

## INTERNATIONAL

# To What Extent Does the OECD Harmful Tax Competition Project Violate the Most-Favoured-Nation Obligations under WTO Law?

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## 1. THE OECD HARMFUL TAX COMPETITION PROJECT – BACKGROUND

In 1996 the OECD launched a project on harmful tax competition that is aimed at eliminating unfair competition among countries as a result of tax provisions. The OECD limited the project to geographically mobile activities, such as financial and other service activities, including the provision of intangible assets. The analysis of the adverse effect of tax incentives designed to attract investment in plant, building and equipment has been postponed.<sup>1</sup> The report identified two separate types of regimes that are deemed to be harmful, namely tax havens<sup>2</sup> and preferential tax regimes.<sup>3</sup>

In its 2000 report the OECD listed several preferential tax regimes among its Member countries as being potentially harmful. It was observed that these regimes have questionable features, but they were not evaluated at this stage as to their actual harmfulness.<sup>4</sup> The OECD has offered its assistance in the process of doing away with harmful provisions.<sup>5</sup>

Furthermore, in 2000 the OECD issued a list of 35 so-called tax havens.<sup>6</sup> The thus denoted countries were given the possibility of making a political commitment to transparency and the effective exchange of information. Until now, only five countries – namely Andorra, the Principality of Liechtenstein, Liberia, the Principality of Monaco and the Republic of the Marshall Islands – have shown no signs of cooperation and were therefore put on the list of uncooperative tax havens.<sup>7</sup> These countries are now facing possible defensive measures, which have been recommended to the Member countries so as to induce the listed tax havens to cooperate. Instead of acting unilaterally, for purposes of increased effectiveness the Member countries may coordinate their defensive measures, while preserving their sovereign right to decide which actions to take.<sup>8</sup>

The proposed defensive measures, as revised in the 2004 progress report, are as follows:<sup>9</sup>

- the use of provisions having the effect of disallowing any deduction, exemption, credit or other allowances in relation to all substantial payments made to persons located in countries or jurisdictions engaged in harmful tax practices except where the taxpayer is able to

establish satisfactorily that such payments do not exceed an arm's length amount and correspond to bona fide transactions;

- the use of thin capitalization provisions restricting the deduction of interest payments to persons located in jurisdictions engaged in harmful tax practices;
- the use of legislative or administrative provisions having the effect of requiring any resident who makes a substantial payment to a person located in a country or jurisdiction engaged in a harmful tax practice, enters into a transaction with such a person, or owns any interest in such a person to report that payment, transaction or ownership to the tax authorities, such requirement being supported by substantial penalties for inaccurate reporting or non-reporting of such payments;
- the use of legislative provisions allowing the taxation of residents on amounts corresponding to income that benefits from harmful tax practices that is earned by entities established abroad in which these residents

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1. OECD, *Harmful Tax Competition – An Emerging Global Issue* (1998), Para. 8.

2. Tax havens have been identified as such according to the following four criteria: the imposition of no or only nominal taxes by the respective jurisdiction, the lack of effective exchange of information, the lack of transparency and the absence of the requirement that the activity be substantial. See note 1, Para. 52.

3. Preferential tax regimes were identified according to four key factors (no or low effective tax rates, ring fencing of regimes, lack of transparency, lack of effective exchange of information) and several other factors, such as an artificial definition of the tax base, failure to adhere to international transfer pricing principles, existence of secrecy provisions, negotiable tax rate or tax base and other. See note 1, Para. 62 et seq.

4. OECD, *Towards Global Tax Co-operation – Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs* (2000), Paras. 10-11.

5. Out of the 47 potentially harmful preferential tax regimes, 18 regimes have been abolished or are in the process of being abolished and 14 have been amended in such a way that all potentially harmful features were removed. After further consideration 14 were declared not to be harmful. Only the Swiss 50/50 Practice with regard to Financing and Leasing will be subject to further analysis. OECD, *The 2004 Progress Report*, Para. 11 et seq.

6. See note 4, Para. 17.

7. Please visit [http://www.oecd.org/document/57/0,2340,en\\_2649\\_33745\\_30578809\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/57/0,2340,en_2649_33745_30578809_1_1_1_37427,00.html) for an updated list of uncooperative tax havens.

