and the analysis on the presence of CFC or other anti-abuse legislation in Luxembourg becomes irrelevant.

4.6.5 Spain: the ETVE

In 1997 Spain introduced a special tax regime for holding companies with foreign participations (i.e. *Entidad de tenencia de valores extranjeros*, hereinafter: “ETVE”). This regime was introduced with a view to increase the international competitiveness of anywhere in the tax legislation. In other words, soparfi entities do not enjoy a special tax regime like the 1929 holding company but merely benefit from the participation exemption on qualifying dividends (and capital gains) rather than being subject to the ordinary classical method, provided the required conditions are met.

For the application of the participation exemption to capital gains the minimum shareholding in the subsidiary must be 25% or the acquisition price must be higher than LUF 250 million (some € 6.2 million).

the Spanish tax system and to offer an attractive alternative location for holding companies within EU. Some conditions must be met by a company in order to acquire the ETVE status. Eligible entities are Spanish companies or branches of foreign companies with a main statutory goal to hold and manage equity participations in non-resident entities. There are strict substance requirements under which the ETVE must have a real organisational structure and adequate facilities to carry out its activities. In principle, ETVEs are subject to Spanish ordinary tax burden, but unlike other Spanish companies (see below) they enjoy a participation exemption on dividends and capital gains. The participation exemption applies provided the ETVE holds a participation in a foreign company of at least 5% for a minimum period of at least one year. Furthermore, the exemption only applies if the foreign subsidiary: (i) is subject to a corporate tax system similar to the Spanish one without enjoying tax-exempt status (but regardless of the actual tax rate borne); (ii) is not resident in a country considered a tax haven under Spanish CFC legislation, and (iii) derives at least 85% of its profits from business activities carried on outside Spain. In addition to the participation exemption, ETVEs are also entitled to exemption from Spanish withholding tax on outbound dividend distributions provided the same conditions are met with regard to the foreign recipient company.

The ETVE regime is special as under Spanish tax law an imputation system relying on the credit method is used to relieve economic double taxation in respect of intercorporate dividend distributions. Dividends received by a Spanish company from a foreign subsidiary are in principle subject to taxation in Spain but enjoy a direct credit for the withholding taxes applied on dividends and an indirect tax credit for the taxes paid by the distributing company on its profits. The indirect tax credit is subject to the condition that the Spanish company holds a participation of at least 5% in the foreign company for a period of 1 year, and that the foreign company is resident in a country with which Spain has concluded a tax treaty or is not resident in a tax haven blacklisted under Spanish CFC legislation.87 Furthermore, outbound dividends paid by Spanish companies to foreign companies (other than EU parent companies qualifying under the Parent-Subsidiary Directive) are generally subject to a withholding tax of 25%.

Unlike the Luxembourg 1929 holding company regime, the ETVE regime has not been blacklisted by the Primarolo Report, notwithstanding it implies a lower tax burden in deviance with the Spanish benchmark tax system and is (partially) ring-fenced within the meaning of the Code of Conduct. Apparently, the Group has based its decision exclusively on the criteria of the Report, considering that the ETVE merely features a participation exemption with strict substance requirements and a subject-to-tax condition, and that it is of no help where Spanish CFC legislation applies. The explanation of the (effects of the) ETVE regime contained in the Primarolo Report seem to confirm this:88 “the benefit only applies if:
- they (i.e. dividends and capital gains) come from corporate profits and not from ‘passive’ income

87 The Spanish CFC legislation is contained in Art. 121 of the Corporate income tax act. Under this legislation, the foreign distributing company must be subject to a tax on its profits in the foreign country similar to the Spanish corporate tax and whose corporate tax rate is at least 75% of the Spanish one.

88 See the Primarolo Report, measure A011, p.35.
- they have been subject to tax abroad at a tax identical to or analogous to that in Spain
- they do not come from a tax haven."

This explanation suggests that there has been no blacklisting on the basis of an assessment of the effects rather than the features of the ETVE regime. This approach, although not incorrect from a theoretical point of view, lacks consistency with the Code of Conduct as well as with the approach followed with regard to (the blacklisting of) the Netherlands and Danish participation exemption. More specifically, it departs from the basic philosophy of the Code of Conduct to repeal special tax regimes ring-fenced from the economy, like the ETVE regime that only applies to foreign subsidiaries mainly operating outside Spain. Furthermore, the absence of withholding tax on outbound dividends distributed by ETVEs makes this regime very tax-efficient for multinational companies especially where there is no applicable tax treaty between Spain and the country of residence of the recipient company. In other words, this feature solicits system-shopping in a way contrary to the Code of Conduct.

As for the blacklisting of the Netherlands and Danish systems, the Primarolo Group seems to have applied inconsistently its own criteria for the assessment of holding company regimes, i.e. the subject-to-tax requirement and the applicability of comprehensive CFC legislation. With regard to the former, it is true that Spanish legislation requires a corporate tax similar to the Spanish one on the profits of the foreign subsidiary, but the actual tax rate to which such foreign subsidiary is subject is irrelevant, just like under the Netherlands participation exemption. The same goes for Spanish CFC legislation, which does not seem very much different from the Danish CFC legislation and features less strict conditions than the latter. It is (probably) true, like the Primarolo Report implies, that the ETVE regime does not especially encourage the non-taxation of passive income or the use of tax havens. The same conclusion, however, can also be reached for both the Danish and Dutch participation exemption regimes, as their very features make it unlikely that they are used especially for this purpose.

Interestingly, the ETVE regime was partially modified in together with the general Spanish system of taxation of dividend distributions for resident companies to further improve the competitiveness of Spain and address some of the above inconsistencies in the light of the Primarolo Report. The recent changes to the ETVE regime improved flexibility for its use as the requirement that the main statutory object of the holding and management of foreign participations was repealed, paving the way for the use of these entities also for other business activities (though not entitled to the special regime). Furthermore, the 5% minimum ownership is no longer required if the acquisition price of the foreign participation exceeds € 6 million, and the subject-to-tax requirement with regard to the foreign subsidiary is considered met even if its income is only partially subject to tax and regardless of the local method applied to compute

taxable profits. Lastly, a new incentive effective as from 2002 allows the amortisation by ETVEs of financial goodwill for the acquisition of eligible foreign participations at a rate of 5% per year (i.e. over a 20-year period). At the same time, the credit method previously applicable in general for dividend distributions under Spanish tax law other than to ETVEs has been changed into a general participation exemption applicable to dividends and capital gains under the same conditions as for the ETVE regime. Apparently, from a harmful tax competition perspective these changes try to make the tax treatment of Spanish-based (holding) companies and ETVEs alike so that the ETVE regime is no longer considered a special holding company regime deviating from the benchmark system. Even though the tax treatment of these companies is now broadly the same, still the ETVE regime is special given the special purpose of eligible entities, their still limited flexibility in carrying out business activities, as well as the limited thresholds with regard to income derived from Spanish activities (i.e. 15% of their total income). The requirements that the ETVEs have substance and be subject to domestic anti-avoidance rules such as thin capitalisation and CFC legislation limit the possibility to use these entities exclusively or merely to erode the tax base of high-tax jurisdictions. However, the features relating to the subject-to-tax condition in view of the recent changes and the (limited) ring-fencing still raise doubts as to the actual harmfulness of this regime under the Code of Conduct and the 2000 Guidelines.

4.6.6 Recent trends in the EU and the future of the participation exemption and holding companies

What conclusions may be drawn from the above analysis? First, that participation exemption and special holding company regimes should not be grouped in the same category and assessed under the same criteria, as they are not similar. Second, whatever one’s opinion on the criteria to assess the actual harmful character of the various regimes, there should be consistency and equality in their application. From the Primarolo Report it seems that the decisions on the blacklisting of the various measures scrutinised are not based on a thorough and level assessment of their features and of Member States’ domestic anti-avoidance legislation. Third, the 2000 Guidelines do not solve these issues and therefore further clarification is needed, as are common principles adopted with by the Member States (see below). The situation is becoming increasingly complex if one looks at the recent developments in the EU. The majority of Member States is progressively abandoning the credit method or mixed systems and switching to general participation exemption regimes for dividends and/or capital gains arising on both domestic and foreign participations. In addition to the countries analysed above, Member States like Germany, Italy (with regard to dividends and shortly also to capital gains), and the UK (with regard to capital gains) have undertaken substantial reforms along these lines, coupling participation exemption regimes with tight anti-abuse legislation (i.e. CFC legislation, thin capitalisation rules).\textsuperscript{90} While some countries like the Netherlands

\textsuperscript{90} For example, Italy has introduced a general 95% participation exemption on dividends received by Italian (holding) companies from foreign non-tax-haven subsidiaries, coupled with extensive CFC legislation and a denial of deductions for payments to residents in blacklisted countries. Furthermore, Italy is due to introduce for the first time strict thin capitalisation rules and to extend the participation exemption to capital gains as from the fiscal year 2003. The UK has introduced a participation exemption for capital gains from the sale of ‘trading'
and Denmark have tightened their participation exemption regimes in a way that mostly likely complies with the Primarolo Report and the 2000 Guidelines (see at 4.6.2. and 4.6.3), new proposed or amended regimes elsewhere in the EU do raise doubts in this respect. We have already seen that Spain has increased the flexibility and extended the tax advantages for ETVEs, for instance by relaxing the subject-to-tax clause, while at the same time granting a general participation exemption also to ordinary Spanish (holding) companies.

