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## The Polarities of Tax Competition

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Tax competition is a topic that is often discussed in the forums of international tax lawyers. Not only lawyers but also economists, politicians, and other scientists discuss tax competition topics. One of the elements that characterize such discussions is the polarity of the key aspects of tax competition. Such polarities are the focus of this article, which pulls together disparate discussions on tax competition polarities. This article adds to the existing knowledge some key elements to consider while studying this field. In that context, this article claims that the study of tax competition should not be done in a one-way approach, rather in a two-way approach.

**Key words:** tax, competition, polarity, harmful

### 1. INTRODUCTION

From the near past and continuing nowadays, tax competition is among the hot topics of discussions in international tax law.<sup>1</sup> Considering the countries' motives to engage in tax competition and tax competition effects, there is no expectation that these discussions shall end soon. This scepticism is more supported by several challenging themes on tax competition whose solutions are not yet found today.

For instance, so far there is no clear definition of harmful tax practices. More than that, instead of engineering a clear definition of harmful tax practices, the pioneering

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<sup>1</sup> OECD, *Countering Harmful Tax Practices More Effectively Taking into Account Transparency and Substance: Action 5: 2015 Final Report* (OECD /G20 Base Erosion and Profit Shifting Project, Paris: OECD Publishing, 2015) p. 3; H Gribnau, 'The Integrity of the Tax System after BEPS: A Shared Responsibility' (2017) ELR 1, p. 12.

institutions in curtailing that practice such as the European Union (EU) and the Organisation for Economic Cooperation and Development (OECD) elaborated on the components of harmful tax practices and the criteria to base on when determining whether or not a regime is harmful. It is unfortunate that those qualifying criteria are also subject of controversies.

As a result, as of now, there is so far no clearly established borderline demarcating unfair tax competition from fair tax competition. Countries and international organisations have also failed to reach a settlement on the definition of harmful tax competition nor on when the harmfulness begins.<sup>2</sup> There is also no clear distinction between permissible practices versus impermissible practices. A variety of competing theories also exist in the field of tax competition, which fuels again the field's discussions. This article is a theoretical inquiry of these polarities. Doing so, the end aim is not to show the existing polarities of tax competition. It is rather to investigate such polarities to show the approach that should be undertaken while studying the field of tax competition.

Recognised as the most dominant legal method in the legal world of research,<sup>3</sup> the legal doctrinal approach was mainly used to produce this article. It has been desk-research, or library-based, and consisted of rigorous analysis and creative synthesis and connections between disparate relevant literature such as legal texts and scholarly publications. This article is structured into eight sections, this introduction being the first. Considering the subject of this article, the polarities are presented in six sections as follows: Section two deals with the polar distinction between tax competition definitions versus tax competition components. Section three is devoted to the permissible versus an impermissible factor of tax competition, while section four focuses on fair versus unfair tax competition polarity. Section five looks at the leviathan versus race to the bottom theories of tax competition. Section six reflects on the principles of tax

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<sup>2</sup> L V Faulhaber, 'The Trouble with Tax Competition: From Practice to Theory' (2018) *Tax Law Review* 71(311) p. 312.

<sup>3</sup> T Hutchinson, 'The Doctrinal Method: Incorporating Interdisciplinary Methods in Reforming the Law' (2015) *European Law Review* 3, p. 131.

competition versus tax competition practices, while section seven looks at the distinction between harmless tax competition versus harmful tax competition. The discussions in this article supplement the world's knowledge in terms of tax competition and contribute to the discussions that are continuously and globally engaged around tax competition. This article also sheds the light on the approach that should be undertaken when studying tax competition. Section 8 is the concluding section.

## **2. HARMFUL TAX COMPETITION: DEFINITIONS VERSUS COMPONENTS**

Without undermining a variety of initiatives dealing with tax competition, this area is mainly characterised by a paucity of definitions of the key concepts underlying it. For example, so far there is no accepted definition of harmful tax competition.<sup>4</sup> The same is the case of the concepts of harmful tax practices, tax havens, harmful preferential tax regimes, which so far have not yet got consistent definitions. The key institutions that are generally considered as the pioneers of regulating tax competition also expressed low interest in defining such concepts. That is the case of the OECD, whose 1998 report on harmful tax practices failed to provide exact definitions<sup>5</sup> and frankly admitted the absence of exact technical meaning of harmful tax competition.<sup>6</sup> As a remedy, the OECD focused on providing details of harmful tax practices aspects without providing proper and consistent technical definitions, which pushed scholars to criticise that approach as constituting a case of 'confusion and puzzle'.<sup>7</sup>

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<sup>4</sup> Faulhaber (n 2) p. 312 and 314.