8. See note 5, *Progress Report*, Para. 31 et seq.

9. *Id.*, Para. 30.

have an interest and which would otherwise be subject to substantially lower or deferred taxes;

- the denial of the exemption method or modification of the credit method. Where a country levies no or nominal taxes on most of the income arising therein because of the existence of harmful tax practices, it may not be appropriate for such income to receive an exemption otherwise intended to relieve double taxation. Member countries that permit foreign tax credits may wish to modify those rules to prevent the pooling of income benefiting from harmful tax practices with other income. In addition, such countries may wish to implement systems to verify that the amounts claimed actually constitute creditable taxes;
- the use of legislative provisions ensuring that withholding taxes at a minimum rate apply to all payments of dividends, interest and royalties made to beneficial owners benefiting from harmful tax practices;
- the use of provisions for special audit and enforcement programmes to coordinate enforcement activities involving entities and transactions relating to countries and jurisdictions engaged in harmful tax practices; and
- terminating, limiting and not entering into tax treaties. Participating countries could adopt, and make public, a policy of not entering into tax treaties with countries and jurisdictions involved in harmful tax practices. Those that are parties to treaties with such countries and jurisdictions may wish to take appropriate measures to ensure that these treaties are limited or terminated. Alternatively, participating countries could consider that all existing or proposed treaties with a country or jurisdiction engaging in harmful tax practices contain a limitation of benefits clause which would prevent the benefits of the treaty from being claimed by third-country residents who had no real connection with the country or jurisdiction. With respect to terminating an existing treaty, it is recognized that such action has important implications that go beyond the revenue impact of the treaty.

The list of possible defensive measures is not exhaustive or exclusive. Still, the above-mentioned measures are seen as being appropriate as well as the best means to neutralize harmful effects of such “unfair” tax regimes.<sup>10</sup>

Uncooperative tax havens have to face severe economic and political disadvantages. It has yet to be discussed to what extent these measures might violate the most-favoured-nation (MFN) obligation under the GATT<sup>11</sup> or GATS.<sup>12</sup> The treatment of uncooperative tax havens differs from that of cooperative ones, Member countries with preferential tax regimes, or any third country.

## 2. MOST-FAVOURLED-NATION OBLIGATION UNDER GATT AND GATS

The GATT and GATS are multilateral trade agreements. The GATT is applicable to the supply of goods, whereas the GATS deals with cross-border trade in services except for those services supplied through the exercise of governmental authority. Legal definitions for the terms “goods” or “services” are not provided for in the agreements.

Under both agreements the Member countries are bound by an MFN obligation. Art. I of the GATT provides that:

with respect to customs duties and charges of any kind imposed on or in connection with importation or exportation, [...] with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, [...] any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.<sup>13</sup>

According to Art. II of the GATS “each member country shall immediately and unconditionally accord to services and service suppliers of any other member country treatment no less favourable than that it accords to like services and service suppliers of any other country.”<sup>14</sup>

Art. II of the GATS is clearly applicable to direct taxation, since it provides that neither the supply of services nor the service suppliers themselves may be treated less favourably. Whether this conclusion can also be drawn with regard to Art. I of the GATT is disputed. The historic assumption of the draftsmen was that Art. I of the GATT does not deal with taxes on income, but on goods. I tend to hold that, although direct taxes are generally levied on income, they can nevertheless be, to a certain extent, defined as taxes on goods. As soon as demand exceeds supply, the entrepreneur has the power to at least partly shift his tax burden on to the consumers by increasing his prices to earn the desired income after taxes. Of course, the extent of this effect depends also on the level competitiveness within the market.<sup>15</sup>

This point of view is still harshly criticized by academics who prefer a narrow interpretation of the term “taxes on goods”.<sup>16</sup> But WTO panels have already demonstrated their willingness to consider direct taxes for specific WTO obligations.<sup>17</sup> Also, tax authorities apparently assume that the scope of Art. I of the GATT comprises direct taxes. Otherwise they would not explicitly include MFN treatment under the GATT in the non-discrimination obligation

10. See note 5, *Progress Report*, Para. 30.

11. General Agreement on Tariffs and Trade.

12. General Agreement on Trade in Services.

13. For general information, see Berrisch, in Prieß/Berrisch (eds.), *WTO-Handbuch* (2003), p. 96 et seq.; Lal Das, *The World Trade Organisation – A Guide to the Framework for International Trade* (1999), p. 15 et seq.; Jackson, *World Trade and the Law of GATT* (1969), p. 249 et seq.; Zinser, *Das GATT und die Meistbegünstigung* (1962).