As from 2002, Luxembourg grants the participation exemption to the soparfi with a minimum 10% shareholding or an acquisition price of €1.2 million for dividends or €6 million for capital gains and requires a one-year minimum holding. Under the new rules the participation exemption also applies to shareholdings held through intermediate transparent entities, which favours tax planning techniques of US-based multinationals aimed at minimising the impact of the US CFC rules. Furthermore, the subject-to-tax condition of a minimum tax burden of 15% no longer applies if they fall within the scope of Art. 2 of the Parent/Subsidiary Directive. This last relaxation has been included to allow the application of the participation exemption with respect to Irish subsidiaries subject to 12.5% tax rate, which would otherwise not be covered by it. It is also interesting that dividends not satisfying the required conditions will be subject to a 50% exemption, the remaining 50% being subject to tax in the hands of the Luxembourg holding. It is debatable whether the new soparfi regime complies with the 2000 Guidelines. The amendment with regard to the subject-to-tax clause is certainly consistent with the Parent-Subsidiary Directive and with the idea of capital export neutrality in the internal market, and accommodates the ECJ case law in this area (e.g. Eurowings, see on this issue above at 4.5.3), but the 2000 Guidelines explicitly require this condition to be imposed regardless of the EU residence of the subsidiary. To clarify these issues, one would hope that guidance would be provided as to whether the subject-to-tax condition is meant (also) for EU subsidiaries and whether “significantly lower” tax burden imposed on the foreign (EU) subsidiary also catches a 12.5% (general) corporate tax rate.

These recent developments call for a consistent approach and common objective rules to assess whether participation exemption regimes and special holding company regimes are compatible with the Code of Conduct. As mentioned above, the flaws of the Primarolo Report and the 2000 Guidelines in this respect are numerous, as they do not endorse this distinction and fail to provide guidance on their application to subsidiaries enjoying a lower tax burden than their parent company’s and on the adoption of effective anti-abuse legislation. Furthermore, they raise doubts with regard to the principle of the denial of the participation exemption even in EU or tax-treaty situations laid down in the Primarolo Report and the 2000 Guidelines as to a potential breach of EU law, tax treaties, and ultimately Member States’ tax sovereignty.

Specific guidelines to be issued in the future should shed light on this complicated issue of the relationship between Member States’ sovereignty on how to design participation exemption regimes and their obligations under international and EC tax

subsidiaries, while still applying the credit method with regard to foreign dividends. On these issues, see a.o. E. Bogenschuetz and K. Wright, Change begets more change: The permanent German tax reform, Tax Notes International, 11/3/2002, p. 1125; and A. Tontsch, Corporation tax systems and fiscal neutrality: the UK and German systems and their recent changes, 30 Interfax, 5/2002, p. 171.
law with the EU fight against harmful tax competition in this area. Furthermore, there should be a uniform framework in the EU for the adoption of countermeasures like CFC legislation and similar anti-avoidance rules able to effectively prevent the abuse of participation exemption or special holding company regimes. Failure to do so would most likely mean the return to an array of aggressive holding company regimes in the coming years, as the recent changes in Member States’ laws in this respect show.

4.7 Tax authorities’ discretion: the old and new Netherlands ruling practices

A last category of PHTMs stems from the ruling practice of Member States’ tax administrations. A ruling is typically a document issued by the competent tax authorities which contains an agreement on the tax treatment of income from a certain transaction or on the transfer pricing for transactions concluded between related entities and is mostly granted before a transaction takes place or an investment is effected. A ruling is binding on the tax authorities only if and insofar as the facts stated by the taxpayer are true and accurate. In itself, a ruling practice is not to be considered harmful tax competition on the basis of the discretion of the authorities. However, in some instances the granting of rulings may be harmful if the tax authorities use their discretion arbitrarily and/or tend to agree on a special favourable tax treatment not openly and on a case-by-case basis. This is acknowledged by the Code of Conduct, which considers harmful all non-transparent tax treatments granted by way of relaxed administrative practices.91

The Netherlands tax authorities offer probably the most notable example of a well developed ruling practice in the EU. Backed by the Ministry of Finance, they have created an efficient ruling practice well known internationally and welcomed especially by multinationals seeking advance certainty on the tax treatment of large investments. Up to the substantial reform of 2001 (see below), there was a basic distinction between standard and non-standard rulings issued by the Dutch tax authorities. The former applied to standard factual situations recurrent in a cross-border context and encompassed seven types of rulings whose required conditions of application and subsequent tax treatment were published by the Ministry of Finance.92

The latter were based on the standard rulings but concerned special situations that did not completely fit into them and thus required a more detailed assessment by the Dutch tax authorities.93 In these cases, they had wider discretion in setting out the tax treatment of the planned transactions as they did not have to fully stick with the published conditions laid down with regard to the standard rulings, even though the application of the non-discrimination principle guaranteed the equal treatment of equal situations. The non-standard rulings were usually published each year by the Ministry of Finance on a no-name basis and in summary after a certain period from their issuance.

91 See the Code of Conduct, Para. B (5), and above at 4.2.2.
The non-standard ruling practice of the Dutch tax authorities has been blacklisted by the Primarolo Report. However, in fact also most of the standard ruling practice with regard to the finance company and finance branch regimes (at 4.4.3 and 4.4.4), the distribution centre regimes and similar cost-plus arrangements (at 4.5.3), and other standard rulings (e.g. on informal capital contributions\(^94\)) have been blacklisted on the basis of the criteria applying to each respective category they fall into. The fact that the conditions for their granting has been published, and the little margin of discretion by the Dutch tax authorities in this respect ruled out that these standard rulings should (also) be characterised as harmful on the basis of Para. B (5) of the Code of Conduct as they were transparent and did not lead to inconsistent tax treatment varying on a case-by-case basis.

The non-standard rulings practice is more suspect in the light of the Code of Conduct and in particular of the mentioned criterion of non-transparency. However, a number of considerations suggests that it probably does not fall foul of the Code's criteria. As the Netherlands delegation pointed out in the Primarolo Report, “certainty in advance will be given within the bounds of Netherlands' Tax Law, Jurisprudence and Administrative Policy which in itself cannot extend beyond the scope of Netherlands' tax law” and that “neither the Minister, nor the Central Tax Authority or the tax inspector has discretionary power in the application of the Tax Laws” and that “no certainty will be given ... if the taxpayer tries to exploit the boundaries of what is possible within that framework.”\(^95\) Furthermore, also non-standard rulings were published (even though not integrally and on an anonymous basis), their duration was usually limited to a period of four years, and they were not granted where the outcome would be contrary to the principle of good faith in the relation with treaty partner countries. Lastly, their granting was conditional on compliance with the general non-discrimination principle, which required the tax authorities to treat similar situations in the same way.

These considerations lead to a general conclusion that the non-standard ruling practice should not have been considered harmful tax competition as a whole. However, in practice the actual assessment on its harmfulness should be carried out for each of the rulings issued by the Dutch tax authorities. In particular, one should assess whether the tax authorities complied with the above principles and granted the ruling within the boundaries of Netherlands tax law (and relating case law) by merely interpreting and applying it to the case submitted to them in compliance with the non-discrimination principle, or instead they went beyond such boundaries. If this were the case and it were apparent that the Dutch authorities had arbitrarily (interpreted and) applied Dutch tax law so as to encourage the applicant taxpayer to effect his investment in the Netherlands, then one would have to conclude that that specific tax ruling did constitute harmful tax competition. The publication of the non-standard rulings would not help much in this respect, because usually the facts and information published by the Ministry of Finance are too vague to reach an accurate judgement.\(^96\) An objective evaluation could only be accurate if all facts and circumstances of the transaction at stake were clearly stated, as were the reasons for the tax authorities to

\(^{94}\) See the Primarolo Report, Measure E004, Informal Capital Ruling, p. 127.

\(^{95}\) See the Primarolo Report, Annexed Note from the Dutch Delegation to measure A008 (i.e., the cost-plus ruling), which is also referred to with regard to non-standard rulings.

\(^{96}\) See, e.g., Betten, \(ct\.), p. 357.
agree on conditions (slightly) different from those of the standard rulings in compliance with statutory tax law.

The new Netherlands ruling practice, effective as from April 2001, has been shaped according to the principles of the Code of Conduct and the Primarolo Report.\(^\text{97}\) Its main aim was to improve the business climate of the Netherlands and facilitate business activities for companies with genuine business activities and substance. The new ruling practice was also meant to comply with the standards laid down in these documents so as to accommodate the criticisms of lack of transparency by the other Member States.