<sup>5</sup> G M Melo, 'Taxation in the Global Arena: Preventing the Erosion of National Tax Bases or Impinging on Territorial Sovereignty (A Critique of the OECD'S Report: Harmful Tax Competition: An Emerging Global Issue)' (2000) *Pace International Law Review* 12(183) p. 186 and 197.

<sup>6</sup> OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD publications, 1998) p. 20.

<sup>7</sup> C Pinto, 'Tax Competition and EU Law' (Doctoral Thesis, University of Amsterdam, 2002) p. 217.

Opposite to the paucity of definitions, the efforts have been concentrated on the components. According to the OECD, harmful tax practices expand on two close but separate related phenomena namely tax havens and harmful preferential tax regimes. A combination of both two phenomena makes up harmful tax practices.<sup>8</sup> The two are very close to an extent that they both share two out of their four main key indicators, namely lack of transparency and lack of effective exchange of information. More than that, tax havens and preferential tax regimes both have common aspects of facilitating tax minimisation in one way or another.

However, the two are also distinct. The main difference between tax havens and harmful preferential tax regimes is elaborated on as follows:

Tax havens have no interest in preventing the race to the bottom whereas countries with harmful preferential regimes may have an interest in eliminating harmful tax competition on condition that other countries do the same.<sup>9</sup>

Another difference between the two is the fact that tax haven refers to a jurisdiction while preferential tax regime refers to a system. Even so, both phenomena are internationally not accepted. In this regard, the question remains: what is permitted and what is not permitted? This makes the subject of the next section.

### 3. PERMISSIBLE VERSUS IMPERMISSIBLE FACTOR

In the practice of tax competition, some behaviours are permitted while others are not. In a general consideration, harmful tax practices are not accepted and are generally discouraged. Opposed to that, tax competition *per se* is generally perceived as not problematic and is even encouraged. As a matter of exemplification, the Explanatory Memorandum to the 2011 Consolidated Common Corporate

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<sup>8</sup> OECD 1998 Report (n 6) p. 8.

<sup>9</sup> B J Arnold & M J McIntyre, *International Tax Primer* (2<sup>nd</sup> ed., Wolters Kluwer, 2002) p. 139 and 141.

Tax Base (CCCTB) Proposal of the European Commission states that:

Fair tax competition on tax rates is to be encouraged. Differences in rates allow a certain degree of tax competition to be maintained in the internal market and fair tax competition based on rates offers more transparency and allows the Member States to consider both their market competitiveness and budgetary needs in fixing their tax rates.<sup>10</sup>

Member States' fiscal sovereignty is also recognised under the EU law, which, as a matter of principle, sets tax competition as a norm.<sup>11</sup> Scholars also recognise some of the tax competition benefits such as restraining appetite for higher taxes, preventing tax cartels, promoting investment and economic growth, spurring productivity and innovation, pressuring States to become more efficient on how they raise and spend taxes.<sup>12</sup> Furthermore, it is an indisputable fact that tax competition can be good and desirable as it can be bad or harmful.<sup>13</sup> As enshrined in the preamble of the EU Council on the Code of Conduct for Business Taxation, the EU Council and Governments representatives have acknowledged 'the positive effects of fair competition' whilst noting that tax competition may lead to harmful effects.<sup>14</sup>

In the above consideration, it becomes undisputable that not all tax competitions are equally harmful<sup>15</sup> and tax competition may be beneficial, therefore promotable as it can be harmful, therefore curtailable.<sup>16</sup> Tax competition benefits

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<sup>10</sup> European Commission, Explanatory Memorandum to a Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), Brussels, COM(2011) 121/4 2011/0058 (CNS) {SEC(2011) 315} {SEC(2011) 316} p. 4.

<sup>11</sup> Pinto (n 7) p. 52, 78, 300 and 302.

<sup>12</sup> P Lampreave, 'Fiscal Competitiveness versus Harmful Tax Competition in the European Union' (2011) *Bulletin of International Taxation* 65(6) p. 5.

<sup>13</sup> Pinto (n 7) p. 1.