14. For general information, see Yi Wang, “Most-Favoured-Nation Treatment under the General Agreement on Trade in Services – And Its Application in Financial Services”, 30 (1) *JWT* 1996, p. 91; Abu-Akeel, “The MFN as it Applies to Service Trade”, 33 (4) *JWT* 1999, p. 103; Senti/Weber, “Das allgemeine Dienstleistungsabkommen (GATS)”, in Thüerer/Kux (eds.), *GATT 94 und die Welthandelsorganisation* (1996), p. 129; Pitschas, in Prieß/Berrisch (eds.), *WTO-Handbuch*, p. 511 et seq.

15. Fischer-Zernin, *Internationale Ertragsteuern und Welthandelsordnung* (1996), p. 18 et seq.; Demaret/Stewardson, “Border Tax Adjustments under Gatt and EC Law and General Implications for Environmental Taxes”, 28 (4) *JWT* 1994, p. 5 (at 14 et seq.).

16. Dam, *The GATT* (1970), p. 124 et seq.; Avi-Yonah, “Treating Tax Issues Through Trade Regimes”, 26 *Brooklyn Journal of International Law* 2001, p. 1683 (at 1684); Stockmann, “Völkerrechtliche Meistbegünstigungsklausel und Internationales Steuerrecht”, *ISr* 1999, p. 129 (at 134 et seq.). Compare also Art. 18 of the Havana Charter.

17. Compare e.g. the *DISC*, *FSC* and *ETI* cases.

in tax treaties.<sup>18</sup> For purposes of the following analysis it is therefore assumed that direct taxes fall within the scope of Art. I of the GATT.<sup>19</sup>

Both agreements provide for certain exceptions, e.g. for customs unions and free trade areas,<sup>20</sup> government procurement,<sup>21</sup> or in order to facilitate exchanges limited to contiguous frontier zones.<sup>22</sup> Developing countries may receive preferential treatment.<sup>23</sup> The MFN obligation may temporarily be suspended if there are extraordinary circumstances, such as a state of emergency,<sup>24</sup> internal security,<sup>25</sup> *ordre public*,<sup>26</sup> or the equilibrium of the balance of trade and payment.<sup>27</sup> Preferences in respect of import duties and charges in force between specific territories at the time of signing the GATT may also be adhered to.<sup>28</sup> In addition, the GATS provides an MFN exception for discrimination covered by tax treaties.<sup>29</sup> Countries were also given the possibility to maintain measures inconsistent with the MFN principle provided that the Member countries had included these measures in a list of exceptions upon acceptance of the GATS.<sup>30</sup>

### 3. POSSIBLE VIOLATION OF THE MOST-FAVOURLED-NATION PRINCIPLE IN WTO LAW BY DEFENSIVE MEASURES

The defensive measures listed in the 2000 report<sup>31</sup> have been criticized for being, in part, inconsistent with the MFN principle of the GATT and the GATS.<sup>32</sup> In its 2004 Progress Report the OECD has partly revised, amended and substantiated the list of recommended defensive measures. It needs to be examined whether the OECD took this criticism into account and withdrew non-compatible defensive measures. Although Andorra, Liberia, Monaco and the Marshall Islands are not members of the WTO, Liechtenstein is. If the OECD decides to take adverse action against this country, Liechtenstein may use the procedures offered by WTO law to combat this treatment. Liechtenstein would have to separately address each country participating in this coordinated action.<sup>33</sup> But even countries<sup>34</sup> that have committed themselves to the programme of the OECD face adverse action if they do not satisfactorily fulfil the demands of the OECD countries.<sup>35</sup> As long as defensive measures are only announced as being impending, it is questionable whether there is a basis for a WTO consultation. GATT jurisprudence is ambiguous in that respect.<sup>36</sup>

Possible defensive measures may affect the supply of goods or services, depending on how the participating countries shape their sanctions. Nowhere do the OECD reports state that the participating countries must exclusively aim their defensive measures at financial or banking services. The respective country may freely decide – after consultations – which measure best serves to neutralize detrimental effects, as long as the measure is proportionate.<sup>37</sup> The disallowance of deductions or exemptions, the levy of withholding taxes or the taxation of certain income may also be imposed with regard to the supply of goods.