The key points of the reform are: (i) a basic distinction between an “Advanced Pricing Agreement” (i.e. “APA”) and an “Advance Tax Ruling” (i.e. “ATR”) practice pursuant to eight decrees issued by the Dutch Ministry of Finance in March 2001;\(^\text{98}\) (ii) the improvement in the organisation of the practice through the creation of an APA and an ATR team in the Rotterdam Tax Office for Large Enterprises also aimed at reducing the time required for the tax authorities’ decisions; (iii) the compliance with the OECD Transfer Pricing Guidelines and the codification of the arm’s length principle; (iv) increased transparency through (possible) publication of all APAs and ATRs. More specifically, APAs are bilateral or multilateral agreements between the taxpayer and the Dutch (and possibly other countries’) tax authorities concerning the transfer pricing method applicable to intra-group transactions. ATRs provide legal certainty with respect to: (i) the application of the Dutch participation exemption for intermediate (i.e. conduit) holding companies with subsidiaries in international structures and top-holding companies, insofar as none of the subsidiaries of the top-holding company conducts any business in the Netherlands; (ii) the tax treatment of hybrid entities and/or hybrid financial instruments in cross border transactions; and (iii) the assessment on the existence in the Netherlands of a permanent establishment of a foreign entity. In situations in which the Netherlands entity lacks substance, APAs and ATRs may only be granted if the taxpayer agrees that the Netherlands tax authorities are allowed to exchange information with the tax administration of the other relevant jurisdiction(s) concerned. Furthermore, the Dutch tax authorities may no longer issue APAs and ATRs with regard to conduit finance companies lacking real economic substance and not bearing sufficient business risks (see at 4.4.3) or to ‘headquarter’ entities on the basis of predetermined notional methods (see at 4.5.3). Lastly, no APAs or ATRs may be issued in situations where there is a potential harm for a justified interest of treaty partners or for other international interests.

These requirements show the efforts to comply with the EU standards of transparency and a full cooperation with other countries’ tax authorities, as well as a

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\(^{98}\) These decrees, issued on 30 March 2001, are: Decree IFZ2001/292M, on the APAs; Decree IFZ2001/293M, on the ATRs; Decree IFZ2001/294M, on intra-group financial service companies; Decree IFZ2001/295M, on transfer pricing, i.e. the arm’s length principle and the OECD Transfer Pricing Guidelines. The decrees on APAs and ATRs are available in English on the Netherlands Ministry of Finance web site http://www.minfin.nl.
tough attitude against tax planning schemes potentially causing loss of tax revenue in other (high-tax) jurisdictions through the use of passive intermediate vehicles located in the Netherlands. The codification of the arm’s length principle and the acceptance of the international transfer pricing principles contained in the OECD Transfer Pricing Guidelines also seem inspired by the need to comply with the Code of Conduct’s principles and the 2000 Guidelines. The outcome seems to be a successful mix of an improved and more efficient ruling practice preserving the Netherlands’ reputation of attractive location for multinational companies with a full compliance of the said EU principles. As for the latter, the new ruling practice provides for enhanced transparency as a result of the publication of all rulings in anonymous form and fights the use of purely tax-driven situations by promoting exchange of information with other countries involved or denying the granting of rulings if the tax bases of other treaty partners may be negatively affected. With regard to the former, it seems to achieve an adequate balance between discretionary power of the tax authorities in interpreting and applying domestic statutory tax law while ensuring equality of treatment of taxpayers in similar situations through increased transparency. The new Netherlands ruling practice may become a model for other countries to achieve the same result in full compliance with the EU principles to counter harmful tax competition.

4.8 The OECD effort to counter harmful tax competition

4.8.1 Introduction

Another project to counter harmful tax competition at international level parallel with the EU one has been embarked on by the OECD in May 1996. This project delegated by the Member countries’ ministers to the Organisation was meant to “develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases”. The outcome of the project have been three subsequent Reports issued in 1998, 2000, and 2001 dealing with harmful tax competition in OECD Member countries and non-Member countries and with the measures to counter this phenomenon. As will be seen, the focus of the OECD attempt has significantly changed over time, mainly as a result of the change in the policy by the US administration and the criticisms on the too tough attitude originally adopted towards non-OECD states. At the moment, a more widespread consensus seems to have been reached between OECD and non-OECD countries as to what needs to be considered harmful tax competition and the actions to be taken in this respect. This has been the result of a number of compromises, which have largely narrowed in scope and importance the OECD work. Still there are several question marks as to the effectiveness of this project and what its final impact will be, but the latest developments point towards a possible workable positive outcome. In particular, a common line of action in the area

99 See also Meussen and Velthuizen, cit., at 9-10, and de Hosson, cit., at 191-192.
100 This is confirmed by recent developments in Belgian corporate tax law, where a new general ruling practice has been introduced in the Corporate Tax Reform Bill for 2003 specifically shaped on the new Dutch practice in order to comply with the Code of Conduct (and the OECD Reports, see Section 4.8).
101 For the full text of the mandate, see on the OECD web site at http://www.oecd.org
of exchange of information through ad hoc bilateral agreements based on a new Model Convention between countries has been reached, which must be seen in conjunction with other projects of international organisations or intergovernmental associations (e.g. the Financial Action Task Force on Money Laundering (hereinafter “FATF”))\textsuperscript{102} or the Financial Stability Forum (hereinafter: “FSF”))\textsuperscript{103}.

The analysis in this section will focus on the three OECD Reports and the progressive change in the OECD approach and focus, with a look at the recent developments and the likely outcome of this project.

4.8.2 The 1998 OECD Report: Scope and criteria to identify harmful tax competition

The first outcome of the OECD project was a report on “Harmful Tax Competition - An Emerging Global Issue”, released in April 1998 (hereinafter: the “1998 Report” or the “Report”).\textsuperscript{104} The Report contains an introduction and three chapters concerning the concept of tax competition, the criteria to identify harmful tax competition, and the recommendations to counter harmful tax competition.

The first chapter features the economic background to tax competition and an analysis of this concept. It highlights that globalisation of the economy and investments has made it possible to shift capital and business activities much more easily than in the past, thereby making domestic fiscal policies of the various countries potentially more able to affect other countries' economies and markets. This has been the main factor behind an increase of tax competition. With regard to the concept of tax competition, the Report describes its two different forms. Good or acceptable tax competition is said to stem from the differences in the countries' tax systems due to their differing domestic fiscal policies and encompasses all tax measures complying with internationally accepted standards.\textsuperscript{105} In other words, tax measures are considered acceptable whenever they are expression of the countries' tax sovereignty and are meant to attract new and genuine investment or to favour the development of depressed areas suffering from specific disadvantages.

\textsuperscript{102} The Financial Action Task Force on Money Laundering (“FATF”), which currently comprises 31 countries, was established by the G-7 Summit in Paris of July 1989 to study measures to combat money laundering. For a description of its main works and the issue of a black list of targeted countries, see especially S. Sieker, Offshore financial centers and 'Harmful tax competition': The developments, Worldwide Tax Daily, 2001, 19-22. See also the OECD Observer, “Name and shame” can work for money laundering, 19/10/2000, available online at http://www.oecdobserver.org/news.

\textsuperscript{103} The Financial Stability Forum (“FSF”) is composed by G-7 countries and other countries, as well as representatives of the International Monetary Fund, the World Bank, the OECD, and other international financial institutions and organisations. Its main goal is to ensure stability of financial markets and its works include the role of offshore financial centres featuring ring-fenced regimes and bank secrecy, which have also been included in a black list; see in detail Sieker, cit.


\textsuperscript{105} OECD 1998 Report, p. 15.
When turning to the concept of “harmful” tax competition, the 1998 Report becomes indeed rather confusing and puzzling for the lack of a definition of what is ‘harmful’ as opposed to ‘acceptable.’ This must be construed by putting together several pieces scattered throughout the Report. It seems that harmful tax competition is to be understood as a country’s exploitation of the interaction of the tax systems “by the enactment of special tax provisions which principally erode the tax base of other countries.” A synonym for harmful tax competition is the term “poaching”, which occurs when “the spillover effect on the other countries is not a mere side effect, incidental to the implementation of a domestic tax policy”, but “the effect for one country to redirect capital and financial flows and the corresponding revenue from the other jurisdictions by bidding aggressively for the tax base of other countries.”

The following forms of potential harm are indicated as likely to be caused by special tax incentives falling in this category: distortion of investment flows; threat to the integrity and fairness of the tax systems; discouragement of taxpayers’ compliance; redesign of the appropriate balance between revenue and public spending; shift of tax burden to other bases, namely labour and consumption; increase of administrative and compliance costs. In short, the 1998 Report poses the accent on the subjective aspect of harmful tax competition related to a country’s policy and intention for the enactment of a certain regime (see Chapter 1, at 1.2.4 and 1.2.6).

As to the scope of the 1998 Report, the introduction points out that it only covers “geographically mobile activities, such as financial and other service activities, including the provision of intangibles.” Therefore, special tax incentives directed at manufacturing activities and more in general at foreign direct investment fall outside its scope. Chapter 2 of the 1998 Report contains a fundamental distinction between OECD member (and high-tax non-member) countries’ harmful tax practices (hereinafter: “HTP”) and non-member countries to be labelled “tax havens,” which together fall into the said broad concept of harmful tax competition.