<sup>14</sup> EU Code of Conduct 1997: Conclusions of the ECOFIN Council meeting of 1<sup>st</sup> December 1997 concerning taxation policy DOC 98/C2/01, *Official Journal of the European Communities*, (6.1.98) C 2/3.

<sup>15</sup> R S Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) *Harvard Law Review* 113(7) p. 1610.

<sup>16</sup> Pinto (n 7) p. 297.

are associated with the hard-core element underlying the philosophy behind tax competition which is about improving a country's economic and social situation through business attraction as a result of lowering the tax burden.<sup>17</sup> Thus considered, as long as sovereignly designed tax measures comply with internationally accepted standards, the system is good and acceptable.<sup>18</sup>

Beneficial tax competition is also further justified by the existence of different national tax systems, which are designed differently pursuant to the universally accepted principle of tax sovereignty. In this respect, while a country is enjoying its tax sovereignty, it is acceptable to set up tax measures purposed at attracting new and genuine investment.<sup>19</sup> It can as well do set up a tax system purposed at favouring the development of a given disadvantaged area.<sup>20</sup> Thus, two cases can justify the use of favourable tax measures, namely attraction of real business activities, i.e. not letterbox or paper companies and favouring a disadvantaged area, which may be a geographical area or a business activity area.

The situation of tax competition that aims at attracting real and genuine business activities poses a challenge when it poaches other countries' tax bases. Even if the country can initiate tax competition without an intention of poaching other countries' tax bases when it reaches this level, it changes from permissible tax practice to impermissible tax competition. At this level, the term 'poaching' becomes closely associated with harmful tax competition by the fact that countries' revenues, capital, and financial flows are not influenced by the domestic tax policies rather by the spill-over effects of other countries' aggressive tax policies.<sup>21</sup>

Thus, tax competition becomes problematic when it crosses from being a mere tax competition to become a harmful tax competition. Therefore, the main baffling and pending issue remains the qualifying element to distinguish harmless tax competition from harmful tax competition. In

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<sup>17</sup> Id., p. 1.

<sup>18</sup> OECD 1998 Report (n 6) p. 15.

<sup>19</sup> Pinto (n 7) p. 216.

<sup>20</sup> Ibid.

<sup>21</sup> OECD 1998 Report (n 6) p. 16.

other words, this leads to thinking of permissible tools that can be used for tax competition and impermissible tools that cannot be used. In other words, the question here is how to distinguish permissible tax competition from the impermissible tax competition?

It is unfortunate that so far there is no objective, distinct and clear answer to this as no single factor can be raised up as a qualifying element. In other words, the issue of the distinction between the two remains so far a puzzle and it appears very difficult to agree upon a borderline between permissible and impermissible tax competition<sup>22</sup> because of a lack of a consistent factor (s). Nonetheless, the distinction puzzle exists not only for the permissible and impermissible tools to tax competition, but also the puzzle exists on the issue of tax competition (un) fairness.

#### 4. FAIR VERSUS UNFAIR TAX COMPETITION

Closely connected to the previous section, fairness and unfairness of tax competition have been also brain-teaser. Distinguishing fair tax competition from unfair tax competition has been described as very contentious,<sup>23</sup> difficult,<sup>24</sup> and thorniest.<sup>25</sup> Furthermore, no practical criterion has been singled out to draw the borderline.<sup>26</sup> In this regard, one scholar highlights that:

It is very difficult to reach a consensus upon a borderline between fair and unfair competition.  
[...] From the legal point of view, it is even more

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<sup>22</sup> A Nahayo, *Harmonising Income Tax Laws within the East African Community Common Market: A Critical Assessment of its Viability* (PhD Thesis, University of Dar es Salaam, 2014) p. 63, unpublished.

<sup>23</sup> H J Ault, 'Reflections on the Role of the OECD in developing International Tax Norms' (2009) *Brooklyn Journal of International Law* 34(3) p. 765.

<sup>24</sup> Lampreave (n 12) p. 3; L Cerioni, 'Harmful Tax Competition Revisited: Why not a Purely Legal Perspective under EC Law?' (2005) *European Taxation*, p. 267.

<sup>25</sup> Pinto (n 7) p. 8.