Except for the last-mentioned sanction, the proposed defensive measures are very likely to violate the MFN obligations under the GATT and GATS. They constitute

either a tax or administrative measure based upon all or selected transactions, or a tax or administrative measure that would penalize the income of a taxpayer trading in goods and services.<sup>38</sup> As this does not affect similar transactions with third countries, they can at first glance be classified as discriminatory. The last sanction with regard to terminating, limiting or not entering into tax treaties is a political one and therefore – although the consequence may be a higher tax burden for the individual – does not violate GATT/GATS obligations. Member countries are not obliged to maintain tax treaties with other states. The other proposed defensive measures possibly violating the MFN principle may fall under an exception or may be justified. This will be examined in the following section.

## 4. EXCEPTIONS

### 4.1. Possible violation of GATT

Art. XX(d) of the GATT allows an exception for any measure “necessary to secure compliance with laws or regula-

18. Compare Art. 1(3)(b) of the US Model Convention: “Notwithstanding the provisions of subparagraph 2(b): [...] b) unless the competent authorities determine that a taxation measure is not within the scope of this Convention, the non-discrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade. [...]” Such provisions were concluded between the United States and Austria, Denmark, Estonia, France, Ireland, Italy, Latvia, Lithuania, Luxembourg, Slovenia, South Africa, Sri Lanka, Sweden, Switzerland, Thailand, Turkey and Venezuela.

19. For a more extensive reasoning and further references, see Hofbauer, “Die abkommensrechtliche Verteilung der Besteuerungsrechte zwischen Ansässigkeits- und Quellenstaat aus WTO-rechtlicher Sicht”, in Gassner/Lang/Schuch/Staringer (eds.), *Die Verteilung der Besteuerungsrechte zwischen Ansässigkeits- und Quellenstaat in den Doppelbesteuerungsabkommen*, (in print).

20. Art. XXIV.4-10 GATT, Art. V GATS.

21. Art. III.8(a) GATT, XVII GATT, Art. XIII GATS.

22. Art. XXIV.3(a) GATT, Art. II.3 GATS.

23. Decision on “Differential and more favourable treatment, reciprocity and fuller participation of developing countries.”; Art. IV GATS; Art. XIX GATS.

24. Art. XIX GATT, Art. XIV GATS.

25. Art. XXI GATT.

26. Art. XIV GATS.

27. Art. XIV GATT.

28. Art. I.2 GATT.

29. Art. XIV(e) GATS.

30. Art. II.2 GATS.

31. See note 4, Para. 35.

32. Grynberg/Chilala, “WTO Compatibility of the OECD ‘Defensive Measures’ against ‘Harmful Tax Competition’”, *Journal of World Investment* 2001, p. 507; Bartholet, “WTO und Steuern – Interdependenzen von WTO-Grundprinzipien und nationalem Steuer- und Abgaberecht”, *Archiv für Schweizerisches Abgaberecht* 2003/2004, No. 6/7, p. 337 (at 360 et seq.); Gross, “OECD Defensive Measures against Harmful Tax Competition Legality under WTO”, *Intertax* 2003, p. 390; Almodí Cid/López Barrero/Serrano Antón, “La organización mundial del comercio como límite a la potestad tributaria de los estados”, *Quincena Fiscal* 2002-II, p. 9 (at 20 et seq.).

33. All OECD members are also members of the WTO.

34. The following cooperative tax havens are WTO members: Antigua and Barbuda, Bahrain, Barbados, Belize, Dominica, Grenada, Maldives, Netherlands Antilles, Panama, St. Lucia, and St. Vincent and the Grenadines. The following have observer status at the WTO: Andorra, Bahamas, Samoa, Seychelles, Tonga and Vanuatu.

35. See note 4, Para. 22.

36. See note 33, Grynberg/Chilala p. 507 et seq., at chapter 3.

37. See note 5, Progress Report, Para. 29.

38. See note 33, Grynberg/Chilala, p. 507 et seq., at chapter 3.

tions which are not inconsistent with the provisions of this Agreement, including those relating to [...] the prevention of deceptive practices.”<sup>39</sup> The meaning of the prevention of specific practices has been interpreted strictly by panels. Only enforcement measures rather than punitive measures are covered.<sup>40</sup> In this light the OECD defensive measures may hardly be subsumed under Art. XX(d) of the GATT since they constitute punitive measures for cases when tax havens are unwilling to cooperate.<sup>41</sup> Other suitable exceptions cannot be found in the GATT.