The concept of tax haven is not defined in the 1998 Report because it “does not have a precise technical meaning.” However, the Report refers to countries “that are able to finance their public services with no or only nominal income taxes and that offer themselves as places to be used by non-residents to escape tax in their country of residence (so-called reputation criterion)” and that “raise significant revenues from their income tax but whose tax system has features constituting harmful tax competition.” Therefore, tax havens are perceived as being actively engaged in the

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109 See on the point Wright, cit., at 462. With respect to the definition of “harmful” tax competition the author refers to the introduction of the 1998 Report (p. 8), which reads: “the Report is intended to develop a better understanding of how .... harmful tax practices 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.” Furthermore, the author cites the following part of the Report (p. 14): [harmful tax practices] “induce potential distortions in the patterns of trade and investment and reduce global welfare ... may alter the structure of taxation (by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals.”
erosion of other countries’ taxable bases and unwilling to be involved in the process to combat harmful tax competition.

The second category encompasses HTPs by OECD countries collecting a significant level of revenue from individual and/or corporate income tax but whose tax systems “have preferential features that allow the relevant income to be subject to low or no taxation.” The Report is concerned that tax revenues of these jurisdictions are jeopardised by the existence of both tax havens and high-tax jurisdictions’ HTPs. Unlike tax havens, these (OECD) countries are perceived to be more inclined to cooperate in the fight against harmful tax practices as long as their competitors agree to do the same. In order to identify tax havens and HTPs within its scope, the 1998 Report lays down four key criteria similar or equal for both categories:

i) “no or only nominal taxes” for tax havens; “no or lower effective tax rates” on the relevant income (i.e. from mobile activities) with regard to HTPs due to a low nominal rate or a narrow definition of the tax base or a combination of them;

ii) “no substantial activity” for tax havens, i.e. availability of a tax regime without requiring a certain minimum presence in that jurisdiction, which gives rise to so-called ‘booking centres’; “ring-fencing” with regard to HTPs, i.e. insulation from the rest of the economy due to its availability exclusively to non-resident taxpayers or to transactions concluded with non-residents;

iii) “lack of effective exchange of information”, namely bank secrecy legislation and administrative practices preventing the supply of relevant information on taxpayers’ activities and funds;

iv) lack of transparency due to favourable administrative practices under which tax authorities issue rulings without publishing the required (objective) conditions, grant them on a discriminatory basis or not consistently with statutory tax law, or fail to enforce tax provisions (e.g. adopt a tax audit policy).

In addition to these key factors, the 1998 Report identifies a number of additional criteria to single out harmful tax competition (i.e. tax havens and HTPs in OECD countries:

- regimes providing for an artificial definition of the tax base, including: a) provisions narrowing the tax base; b) unconditional rules for the avoidance of double taxation, such as full credit and unrestricted participation exemption; c) deductions for deemed expenses; d) rules allowing the formation of special reserves and provisions; e) computation of the taxable base under the cost-plus or resale-minus methods or other non-transparent notional methods deviating from OECD standards;
- failure to comply with internationally accepted (i.e. OECD) transfer pricing rules, such as: a) calculation of adjustments on narrow bases; b) inappropriate use of advance rulings; c) use of “safe harbour” prices or margins;
- adoption of the full exemption method for relieving international double taxation on foreign-source income (i.e. including passive income).

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114 OECD 1998 Report, pp. 21 ff. The 1998 Report breaks down the four key criteria and the other criteria indicated below in two categories with respect to tax havens and preferential tax regimes of non-haven jurisdictions, but they largely coincide and are grouped together in the text.
The 1998 Report also sets out other criteria to identify harmful tax competition that seem superfluous because they are already implied by the aforementioned ones. Lastly, the Report points out that the assessment on the harmful character of a certain measure must consider the following effects caused by its implementation:

- mere relocation by taxpayers of an already existing investment with a view to take advantage of the preferential regime rather than generation of new investments;
- creation of new activities commensurate with the size of the investment or the income obtained;
- lack of motivations for an investment other than the exploitation of the favourable tax measure.

The 1998 Report was adopted by OECD Member countries with the abstention of Luxembourg and Switzerland. In their final statements, they lamented that it was partial and unbalanced as to its limited scope to financial activities and to the use of the criterion of bank secrecy legislation. In the former respect, Luxembourg praised the broader scope of the Code of Conduct and the more general EU approach to deal with harmful tax competition. In the latter respect, both countries stressed that the remedy sought by the OECD to push for exchange of information and the repeal of bank secrecy legislation ruling out alternative means like withholding taxes was unacceptable on the grounds that it was contrary to the need to protect taxpayers' data and confidentiality considered fundamental by these countries. However, a mere abstention rather than a formal veto by Luxembourg and Switzerland meant that the adoption of the 1998 Report at OECD level would still be valid, the only effect being that these two countries would not be bound by the Report.

4.8.3 Countermeasures recommended by the 1998 Report and the "Forum on Harmful Tax Practices"

The 1998 Report recommends several remedies to counter HTPs and tax havens in its Chapter 3. Interestingly, it makes clear that "whilst many of the measures proposed are addressed towards counteracting the effects of both tax havens and harmful preferential tax regimes, the emphasis placed on the appropriate response may differ." This suggests that even though the proposed countermeasures are recommended towards both OECD and non-member countries as well as tax havens, the approach might be milder with regard to the former and tougher with regard to the latter. The Report sets out a total of 19 non-legally-binding recommendations broken down into three categories dealing with (i) domestic laws of the Member countries, (ii) tax treaties, and (iii) international co-operation.

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115 See OECD 1998 Report, pp. 32 ff. These superfluous criteria are: a) possibility for a taxpayer to negotiate the tax rate or tax base with the local tax authorities; b) existence of secrecy legislation, including bank secrecy, anonymous debt instruments or bearer shares; c) existence of regimes favouring purely tax-driven transactions and involving no substantial activity.
117 See the statements contained in Annex II to the 1998 Report, the Luxembourg one at 73-75 and the Swiss one at 76-78.
118 OECD 1998 Report, Para. 96. See also Paras. 151 and 158-159 of the 1998 Report, which support the conclusion indicated below in the text (see also at 4.8.4. and 4.8.5).
119 The 19 recommendations are contained in the OECD 1998 Report, pp. 40 ff. See the critique by G. M. Melo, *Taxation in the global arena: Preventing the erosion of national tax bases or impinging on territorial sovereignty*, 12 Pace
The first group of recommendations regards countermeasures to be adopted under domestic legislation and includes: introduction (or amendment) of controlled foreign corporations (CFC) and foreign investment funds (FIF) legislation to cover HTPs of (OECD) countries and tax havens; restriction on the application of the participation exemption and similar mechanisms to relieve international economic double taxation with respect to dividends distributed out of profits enjoying HTPs or originating in a tax haven; foreign income information reporting rules; transparency and objectiveness of the conditions for the issuance of advance rulings by a country’s tax administration; consistent application of transfer pricing legislation; access to banking information.

The recommendations in the second category call for tax treaties to contain: adequate provisions on exchange of information, or more efficient and effective use of existing provisions; strict exclusion provisions and limitation on benefits rules; a comprehensive commentary clearly explaining the contracting states’ internal anti-avoidance doctrines and rules applicable to treaty provisions; and termination of tax treaties concluded with tax havens.¹²⁰

The third category of recommendations is meant to enhance international cooperation in order to counter harmful tax competition and to adopt a comprehensive coordinated strategy under the auspices of the OECD. In particular, Recommendation No. 15 provides for the creation and establishment of a “Forum on Harmful Tax Practices” (hereinafter: the “Forum”) composed of representatives of OECD countries and whose main task is the actual implementation of guidelines on how to deal with harmful tax practices to be drafted by it.¹²¹ The 1998 Report clarifies that the Forum is a subsidiary body of the Organisation’s Committee on Fiscal Affairs, its effectiveness should be reviewed after five years from its establishment and every three years thereafter.

The main task of the Forum is the supervision on the implementation of the standstill and rollback provisions envisaged by the guidelines annexed to Recommendation No. 15. These guidelines set forth that (OECD) countries must refrain from adopting new harmful tax measures within the meaning of the Report or from broadening the scope of already existing ones in their legislation or administrative practices (standstill), and that they must review their existing harmful tax practices with a view to repeal or amend the ones caught by the Report (rollback). A list of such measures was due to be drawn up by the end of the year 2000, and their actual repeal should be completed by April 2003. Extension of harmful regimes would possible up to the end of 2005 under grandfathering provisions in favour of taxpayers benefiting from them before 31 December 2000.¹²² The other tasks of the Forum are listed in Recommendations No. 16 through 19.¹²³ In particular, the Forum is supposed to: a) issue a list of “tax havens” within the meaning of the Report by the end of the year 2000; b) engage in dialogue with non-member countries, namely the tax havens; c) undertake and develop the study and discussion on other topics relating to harmful tax competition.¹²⁴


¹²⁰ See in particular the OECD “Draft Contents of the 2002 Update to the Model Tax Convention”, 2 October 2001, at http://www.oecd.org, especially Paras. 10.1-10.2 and Para. 21, entitled “Provisions which are aimed at entities benefiting from preferential tax regimes.”
¹²⁴ The areas for further study include domestic legislation denying deductions for payments made to tax havens.
4.8.4 The 2000 Report on harmful tax practices and the list of tax havens

In fulfilment of the 1998 Report, the OECD came up with a second report “Towards Global Tax Co-operation - Progress in Identifying and Eliminating Harmful Tax Practices” in June 2000 (hereinafter: “2000 Report”).125 The 2000 Report, again approved with the abstention by Luxembourg and Switzerland, is divided into four parts containing a summary of the work carried out since the 1998 Report, the progress with regard to HTPs of Member countries and tax havens, and the way forward in the OECD project.