<sup>26</sup> *Id.*, p. 15.

problematic to find a starting point for this distinction'.<sup>27</sup>

Not only difficult but also lawyers tend to be silent on the subject of distinguishing criteria between fair tax competition and unfair tax competition.<sup>28</sup> An empirical investigation of the underlying reasons would be an interesting topic. Unfortunately, it is outside the scope of this article.

Elaborating further on the (un) fairness in the matter of tax competition, distinguishing fairly acceptable tax competition from unfairly acceptable tax competition is difficult because all countries engage in tax competition in one way or another, with some using more sophisticated and less transparent mechanisms than others.<sup>29</sup> The situation becomes also complicated by the fact that the concept of 'fairness' itself is complicated. That couples with the silence of tax competition key players to provide a determining factor, which fuels more the discussions in the legal scholarship.

#### 4.1. Complexities with fairness in general

On the fairness or unfairness of tax competition, it is worth mentioning that the concept of fairness itself in tax law raises controversies. Acknowledging the fact that taxation should be fair, it has been contended that what that fairness refers to is less evident.<sup>30</sup> Attempting to digest fairness in tax law, the starting point should be made to the distinction between tax fairness at the national level and tax fairness at the international level. Briefly, tax fairness at the national level entails the distribution of the tax burden among taxpayers. At the international level, tax fairness entails the distribution of the tax revenues and the taxing rights between states. The challenging point becomes then from which point fairness

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<sup>27</sup> W Schön, 'Tax Competition in Europe – The National Perspective' (2002) *European Taxation* 42(12) p. 492.

<sup>28</sup> *Id.*, 490.

<sup>29</sup> A Christians, 'BEPS and the New International Tax Order' (2017) *Brigham Young University Law Review* 2016(6) p. 1630.

<sup>30</sup> I J J Burgers & I J M Valderrama, 'Fairness: A Dire International Tax Standard with No Meaning?' (2017) *Intertax* 45(12) p. 767.

can be established or not? Besides that, issues of tax fairness may be perceived differently depending on whether they are looked at from the perspective of the taxpayer or from the perspective of the tax administration. Referring to OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, the idea underlying its output is that tax allocation becomes fair when it reflects economic reality and the place where the value is created. However, these may be too vague, too and the exercise would have been easy if the pioneer of tax competition regulation, i.e. the EU and the OECD, have laid down a clearly determining element.

#### **4.2. Absence of the EU and the OECD determination**

Still, on tax competition fairness, it is worth mention that the EU and the OECD, the main game players in international tax competition, have not as well established definitions of fair tax competition or unfair tax competition. They only provided criteria for qualification. For instance, for The OECD, such criteria are the distortion of investment flows; the threat to the tax systems' integrity and fairness; discouragement of taxpayers' compliance; imbalance between public revenues and public spending; the shift of the tax burden; and increase of administrative and compliance cost.<sup>31</sup> As earlier elaborated on, the established criteria are also subject of discussions by a lack of direct and consistent measurement. Furthermore, not only these criteria are to a large extent subjective because they cannot be assessed objectively, they also fit to be considered as consequences more than qualifying criteria. From that absence, law scholars attempted to close the gap as detailed below.

#### **4.3. From the legal scholarship**

The difficulties in determining the distinctive line between fair and unfair tax competition led to a point of considering it as impossible.<sup>32</sup> However, in the absence of a clear distinction

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<sup>31</sup> OECD 1998 Report (n 6) p. 16.

<sup>32</sup> H G Petersen (ed.), *Tax Systems and Tax Harmonisation in the East African Community* (Report for the GTZ and the General Secretariat of the EAC on Tax Harmonisation and Regional Integration, Potsdam, 2010) p. 25.

line by pioneering institutions such as the OECD and/or the EU, law scholars have been trying to establish the distinctive line between fair and unfair tax competition. Trying to close the gap, one scholar refers to the European context and contends that tax competition becomes harmful and unfair if a State ‘enacts special tax measures deviating from its general tax system, not pursuing desirable fiscal, economic or social objectives consistent with the European Community Treaty’.<sup>33</sup> Though commendable, this contribution adds another complication with the use of ‘desirable objective’, which not easily understandable at all. More than that, a general objective qualifying element, beyond the European Community Treaty, would be more desirable. According to another law scholar, fair tax competition occurs when a country decides to reduce the tax burden to both residents and non-residents, either by lowering tax rates or by granting tax credits.<sup>34</sup> Beyond that, there is also a polarity in the theories that govern the field of tax competition.