#### 4.2. Possible violation of GATS

Under Art. II.2 of the GATS, states are allowed to maintain a measure inconsistent with the MFN principle provided that such a measure was listed in the Annex to Art. II of the GATS. The United States filed a broad exemption for all direct tax measures influencing service supplies of all sectors at the federal level and, with some limitations, also for sub-federal tax measures.<sup>42</sup> Within its individual or corporate income tax law the United States may therefore treat any third state differently from other states. Defensive measures taken by the United States within the harmful tax competition project and directed at service supplies or service suppliers are therefore not enforceable under WTO law.<sup>43</sup>

Other countries have made sector-specific restrictions.<sup>44</sup> Although these are not full direct tax carve-outs, they may still have repercussions, depending on which restrictions were announced and what limitations exist thereto.<sup>45</sup> It is therefore possible that one OECD member could argue that the defensive measure taken falls under its “personal” exceptions, as announced, whereas the same measure is seen as being inconsistent with Art. II of the GATS by another Member country. Regarding insurance services the Understanding on Commitments on Financial Services may also provide for exceptions.

Like Art. XX(d) of the GATT, Art. XIV(c) of the GATS allows measures “necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this agreement, including those relating to i) the prevention of deceptive and fraudulent practices [...]” Although the aim of the OECD’s harmful tax competition project is to increase transparency and the effective exchange of information and to abolish the discrimination between onshore and offshore activities, these goals cannot be subsumed under this exception. Art. XIV(c) of the GATS refers to commercial fraud rather than any civil tax matters and is therefore not in line with the mission of the OECD.<sup>46</sup> In addition, it can be argued that the term “prevention” will be interpreted similarly to the equivalent GATT provision although no case law exists in this respect.

Art. XIV(e) of the GATS provides for a carve-out for any discrimination of residents of third countries if this different treatment is subject to a tax treaty or a similar treaty. If any adverse action against service supplies or service suppliers is implemented through a tax treaty, it thus cannot be combated. This exception again is subject to the condition

that these measures may not lead to arbitrary and unjustifiable discrimination, which might easily be the case if adverse actions in a tax treaty are only taken against a single country.<sup>47</sup> Especially the first and fifth adverse actions, which deal with the credit of foreign taxes and the exemption of income earned abroad, may fall under this exception as long as they are executed via a tax treaty. Unilateral measures are not subject to this exception and, thus, the MFN principle still has to be adhered to.

#### 5. SUMMARY

OECD members are well advised to abstain from extensive discriminatory taxes and administrative measures. Concerned tax havens will keep an eye on possible sanctions taken by the members. As long as both sides are parties to the WTO Agreement these defensive measures may be combated in respect of possible inconsistency with WTO law. There is a good chance that a WTO panel would declare such defensive measures in conflict with the MFN under the GATT and/or GATS as most of them do not fall under an exception. It has been established that possible exceptions regarding the supply of services are more numerous than those under GATT law. This is due to the fact that the negotiating governments were more cautious when drafting the GATS, as the supply of services was seen as a more sensitive business area. Only the implementation of several exceptions to leading principles eventually led to the conclusion of the agreement.

Final conclusions cannot be drawn. For one, the measures are hardly actionable at the moment as they need to be implemented first. Secondly, only a demonstrative list of possible defensive measures exists, and there is no guarantee that only these will be used in exactly the way they are defined. It will also make a difference which countries will participate in a coordinated proceeding, as only WTO member countries can be addressed by a WTO panel. The United States, for example, has completely opted out of any responsibility with regard to discrimination caused by direct tax matters in service supplies. Another disadvantage for the claimant is that the respective country will have to denounce each participating country separately.

The only conclusion to be drawn is that the OECD has not considered the criticism concerning its proposed defensive measures.

39. In addition, the applicability of Art. XX(d) of the GATT is subject to the restriction that only measures that are applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail may fall under this exception; see note 14, Berrisch, p. 152 et seq.

40. Panel Report “EEC-Regulation on Imported Parts and Components”, L/6657, adopted 16 May 1990, 37/s 195-197, Paras. 5.14-5.18.

41. See note 33, Grynberg/Chilala 507 et seq., at chapter 3.II.

42. GATS/EL/90, 15 April 1994.

43. See note 33, Grynberg/Chilala, p. 507 et seq., at chapter 3.II; See note 32, Barholet, p. 358.

44. Art. II.2 of the GATS and the respective Annex.

45. Some of these exemptions only last for a 10-year period.

46. See note 33, Grynberg/Chilala, p. 507 et seq., at chapter 3.II.

47. See note 33, Gross, p. 397.