The work with regard to OECD countries relied on a self-review of their potentially HTPs by each country as well as a peer review under the coordination of different study groups within the Forum. In the end, a total of 47 potentially HTPs was singled out, covering income from financial and insurance activities, ‘headquarters’ and other intra-group centres’ functions, the shipping area, and a residual category of miscellaneous regimes. Among EU Member States’ tax regimes analysed above under the Code of Conduct and the Primarolo Report, the OECD 2000 Report blacklists the Belgian coordination centre regime, the Belgian, the French, and the Netherlands service and distribution centre regimes, the Netherlands CFM, the Netherlands and Luxembourg finance companies and finance branches regimes, the Irish IFSC and the Madeira ZFM. Interestingly, these regimes are still considered potentially harmful, requiring further study on their economic effects and a more thorough assessment in the light of the criteria of the 1998 Report to ascertain which of them is actually harmful. For this purpose, the 2000 Report states that general guidelines (i.e. the “application notes”) will be developed on how to apply in practice these criteria to each of the 47 regimes.126 Eventually, the Forum on harmful tax practices will rely on these application notes to draw up the final black list and recommend to Member countries ways to remove the harmful features of these regimes.127 The 2000 Report confirms that Member countries will have to repeal their HTPs included in the final list before April 2003 (extended to December 2005 for taxpayers enjoying them by December 2000), failure to do so implying the imposition of appropriate defensive measures by other Member countries.128

As for tax havens, the 2000 Report blacklists 35 jurisdictions meeting the criteria of the 1998 Report and failing to have committed to comply with its principles. Moreover,
the 2000 Report invites all these jurisdictions to make a "public commitment" to this effect before July 2001 in order to avoid being included in a final "list of uncooperative tax havens" to be drawn up at that date (see below). The jurisdictions included on this list would then be subject to a number of sanctions to be implemented in a coordinated way by (Member) countries. These are also included in the 2000 Report, which recommends the following countermeasures with regard to transactions concluded with entities located in these jurisdictions: \(^{129}\) denial of deductions, exemptions, or credits relating to payments to these entities; comprehensive information reporting rules for transactions involving these jurisdictions; effective CFC legislation; denial of domestic exceptions able to avoid the application of domestic sanctions; denial of the foreign tax credit or of the participation exemption for distributions of profits arising in these jurisdictions; imposition of withholding taxes on payments to entities or residents located in these jurisdictions; enhancement of audit and enforcement procedures towards domestic taxpayers engaged in activities in these jurisdictions; denial of deductions and cost recovery for fees and other expenses incurred in establishing or acquiring entities located in these jurisdictions; imposition of transactional charges for transactions concluded therein; application of any other current and future countermeasure adopted towards (Member) countries HTPs also against these jurisdictions' regimes.

In the last part, the 2000 Report stressed the need for an increased dialogue and involvement in the harmful tax competition project of cooperative tax havens that have made or will make the public commitment (see below). \(^{130}\) This includes their participation in the Forum and their contribution to the development of a model convention for effective exchange of information (see at 4.8.8). Furthermore, it recognises that these jurisdictions will need assistance, both financial and technical, in the transitional period after their commitment with a view to smoothening the possible negative consequences on their economies, which the OECD is ready to provide. Lastly, the 2000 Report calls for an involvement of the non-member economies, which are also affected by HTPs of OECD countries or by tax havens, to comply themselves with the principles of the 1998 Report and to participate in the Forum.

In order to avoid being included in the list of uncooperative jurisdictions subject to the above sanctions and excluded from the Forum, the 2000 Report refers to a "public political commitment" containing a 'scheduled commitment' with a timetable and milestones to repeal the harmful features of their tax regimes steadily but effectively. The details of this public commitment have been set out in November 2000 in a memorandum of understanding (hereinafter: "MOU") \(^{131}\) meant to ensure that tax havens would progressively promote transparency, engage in effective exchange of information, and do away with regimes meeting the 'no substantial activity' criterion. The salient points of the commitment as envisaged by the MOU are transparency and

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\(^{129}\) OECD 2000 Report, para. 35. Most of these countermeasures are the same recommended by the OECD 1998 Report (see at 4.8.3).


\(^{131}\) OECD, Framework for a collective memorandum of understanding on eliminating harmful tax practices, available on the OECD web site in together with the cover letter sent by the OECD to all the blacklisted tax havens. See also the News Release of 24/11/2000, available on the OECD web site in the news section at http://www.oecd.org/media/release/nw00-123a.htm.
exchange of information. As for transparency, it is required that information about beneficial owners of companies, partnerships, trusts and other entities be available to the local administration and that financial accounts of all these entities be drawn up according to generally accepted accounting principles and be audited or filed for all of them. The deadline for the implementation of these rules should be December 2002. Within 2003, other non-transparent characteristics of tax haven’s systems would have to be repealed, such as the granting of secret rulings or rulings departing from OECD (transfer pricing) principles, or the possibility to elect or negotiate the applicable the tax rate with the local tax authorities. With regard to information exchange, within the end of 2003 any relevant information should be available in criminal tax matters and exchanged in an effective way and without being subject to the ‘dual criminality’ principle, i.e. to the requirement that the situation investigated in the country requesting the information would also constitute a criminal (tax) offence in the country addressee of the request. Furthermore, the MOU calls for the elimination of any (legal) impediment to the submission of information, requiring that the local authorities have access to bank information relevant for the criminal investigation. By the end of 2005, the exchange of information would have to be available in all tax matters, i.e. with regard to the determination, assessment, collection and enforcement of tax (referred to as “civil” tax matters). Moreover, the MOU provides that the information should be granted regardless of the addressee country having an interest in obtaining the information also for domestic tax purposes and that there should be neither practical nor legal impediments such as bank secrecy legislation preventing the local authorities to gather all relevant (financial) information.

4.8.5 Reactions to the 2000 Report (and the MOU) and follow-up

The 2000 Report and the subsequent MOU on the details of public commitment of tax havens generated a spate of criticism from representatives of the targeted jurisdictions and also of OECD member countries as well as from a number of legal commentators. The main such criticism concerned the unjustified intrusion of the OECD in internal affairs of sovereign countries, which were pushed to increase their tax rates and repeal their regimes aimed at attracting foreign investors and sustain the local economy. In other words, the OECD project would be contrary to basic principles of international law and international tax law, as well as possibly to WTO principles and resolutions approved by the UN. Moreover, this attempt would be meant to protect the interests of high-tax (OECD) jurisdictions and their inefficient public administrations and large public spending programs. The fact that Member countries were themselves in breach of, or not prepared to comply with, the obligations contained in the MOU, that they were trying to unduly impose on tax


havens exacerbated these criticisms and evidenced the OECD’s arrogant attitude towards the targeted tax havens. More specifically, as for the conditions laid down in the MOU with regard to transparency, it is remarkable that most Member countries do not require disclosure or information on ultimate beneficial owners behind each entity or investment, especially transparent entities and trusts. Furthermore, the drawing up of financial accounts and their filing and auditing are usually only required for larger companies exceeding certain thresholds, for public companies, or for companies performing services of public interest. With regard to exchange of information in ‘civil’ tax matters, Member countries only exchange information in the presence of an income tax treaty providing for a specific clause to this effect or of specific tax information exchange agreements. Furthermore, a number of OECD countries have bank secrecy legislation in place preventing them from exchanging information in all such civil tax matters, such as Luxembourg, Switzerland, Austria, and the US itself, where states like Alaska, Delaware, and Nevada have strict laws guaranteeing investors data protection and confidentiality. By contrast, the MOU urges tax havens to publicly and unilaterally agree to exchange tax information in both criminal and civil tax matters without referring to the presence of an appropriate instrument or to the need to guarantee protection of taxpayers’ rights. Lastly, it is remarkable that the MOU calls for tax havens to remove any obstacle to information exchange and to make available sufficient expert personnel for this purpose whereas most OECD states do lack adequate resources and personnel themselves.