## 5. LEVIATHAN HYPOTHESIS VERSUS RACE TO THE BOTTOM HYPOTHESES

Another polarity of tax competition exists on its usefulness and consequences. Some scholars contend that some forms of tax competition may be good and beneficial while others may be bad and harmful.<sup>35</sup> It is in this regard that tax competition has got two sets of hypotheses: the race to the bottom hypothesis and the leviathan hypothesis.<sup>36</sup> This section describes those two hypotheses that underlie the study of tax competition.

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<sup>33</sup> Pinto (n 7) p. 301.

<sup>34</sup> Lampreave (n 12) p. 6.

<sup>35</sup> D M Ring, ‘What’s at Stake in the Sovereignty Debate: International Tax and the Nation-State’ (2008) *Virginia Journal of International Law* 49(1) p. 184; B Amira, *Harmful Tax Competition: Past and Future* (MA Dissertation, University of London, Institute of Advanced Legal Studies, School of Advanced Study, 2014) p. 7, available at <https://sas-space.sas.ac.uk/5909/>, accessed on 19<sup>th</sup> January 2019.

<sup>36</sup> Ault (n 23) p. 764; Petersen (n 32) p. 22.

### 5.1. The race to the bottom theory

The race to the bottom hypothesis is associated with the loss of tax revenues because of lowering taxes, thus leading to a regressive national system<sup>37</sup> mainly characterised by dangerous fiscal degradation.<sup>38</sup> In this situation, the governments raise too little tax revenue to cover decent public services against the unjustified benefit of internationally mobile capital.<sup>39</sup> In this consideration, the race to the bottom hypothesis argues that tax competition between states is destructive as it leads to a permanent fiscal degradation.<sup>40</sup> In consequence, this ends up creating a situation of public poverty,<sup>41</sup> mainly characterised by States' inability to finance the public services.<sup>42</sup> In this context, tax competition endangers the social welfare state and contributes to human sufferings because of State's under-provision of public goods and public services.

### 5.2. The leviathan theory

Opposite to the race to the bottom hypothesis, the leviathan hypothesis looks at tax competition as good and healthy. This hypothesis brings an idea that governments may tend to maximize their budgets, which may have detrimental effects on the economy. The tax competition, therefore, comes in to refrain States' appetites for higher taxes along with preventing tax cartels.<sup>43</sup> Equally, with tax competition, the States become subjected to pressure to become more efficient in raising and spending the taxes.<sup>44</sup> The tax competition's role

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<sup>37</sup> I O Ozai, 'Tax Competition and the Ethics of Burden Sharing' (2018) *Fordham International Law Journal* 42(1) p. 75.

<sup>38</sup> Pinto (n 7) p. 9.

<sup>39</sup> P J Wattel, 'Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters', *World Tax Journal*, February 2013, at p. 135.

<sup>40</sup> *Ibid.*

<sup>41</sup> Bos, W. "Harmful Tax Competition", Speech to the OECD, Dutch Finance Ministry, 29 June 2000, cited in R H J Lemmens, *Tax Competition: How Harmful is Tax Competition Really* (Master Thesis International Business Taxation, Tilburg University, Tilburg School of Economics and Management, 2014) p. 6.

<sup>42</sup> Petersen (n 32) p. 22; Ault (n 23) p. 764.

<sup>43</sup> Lampreave (n 12) p. 4.

<sup>44</sup> *Ibid.*

is, therefore, to counter leviathan effects by forcing the governments' to rationalise the public services through balancing the tax burden imposed on taxpayers and governments' abilities to provide public services.<sup>45</sup> In the same sense, reducing government waste and disciplining politicians stand among the benefits of good tax competition.<sup>46</sup> In other words, the leviathan hypothesis looks at tax competition as an instrument to control the Leviathan by imposing budgetary restraints on excessive or wasteful spending.<sup>47</sup> In brief, the leviathan hypothesis looks at tax competition as a suitable instrument to counteract governments' abuses in terms of tax matters. Even though both hypotheses are correct, the principles of tax competition diverge with its practice as detailed below.

