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EUROPE LEADS THE FIGHT AGAINST TAX HAVENS

Europe contains a number of tax havens, but is becoming less tolerant of them: in fact, the European Union has increasingly taken the lead in the global fight against tax havens and offshore financial centres. Christian Chavagneux and Ronen Palan outline how the EU is leading the way.

The European Community's Court of Justice (the highest court in the EC) has signalled how attitudes are shifting in Europe. As recently as 2005, the Court tended to side with individuals and corporations and not with states seeking to protect their revenues. But then, in a landmark judgement in April 2005 (the Halifax case), the Court ruled that European law forbids transactions having the sole purpose of creating a tax advantage. This interpretation was reaffirmed in a case involving Cadbury Schweppes in May 2006, when the court condemned what it called "wholly artificial" subsidiaries in tax havens. In another important judgement delivered on 13 March 2007 (the so-called 'thin-cap' affair), the Court ruled that states could restrict freedom of establishment of wholly artificial structures devoid of economic reality and having tax avoidance as their principal objective.

Three swallows do not, of course, make a summer: we must carefully monitor future rulings. But the change in attitude signals that something important is happening.

European states, for their part, have been making progress on three fronts.

First, on the **taxation of the savings of non-residents**. Since July 2005, an EU directive applying to all member states requires information to be exchanged on non-resident deposits with the relevant national authorities. Austria, Belgium and Luxembourg secured the right to retain their banking secrecy, but are required to impose a withholding tax on earnings from deposits starting at a rate of 15 per cent from 2005 to 2007, rising to 20 per cent from 2008 to 2010, and to 35 per cent thereafter. This depended on applying equivalent measures to the principal non-EU member state competitors (Andorra, Liechtenstein, Monaco, Saint Moreno, Switzerland) plus all the dependencies and associated territories

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of member states (the Channel Islands, Isle of Man, and Caribbean islands). And, despite pessimism about being able to do this, this was achieved. European financial diplomacy has continued: in early 2006, the Cayman Islands and Montserrat agreed to information exchange in principle, and the British Virgin Islands and Turks and Caicos opted for the principle of a withholding tax.

The European Commission admits that some of Europe's offshore capital has simply fled to Asia as a result. But this has prompted the EU to widen the geographical scope of its initiative, and now it is seeking to open negotiations with Hong Kong, Singapore, Macau and Japan, as well as with Canada, Bahrain, Dubai and the Bahamas. Since last March, there are clear indications that the Commission has targeted several loopholes in the directive, and is working with financial intermediaries to try and identify how best to close them. After that, the EU will have to convince the tax havens to follow suit, as it has already done with the original directive. According to tax expert Richard Murphy "if that happens, most of the existing loopholes in the directive will disappear".

Second, the EU is also pushing for the **harmonisation of company taxation** across the community. Multinational companies with subsidiaries in more than one European country pay taxes in the countries they operate in, but they tend to shift profits to the lowest-tax country through complex systems of transfer pricing. A European-wide tax base would reduce the incentives for doing so: applying a "formulary apportionment" process would mean that group profits are taxed just once in the EU, and the resulting revenues are then distributed between the different countries according to agreed criteria (e.g. amount of capital invested, sales turnover) as is already done between states in the U.S., and in Canada. There is a long way to go before a consensus is reached, but Germany and France support the proposal. The United Kingdom and Ireland, predictably, oppose it, because they fear that harmonisation of the tax base will be followed by harmonisation of tax rates. The proposal is also opposed by the Baltic states and Slovakia, which fear that a harmonised tax base will be narrower, and will allow more exemptions, than their existing regimes. The Commission has given itself until 2008 to come up with a directive for company taxation.

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Finally, for several years a **code of good conduct on business taxation** has been applied within the European Union. The code does not have the status of a legal instrument, but provides an informal approach to regulation which has nonetheless proved effective. In adopting this code, member states have been working towards eliminating a number of harmful tax competition practices and avoiding new ones. The code sets out explicit criteria for identifying harmful tax practices in the EU, including: lack of transparency; tax rates significantly lower than in other countries; tax advantages specifically targeted at non-residents (i.e. ring fenced from the local economy) or targeted at economic or financial activities not connected to real domestic economic activity; or ways of taxing profits that fall outside international norms.

The code of conduct introduced an important innovation that overturns a traditional objection of tax havens: that under the principle of sovereign equality large and powerful states cannot dictate to smaller states what laws or rules they can or cannot impose in their own territories. To avoid the charge of 'imperialism', the code does not try to elaborate a principle of "just taxation" and then impose this on recalcitrant states. Instead, taking a line of reasoning adopted by the OECD, the code accepts the principle of tax competition, allowing states freedom of choice in this matter. But then, crucially, it insists that the tax regime's rules are applied equally on all businesses in the jurisdiction. This confronts and challenges jurisdictions that have created a niche in the global economy precisely by making a distinction in their tax treatment between resident and non-resident companies. Citing the code, for example, in 2006 the Commission forced Luxembourg to abandon its tax regime for holding companies. Similarly, the adoption of new tax regimes by Jersey, Guernsey and the Isle of Man from 2008 onwards (notably the 0% tax rate on business profits) may be taken to task for not respecting the Code.

The struggle against tax havens has a long and difficult road ahead. But we should recognise that the European Union has already taken several positive steps, and seems to want to go still further.

Christian Chavagneux and Ronen Palan co-authored Les paradis fiscaux *published by La Découverte, Paris, new edition 2007*

UPDATE

Europe is playing hardball on this: Reuters reported on October 2 that Singapore's refusal to soften its strict bank secrecy laws could scupper talks with Europe about a trade agreement. "Clearly people engaged in money laundering are looking for places like Singapore with low levels of transparency to actually engage in money laundering," said Glyn Ford, a Member of the European Parliament. "Is this a dealbreaker? Potentially yes."