A host of criticisms also concerned the draconian sanctions ‘recommended’ by the OECD, which should only be taken against the uncooperative tax havens. Both the 1998 Report and the 2000 Report try not to emphasise the different approach in the use of countermeasures towards HTPs of high-tax (OECD) jurisdictions and the tax havens, but it is crystal clear that the harsh measures mentioned above should only be adopted towards the latter. This is an unjustified discrimination, which the OECD seeks discharge from by making it clear that it merely recommends the coordinated adoption of these sanctions within the OECD framework, but that it is the Member countries that must implement them using their discretion “in a manner that is proportionate and prioritised according to the degree of harm that a particular jurisdiction has the potential to inflict.”¹³⁴ To show a positive attitude towards tax havens and persuade them to make the commitment in accordance with the MOU, the 2000 Report offers in exchange the possibility to make their opinions heard within the Forum and financial assistance for a smooth transition to a new high-tax system. This has spurred harsh criticisms by these jurisdictions on the grounds that the OECD attempts to make their economies and ultimately their sovereignty dependent on its willingness and generosity to provide the promised financial and administrative support and ultimately become even more powerful in determining their well-being or rather survival.¹³⁵

Most of these well-founded criticisms have forced the OECD to rethink its approach after the release of the 2000 Report and of the MOU. Perhaps the most important factor in this respect was the changed approach by the US administration, which

¹³⁴ See the OECD 2000 Report, para. 33.
¹³⁵ It is estimated that some tax havens targeted by the OECD would experience a GDP loss of as much as 25%: see Mitchell, at, also reporting a number of other criticisms by representatives of tax havens.
acknowledged the need to respect other countries' (tax) sovereignty and to avoid interfering with their fundamental decisions concerning the setting of tax rates or the framing of their special (ring-fenced) tax regimes linked to the adoption of the territoriality principle of taxation and having substantial positive effects for their economies. As a consequence, the US stressed the importance to refocus the whole effort merely on transparency and exchange of information, but ensuring that the main flaws and inequities implied by the MOU would be eliminated. At the same time, the tax havens started an active cooperation among themselves, which was sanctioned at a meeting in January 2001 also attended by OECD officials and which paved the way for a more powerful involvement in the OECD project and a changed relationship with the OECD and its Member countries.

4.8.6 The 2001 Progress Report and the milder approach of the OECD

The most recent Report on harmful tax competition was released by the OECD in November 2001 (hereinafter: "2001 Report"). It outlines the progress made since the 2000 Report with regard to both OECD countries' HTPs and tax havens and clearly shows a changed approach as a result of the new US strategy and the above criticisms to the 2000 Report and the MOU. This is also acknowledged by the 2001 Report, which states that "the dialogue between the OECD Members and the tax haven jurisdictions has resulted in the OECD having a better understanding of the concerns of the jurisdictions regarding the commitment process."

As to HTPs of Member countries, the 2001 Report devotes only two paragraphs to the progress work. It indicates that the OECD is still drafting the 'application notes' on how to identify their actual harmful regimes and how to amend them consistently with the 1998 Report and the 2000 Report (see also at 4.8.4). For this purpose, the 2001 Report also stresses the importance of further involving the business community and, in particular, the Business Industry Advisory Committee (i.e. the "BIAC"). Details on the progress on the application notes and their implementation in the Member countries are said to be the focus of future reports to be published by the OECD. One notices that the application notes were already mentioned in the 2000 Report, where it was indicated that they would be published in early 2001. Not only does the 2001 Report not contain them, but it also does not mention the timing for their publication,


139 OECD 2001 Report, para. 23.


141 See also the criticism by the BIAC in A business view on tax competition, 40 European Taxation, 8/2000, p. 421.
generically referring to new progress reports to be issued in the future. The impression is that the 2001 Report is deliberately avoiding focusing on the progress work in Member countries due to problems faced in this respect (see below).

The main focus of the 2001 Report is the work related to tax havens, in particular those blacklisted in the 2000 Report failing to make the public political commitment in the meantime (see at 4.8.4). Of the 35 jurisdictions blacklisted in the 2000 Report, only 12 had made such commitment to be taken off the “list of uncooperative jurisdictions” up to the release of the 2001 Report. As a result of the OECD’s changed approach to engage in discussions and negotiations with each tax haven, the 2001 Report contains four important changes aimed at encouraging the remaining blacklisted jurisdictions to make the public political commitment. Three of these changes have to do with the timing of the commitment and the release of the final list of uncooperative jurisdictions, while one has to do with the substantive criteria used by the OECD to single out tax havens.

The changes concerning the timing extend the deadlines set in the 2000 Report in order to grant an additional period to blacklisted tax havens to make the commitments and then implement them. In particular, the 2001 Report sets 28 February 2002 as the new deadline for making commitments, seven months later than the previous deadline of 31 July 2001, and announces that the final list of uncooperative jurisdictions will be issued shortly thereafter. The 2001 Report also provides for a longer period for tax havens to gradually eliminate the harmful features of their tax regimes by 31 December 2005. Another modification concerns the timing for applying the 2000 Report’s defensive measures against the uncooperative jurisdictions failing to make the commitment, which under the 2001 Report are not applicable any sooner than their application to OECD countries failing to repeal or amend their blacklisted HTPs.

The most significant change set out in the 2001 Report is the dropping of the “no substantial activity” criterion to identify uncooperative tax havens.142 The Report indicates that the reason for this is the difficulty in ascertaining when and whether local activities are substantial, a difficulty which had already been anticipated in the 1998 Report. However, one may guess that the real reason is linked to the criticisms that its application meant an infringement of tax havens’ sovereignty, with potentially negative consequences on their economies if their regimes caught by it were to be repealed. As a result of these changes, the OECD uses three main criteria to identify tax havens. The criterion of no or low effective tax rates is still used, but it is considered a mere “gateway criterion” needed to assess whether scrutiny of the other two criteria is necessary. Therefore, the 2001 Report focuses on the two remaining criteria of lack of transparency and lack of effective exchange of information, object of the public commitment by tax havens to prevent inclusion in the final list of uncooperative jurisdictions, and contains some changes as compared to the MOU.143

With regard to transparency, the 2001 Report stresses the need to do away with secret advance rulings and the possibility to negotiate applicable tax rates with the tax

142 As a result of this change, the jurisdictions already committed to eliminating the harmful preferential tax regimes are no longer bound to amend the regimes caught by this criterion. Nevertheless, the OECD welcomes tax havens’ commitments also aimed to eliminate tax regimes that violate this criterion.
143 The details on transparency and exchange of information object of the public commitment are included in the OECD 2001 Report, paras. 37 and 38.
authorities. This should ensure a fair and consistent application of tax law to all taxpayers, with no possibility for the local administration to grant hidden incentives to certain taxpayers only. The 2001 Report also reiterates the need to set adequate bookkeeping standards and to require financial statements to be filed or audited, but unlike the MOU it allows exceptions with respect to de minimis transactions or to local entities exclusively engaged in local activities and with no foreign ownership, beneficiaries, management, or other involvement. As for effective exchange of information, the 2001 Report confirms that information should be made available in both criminal and civil tax matters. It again calls for adequate administrative procedures whereby the local authorities are provided with the necessary legal instruments to gather the requested information and are well trained and efficient enough in this respect. This also entails the abolition of banking secrecy laws and access by the tax havens’ authorities to information on the beneficial ownership of local entities and other relevant financial information, possibly in collaboration with local banks and other financial institutions. Unlike the MOU, the 2001 Report explicitly points out that confidentiality of taxpayers must be safeguarded and information should exclusively be used for the purpose for which it was requested, thereby preventing ‘fishing expeditions’ by high-tax countries’ tax authorities. Furthermore, it provides that for exchange of information in civil tax matters the requesting country must always indicate whether the requested jurisdiction has an interest to gather that information also for domestic tax purposes. The 2001 Report also states that a working group of OECD Member countries has been set up to develop an appropriate legal instrument to achieve effective exchange of information within this framework, also involving the committed tax jurisdictions (for the outcome, see at 4.8.8).

The 2001 Report also confirms that the OECD will help committed jurisdictions to deal with the potential negative economic consequences of the changes in their tax systems as a consequence of the commitment. For this purpose, the OECD will work in close cooperation with the International Monetary Fund and the World Bank to enter into adequate financial assistance programs. In the attempt to secure increased administrative cooperation and achieve an effective information exchange, the OECD also confirms its administrative cooperation and support to the committed jurisdictions in the effort to strengthen and improve their local tax administrations. Lastly, the 2001 Report restates the application of the coordinated defensive measures laid down in the 2000 Report towards the jurisdictions failing to make the public commitment by the new deadline of 28 February 2002 in accordance with the above changes, again pointing out that countries retain discretion as to whether or not to implement them, and if so, to make them proportionate and aimed at undoing only the harmful effects of the targeted tax regimes/jurisdictions.

4.8.7 Comments on the 2001 Report and its flaws

The 2001 Report clearly reflects the changed approach by the OECD as a result of the changed US policy and the harsh criticisms by the tax havens. Even though it does make some improvements in its drive against harmful tax competition, it still does not address satisfactorily all of the criticisms and still suffers from a number of underlying
problems. First, the political clash among OECD Member countries entails a limited political support for its project. This is mainly shown by the fact that two more OECD countries, Belgium and Portugal, have abstained from approving the 2001 Report. They have joined Luxembourg and Switzerland, which had confirmed their abstention to this Report after abstaining from the approval of the 1998 Report and the 2000 Report. With regard to the 2001 Report, the Luxembourg delegation stated that it “is further away from the goal of combating harmful tax competition with respect to the location of economic activities” and Switzerland confirmed that “its 1998 abstention applies to any follow up work undertaken since 1998.144 The OECD tried to play down these abstentions by affirming that Luxembourg and Switzerland have always actively cooperated in the process to counter harmful tax competition and that Belgium and Portugal still adhere to the previous Reports of 1998 and 2000, and that a mere abstention is not as important as a veto, which would have stalled the whole process. However, one would expect that the Portuguese and Belgian abstentions had to do with the inclusion in the 2000 Report’s black list of their special tax systems, i.e. the Madeira ZFM and the preferential regimes for coordination centres, distribution centres and service centres for Belgium. It does not seem a coincidence that a number of special regimes implemented by Luxembourg and Switzerland have also been included in the list of preferential tax regimes contained in the 2000 Report, as well as the OECD crusade against (their) bank secrecy laws. These abstentions are needed by the four Member countries to claim that they are not bound by any of the OECD Reports either from a legal or from a political point of view, and thus to avoid having to repeal or amend their blacklisted tax regimes.