## 6. PRINCIPLES OF TAX COMPETITION VERSUS TAX COMPETITION PRACTICES

In principle, harmful tax practices are not permitted, but in practice they extensively exist. This polarity leads to thinking of the underlying cause of the differences between the principle, condemning tax competition, and the practices, through which the states behave as if tax competition is permitted. This state of indecision is more exacerbated by the fact that the same states that condemn tax competition are the same states to engage in tax competition. This finally ends up in a game of cheating where the states' official statements are not really their beliefs, therefore, not reflecting what they really do or wish to do. However, worth noting is that this is not a particularity of tax competition rather a general situation of international tax law. In his inaugural lecture at the University of Amsterdam, Professor Sjoerd Douma described that as an issue of miscommunication and distrust

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<sup>45</sup> Pinto (n 7) p. 8.

<sup>46</sup> Lampreave (n 12) p. 14.

<sup>47</sup> J Englisch and A Yevgenyeva, 'The Upgraded Strategy against Harmful Tax Practices under the BEPS Action Plan' (2013) *British Law Review* 5, p. 624.

in the international tax debate.<sup>48</sup> This is translated into hidden agendas with individuals wearing two hats and result in a substantial lack of trust between actors of taxation system, namely the governments, multinationals, tax advisors, academics, non-governmental organisations, and the general public.<sup>49</sup> In this consideration, the area of tax competition is a conclusive pretty good example of distrust where the players wear two hats at the same time.

### **6.1 Harmless tax competition versus harmful tax competition**

In completion of the previous sections, another polarity of tax competition turns around the discussions about the distinction between harmless tax competition and harmful tax competition. Such discussion is broadly fuelled by an absence of a clearly agreed-upon dividing line showing from when a tax competition ceases to be harmless to become harmful. Yet, such distinction is very important because of the consequences that thereto result. Indeed, harmless tax competition is healthy and should be supported while a harmful tax competition is unhealthy, which justifies the need to curtail it.

Establishing the dividing line is also very difficult for a variety of reasons. One, the OECD as a pioneer of international regulation of tax competition recommends not focusing just on one factor rather considering an overall balanced assessment of all factors.<sup>50</sup> On this aspect, what matters is not the number of factors that score positive or negative, rather the weight given to each factor. This way of assessment may open room for subjectivity because people can give different weights to one factor. Second, the EU,

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<sup>48</sup> University of Amsterdam, 'Inaugural lecture Sjoerd Douma: Miscommunication and Distrust in the International tax debate', <http://www.uva.nl/en/shared-content/faculteiten/en/faculteit-der-rechtsge-leerdheid/news/2018/06/inaugural-lecture-sjoerd-douma-miscommunicati-on-and-distrust-in-the-international-tax-debate.html>, accessed on 01/02/ 2019.

<sup>49</sup> Ibid.

<sup>50</sup> OECD 1998 Report (n 6) p. 25; O Pastukhov, 'Counteracting Harmful Tax Competition in the European Union' (2010) *Southwestern Journal of Internal Law* 16, p. 162.

another pioneer, considers the assessment, not as an exact science,<sup>51</sup> which again may open room for differentiations. Indeed, evaluation of tax competition stands as an exercise which pivots between legal and political interactions. In consequence of these aspects of tax competition, the key institutions that pioneered the regulation of tax competition, namely the EU and the OECD, endeavoured to establish criteria to base on while determining whether a given practice is harmful or harmless tax competition.

According to the EU Code of Conduct adopted by the ECOFIN Council of the European Union on 01 December 1997, harmful tax competition is determined using five criteria. Such criteria are:

- (1) whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents; or (2) whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base; or
- (3) whether advantages are granted even without any real economic activity or substantial economic presence; or
- (4) whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD; or
- (5) whether the tax measures lack transparency, including where legal provisions are relaxed at the administrative level in a non-transparent way.<sup>52</sup>

The above factors are summarized as lower taxation, ring-fencing, lack of substantial activity, lack of arm's length dealing, and lack of transparency.<sup>53</sup> Thus considered, a tax measure becomes harmful if it grants a significantly lower level of taxation and is ring-fenced, is not respecting arm's

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<sup>51</sup> CEU, Agreed Guidance by the Code of Conduct Group (business taxation): 1998-2018, FISC 44 ECOFIN 75, 5814/4/18 REV 4, Brussels, 20/12/2018, p. 14.

<sup>52</sup> EU Code of Conduct (n 14) C 2/3; M Seeruthun-Kowalczyk, *Hard Law and Soft Law Interactions in EU Corporate Tax Regulation: Exploration and Lessons for the Future* (Ph.D Thesis, Edinburgh University 2011) p. 172.