The fact that these four Member countries will not feel compelled to repeal their listed preferential tax regimes by the April 2003 deadline is likely to upset both Member countries and non-OECD countries. The former will consider it unjust to have to repeal their own blacklisted preferential tax regimes (and possibly also force their dependent or associated territories to do so) while four fellow Member countries refuse to do so. This may well lead to retaliation either by not going ahead with the repeal or amendment of their regimes or by imposing strict countermeasures (also) against the four non-compliant Member countries. As for the non-OECD jurisdictions, they feel that the failure of the OECD to force its own Member countries to abide by the 1998 Report and the 2000 Report does not justify the push to repeal or amend their tax regimes in conformity with the same Reports. These jurisdictions also fear that they would lose out to the four abstaining OECD Member countries, since their onshore tax regimes would likely attract capital and investment shying away from the tax havens’ offshore regimes that comply with the OECD standards.

As for the tax haven work, the openings of the 2001 Report with regard to the extension of deadlines and the timing for the application of the defensive measures against uncooperative jurisdictions simultaneously with OECD countries do not seem sufficient to accommodate all the criticisms to the 2000 Report and the MOU. The fact that the harsh countermeasures contained therein are exclusively applicable to tax havens and that the defensive measures towards OECD countries would be milder, being limited to the application of domestic anti-avoidance legislation already in place (e.g. CFC regimes) and political peer pressure, seem objectively unjustified. The

144 OECD 2001 Report, footnote 1, p. 4.
OECD argues that harsher measures are needed in situations in which more harm is caused, like in the case of tax havens. However, this has led to further resentment among tax havens as they feel discriminated against by the large OECD players in the area of sanctions as well as in other areas. Eventually, Switzerland, Luxembourg, and possibly Belgium and Portugal face milder, less effective sanctions than the ones imposed on them, if at all. Last but not least, notwithstanding the changes adopted by the 2001 Report, the OECD is still pushing tax havens to comply with standards that not all the OECD countries are prepared to comply with themselves, such as full transparency of their tax systems and an effective exchange of information in both criminal and civil tax matters as well as the repeal of bank secrecy laws. All the above (unresolved) issues with regard to both OECD countries and tax havens make the OECD's statements in the 2001 Report that the “objective of the tax haven work remains to obtain commitments from as many of the jurisdictions as possible” and that hopefully “it will not be necessary to issue a list” of uncooperative jurisdictions\textsuperscript{145} seem very optimistic indeed.

4.8.8 The new black list, the Model Convention on information exchange, and the way forward of the OECD project

After the release of the 2001 Report, virtually nothing happened up until the new deadline of 28 February 2002 neared. Apparently, the flaws just described prevented uncommitted tax havens to feel compelled to adhere to the OECD project. At that date, only 16 out of the 41 originally targeted jurisdictions had made public commitments. Considering that 2 jurisdictions had been removed by the black list, 23 jurisdictions were still reluctant to make the public commitment required by the OECD, despite the concessions of the 2001 Report.\textsuperscript{146} Surprisingly, 4 of the new commitments were made just the day before the deadline, and in the days following its expiration there were a number of new commitments even by countries adamantly opposed to the OECD project.\textsuperscript{147} The OECD released the amended black list of “uncooperative tax havens” on 18 April 2002, which contained only 7 jurisdictions out of the 35 jurisdictions included in the 2000 black list.\textsuperscript{148} What is the reason for this sudden success of the OECD project and the adherence of so many jurisdictions to it? Apparently, it was not their fear to be subject to the

\textsuperscript{145} OECD 2001 Report, para. 33.
\textsuperscript{147} See C. Scott, More tax havens commit to OECD project days after the deadline, Tax Notes Today, 11/3/2002, 94-1272. For an update of the jurisdictions committed and the text of their commitment, see the OECD web site http://www.oecd.org/daf/la/harm_tax. The case of Panama is emblematic, as this country made its public commitment in April 2002 after even threatening to retaliate against OECD Member countries and other jurisdictions that would impose the sanctions recommended by the OECD for blacklisted uncooperative jurisdictions. Such threat culminated in a proposed legislation providing for three main retaliatory measures to be adopted by Panama, among which a 40% withholding tax on all payments or remittances to banks or financial institutions established in the said countries. The draft law was contained in the Anteproyecto de ley de retorsion 47 de 2001, “Por el cual se toman medidas de retorsion para defender la economía nacional de medidas unilaterales discriminatorias contra la República de Panamá.”

\textsuperscript{148} The 7 blacklisted countries are: Andorra, Liechtenstein, Liberia, Monaco, the Marshall Islands, Nauru, and Vanuatu. See the OECD web site, which contains the list and the statement on the uncooperative tax havens by the OECD Fiscal Affairs Committee Chair, Gabriel Makhlouf. See also R. Goulder, OECD updates tax haven blacklist, claims progress in curbing harmful tax competition, Worldwide tax daily, 19/4/2002, 76-2.
defensive measures, but rather the new last-minute concessions made by the OECD to prevent a complete failure in spite of its milder approach endorsed in the 2001 Report. The two main concessions, reflected in the latest public commitments, were that: (i) tax havens would no longer be bound by the commitment in the event that all OECD member countries did not themselves comply with the same standards, and in case of their failure to do so that they would be subject to the same coordinated countermeasures originally envisaged only for tax havens, and (ii) tax havens would participate in the Forum on harmful tax competition on an equal and full access basis. What this boils down to is an apparent failure of the OECD project, at least as originally intended by the Organisation. Even though OECD officials claim success in getting several jurisdictions to make the public commitment as a result of its changed approach and to accept transparency and exchange of information in both criminal and civil tax matters, an impartial observer cannot be impressed. The feeling is that in the absence of the new concessions, which testify a dramatic scaling back as compared to the OECD initial attitude, the whole project would have been immediately buried by the Organisation as a result of the growing number of dissenting countries within the OECD (i.e. the 4 abstaining countries plus, mildly, the USA) and the inability to persuade the targeted offshore jurisdictions to adhere to it. By granting these concessions, it seems that the OECD has merely gained some more time to try and convince its reluctant Member countries to finally comply with the standards set out in the most recent Report and eventually reach a global compromise within the Forum (see below).

At the moment, nobody may predict whether the OECD finally succeeds in this extremely difficult task. While the limitation of the focus of the harmful tax competition project to transparency and exchange of information with an active involvement by all tax havens is to be welcomed as it no longer implies an interference with their tax sovereignty on the setting of tax rates and on the implementation of (ring-fenced) regimes meant to attract foreign investment, there is still a long way to find a global compromise. The main issues concern the details of the exchange of information and of the dissenting jurisdictions' domestic bank secrecy laws protecting individuals' privacy and investments. The conflicting interests at stake are the need to cooperate in money-laundering and criminal tax matters implying tax evasion with the need to avoid 'fishing expeditions' by high-tax jurisdictions' tax authorities seeking to obtain any sort of taxpayers' private information without a specific allegation or investigation of tax evasion or other "civil" tax matters.149 As for bank secrecy, the situation is even more complex since the countries' need to prevent money laundering and tax evasion must be weighed against the need to avoid hurting the financial services industry with burdensome compliance obligations or unreasonable requests, as well as to protect wealthy individuals from domestic political and/or financial turmoil.150 In their commitments, tax havens have accepted to exchange information with regard to criminal tax matters

149 In these cases, there is also the need to ensure confidentiality on the information submitted and protection of taxpayers' rights embodied in several countries' constitutions, such as due process clauses or the taxpayers' rights of defence or of being heard.
150 Banking secrecy laws are crucial to protect wealthy individuals from extremist governments (e.g. attempts by dictatorships to seize their assets) or from other possible adverse situations (e.g. kidnappings and other crimes against them to obtain their money).
even without the 'dual criminality' principle, and with regard to civil tax matters even if they do not have a domestic tax interest to obtain the information. However, they require that there be sufficient criminal allegations or evidence of a civil tax investigation to exchange the information and that specific safeguards to taxpayers' privacy and to the prevention of the unauthorised disclosure or use of such information be put in place.

The OECD has released shortly after the new black list a Model tax information exchange agreement (hereinafter: "TIEA") in the framework of its harmful tax competition project fundamentally incorporating the principles on transparency and exchange of information set out in the 2001 Report (and in the tax havens' commitments) and seeking to accommodate the above conflicting interests.\(^{151}\) The Model TIEA was developed by a working group of the Forum comprising representatives of both Member countries and committed tax havens in response to the 1998 OECD Report's criterion of "the lack of effective exchange of information."\(^{152}\) It consists of a bilateral and a multilateral version depending on the number of countries party to it and of a Commentary of each provision annexed to it. The Model TIEA applies to both criminal and civil tax matters, with different dates for its entry into force with regard to the former (i.e. 2004) and to the latter (i.e. 2006) consistently with the deadlines set by the 2001 Report. It endorses the repeal of the 'dual criminality' principle and of the requirement that the country to which the information is requested must have a domestic tax interest in obtaining that information (see Art. 5 (1) and (2)). It also adequately protects taxpayers' rights and provides safeguards meant to ensure confidentiality and prevent unjustified information requests and use (see especially Arts. 5 (5), 7 and 8). For this purpose, the TIEA allows the addressee country to decline a request in a number of circumstances (see Art. 7), which could also be used by certain countries to render ineffective the agreement. However, bank secrecy laws, although not explicitly prohibited by the TIEA, are in fact banned as countries part of an agreement commit to exchange also the relevant (financial) information held by banks and financial institutions (Art. 5(4)(a)) and are prevented from declining a request on the grounds of the presence of these laws.\(^{153}\) Lastly, the Model TIEA provides for a mutual agreement procedure between the countries' competent authorities to solve issues undermining the effective application of the agreement (see Art. 13). This provision might be useful especially for controversies on the access to information (e.g. issues on bank secrecy laws) or on denial of requests based for instance on public policy reasons.

The OECD Model TIEA represents a fundamental step towards cooperation and information exchange in tax matters between OECD countries and tax havens. The


\(^{152}\) The OECD Model TIEA was developed by the OECD's Global Forum Working Group on Effective Exchange of Information, which included representatives from OECD countries and tax havens such as Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, the Netherlands Antilles, some of which had already entered into bilateral TIEAs with the USA.

\(^{153}\) See in particular the Commentary to the OECD Model TIEA on Art. 5(4)(a), especially its Para. 46, which states that bank secrecy legislation does not form part of the public policy (ordre public) able to justify a decline in providing the information under Art. 7(4). Furthermore, its Para. 48 refers to the OECD 2000 Report Improving access to bank information for tax purposes to state that information held by banks may be obtained either directly or indirectly, and in the latter case that the process must not be time-consuming or constitute an impediment to obtaining the information.
fact that a number of representatives from the latter jurisdictions actively participated in its drafting suggests that there might be political consensus to its adoption by several such jurisdictions. However, there are still unresolved issues undermining the success of the OECD project, the most important one being bank secrecy legislation. As seen above, the Model TIEA presupposes that countries do away with it, which apparently OECD countries such as Switzerland and Luxembourg and tax havens such as the blacklisted jurisdictions are not prepared to do at the moment. Perhaps, a closer coordination of this OECD project with concurrent efforts by the OECD itself and by other organisations such as the EU (namely, in the area of the savings directive, see at 4.2.1), the FATF, and the FSF (see at 4.8.1), which also aim at (progressively) repealing bank secrecy, might eventually lead to a global compromise. It is true that these projects mainly focus on the fight against money laundering and (partly) on tax evasion and not on civil tax matters. However, they all have in common the objective to lay down similar standards for the exchange of information, they all rely on the cooperation among several jurisdictions, and they all distinguish between cooperative and uncooperative jurisdictions.

Another issue faced by the OECD project will be the major effort needed to get as many countries as possible to sign bilateral or multilateral TIEA conventions and to make them work effectively. Furthermore, it may take long for all countries, both OECD and non-OECD, having these agreements in place to provide themselves with the necessary financial and administrative resources for this purpose. In the end, the success is likely to depend on the OECD’s ability to keep up with its promises by constantly speeding up this process and providing cooperative jurisdictions with the necessary financial and administrative assistance, while at the same time persuading uncooperative OECD countries and tax havens to repeal their bank secrecy laws and join the exchange of information network. Only if an overall political compromise is reached will the OECD effort likely to achieve the 2001 Report’s objective to create a fair and level playing field among all countries, OECD and non-OECD, rich and poor, large and small.

154 It is remarkable that the Commentary to the OECD Model TIEA explicitly refers to the OECD project on bank secrecy culminated with the Report *Improving access to bank information for tax purposes*, released on 12/4/2000: see previous footnote. On this project and its updates, see on the OECD web site at [http://www.oecd.org/daf/ia/evasion/accessbankinf.htm](http://www.oecd.org/daf/ia/evasion/accessbankinf.htm).


157 See in this respect also the interview to J. Owens, *Towards world tax co-operation*, OECD Observer, 5/7/2001, available on the web site at [http://www.oecdobserver.org/news](http://www.oecdobserver.org/news). One must also consider that the chances of success of these projects, especially the FATF one, have significantly increased after the dramatic terrorist events of late 2001.
4.9 Concluding remarks on the EU and the OECD projects to counter harmful tax competition

A final analysis of the EU and OECD projects to counter harmful tax competition and the possible future developments must focus on their relationship and differences. The OECD 1998 Report stressed the broad compatibility of the two projects as well as their mutual reinforcing character, but also stated that “the Committee considers that each Organisation is responsible independently for the interpretation and application of its respective instruments”. This statement refers to the different political framework as well as to the different nature and powers of the OECD and the EU, the former being an intergovernmental body of mainly developed countries and lacking power to issue legally-binding acts towards its Member countries, the latter being a supranational body aiming at a wide integration between a smaller number of countries in the geographical area of Western Europe (and shortly also Central and Eastern Europe) and entrusted with far-reaching powers to adopt legally-binding acts towards its Member States.

The scope of the EU project is wider than that of the OECD as it covers corporate taxation as a whole, whereas the latter is limited to income from mobile (i.e. financial) activities. The Primarolo Report and the 2000 Guidelines have further widened this difference by targeting also general participation exemption and other holding company regimes, whereas the OECD 2000 Report specifically excludes these regimes from its scope even though it calls for their separate evaluation in the fight against harmful tax competition. By contrast, the scope of the OECD project is geographically more extended because this Organisation encompasses more countries and has involved several non-OECD tax-haven jurisdictions. The EU project embraces EU Member States and (to a lesser extent) their dependent and associated territories, even though it also attempts to extend its geographical reach to other non-EU countries.

As for the criteria used by the EU and the OECD to identify harmful tax regimes, they are broadly the same. The main difference concerns the criterion of exchange of information and bank secrecy laws, which in principle is used by the OECD only. In practice, however, also the EU has shown its commitment to force Member States to progressively give up their bank secrecy laws and promote full exchange of information in its fight against (money laundering and) tax evasion, which should eventually lead them to progressively dismantle these laws by the year 2010.

More important are the differences with regard to the approach chosen to counter harmful tax competition and the chances of success of the EU and OECD projects. Interestingly, the OECD 1998 Report stated that “the review procedure reflects the different institutional frameworks within which each Organisation operates” and “the EU Code is part of a Package of measures whereas the OECD Guidelines are accompanied by 19 detailed Recommendations relating to specific issues of harmful tax competition.” Looking at it retrospectively, it seems that the OECD 1998 Report already anticipated implementation problems as compared to the Code of Conduct. The latest developments concerning the OECD project confirm the lower political

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support for this project, which already caused a dramatic change in approach and a limitation of its focus to transparency and exchange of information since the release of the 1998 Report and the 2000 Progress Report (and the MOU). However, if successful the outcome of the OECD project is to be welcomed as it will imply (desirable) tax competition worldwide and leave mostly intact small countries’ tax sovereignty while providing effective instruments to counter tax evasion (and money laundering) and avoidance worldwide, especially through the new Model Convention on exchange of information in tax matters.

The most recent developments concerning the EU project confirm that the progress made within the Union has been significant, despite the difficulties surrounding the directive on savings and the uncertainty on its final approval. Regardless of the outcome of the Package and the implementation of the other two elements, it is clear that Member States are taking appropriate steps to repeal or amend their blacklisted regimes in a way compatible with the Code of Conduct (and the Primarolo Report), possibly also due to the pressure imposed by the Commission’s simultaneous use of the Treaty state aid rules against some of these blacklisted regimes. This may gradually persuade all Member States to do away with special harmful tax incentives and compete transparently through their ‘benchmark’ tax systems in order to attract investment, which will benefit the internal market as a whole and will contribute to preserve the fundamental Treaty objectives. This is also shown by the significant political support for the EU project, despite the lack of binding force of the Code of Conduct and its relating documents (i.e. the Primarolo Report and the 2000 Guidelines).

A more general conclusion one can draw is that the new EU strategy in direct tax matters, which pursues tax coordination in certain areas through political commitments and soft law instruments subject to peer pressure, is proving to be effective. Apparently, Member States feel more comfortable with these commitments than with legally binding acts enforceable before the ECJ. This underscores that in politically sensitive areas like corporate taxation a soft approach based on negotiation and political bargaining may prove successful in reaching results unimaginable to reach through legal instruments requiring consensus of all Member States. This does not mean that the EU project will certainly achieve its goal to curtail harmful tax competition within the Union while promoting desirable tax competition among Member States’ general tax systems, as the Code of Conduct, the Primarolo Report, and the 2000 Guidelines contain several flaws and inconsistencies that must still be eliminated or at least reduced. Whatever the outcome, though, the progress and the results achieved so far are remarkable to say the least, especially if one considers how sceptically this project and the release of the Code of Conduct were originally greeted by a number of politicians, legal and economic scholars, as well as representatives of the business community.