<sup>53</sup> B J M Terra and P J Wattel, *European Tax Law* (5<sup>th</sup> edn, Kluwer 2008) p. 112.

length principles, lacks substantial activity, or lacks transparency.

Besides the EU Code of Conduct, the OECD laid down its criteria to evaluate harmful tax competition through its report of 1998. According to this Report, harmful tax practices occur in two cases: the case of tax havens and the case of harmful preferential tax regimes.<sup>54</sup> According to the same report, tax havens are characterized by:

- (a) having no or only nominal taxes either in general or in special circumstances for non-residents,
- (b) having laws and/or administrative rules and/or practices that prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdictions,
- (c) lack of transparency, and
- (d) absence of any requirement for substantial activity.<sup>55</sup>

Besides tax havens, harmful preferential tax regimes are characterized by two categories of factors. The first category is composed of four factors which OECD refers to as 'key factors', namely:

- (a) low or zero effective tax rate on specified kinds of income such as movable sources of income
- (b) ring-fencing from the domestic economy,
- (c) lack of transparency, and
- (d) no effective exchange of information with other governments.<sup>56</sup>

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<sup>54</sup> OECD 1998 Report (n 6) p. 7; OECD, *Harmful Tax Practices – 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS Action 5* (Paris: OECD Publishing, 2019) p. 41; M Littlewood, 'Tax Competition: Harmful to Whom?' (2004) *Michigan Journal of International Law* 26(1) p. 413 and 419; S Jogarajan and M Stewart, 'Harmful Tax Competition: Defeat or Victory?' (2007) *Australian Tax Forum* 22, p. 8; Gribnau (n 1) p. 20.

<sup>55</sup> OECD 1998 Report (n 6) p. 22.

<sup>56</sup> *Id.*, pp. 26-30; Joint Committee on Taxation, *Background, Summary and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15, Nov. 2015) p. 18.

The second category is made of eight factors and are referred to as other factors. These factors play a support role to the key factors.<sup>57</sup> They are:

- (a) an artificial definition of the tax base
- (b) failure to adhere to international transfer pricing principles
- (c) exemption of foreign source income from residence-country taxation
- (d) negotiable tax rates or tax bases
- (e) existence of secrecy provisions
- (f) access to a wide network of tax treaties
- (g) promotion of the regime as a tax minimization vehicle, and
- (h) encouragement by the regime of purely tax-driven operations or arrangements.<sup>58</sup>

Without undermining the efforts of the EU and the OECD that laid down the criteria and factors determining harmful tax competition, the established criteria are also problematic in several respects. One, it is very difficult to determine the exact definition and the exact scope of application of some criteria.

This is, for instance, the criterion of the substantial activity requirement of the EU Code of Conduct. This criterion is subdivided into two: the substantial economic activity and the substantial economic presence. In many occasions, this criterion has been regarded as very difficult to evaluate.<sup>59</sup> Furthermore, some criteria change the weight from time to time. Still, the substantial activity requirement is

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<sup>57</sup> K van Raad, *Materials on International & EU Tax Law* (13<sup>th</sup> edn, International Tax Center 2013) p. 1320.

<sup>58</sup> OECD 1998 Report (n 6) pp. 30-34; Joint committee on taxation (n 56) p. 18; K van Raad, *Id.*, p. 1320-1322; Littlewood (n 54) pp. 423-24; H M Liebman, W Heyvaert and V Oyen, 'Countering Harmful Tax Practices: BEPS Action 5 and EU Initiatives – Past Progress, Current Status and Prospects' (2016) *European Taxation*, pp. 102-03.

<sup>59</sup> Pinto (n 7) p. 226; OECD, *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* (Paris, OECD Publications, 2001) p. 10; M F Ambrosanio and M S Caroppo, 'Eliminating Harmful Tax Practices in Tax Havens: Defensive Measures by Major EU Countries and Tax Haven Reforms' (2005) *Canadian Tax Journal /Revue Fiscale Canadienne* 53(3) p. 690; Seeruthun-Kowalczyk (n 52) p. 202.

a good example. This criterion was initially set among the criteria to evaluate tax havens.<sup>60</sup> However, this criterion was dropped in 2001 because there were difficulties in determining exactly what substantial means.<sup>61</sup> Its use resumed later in 2015 fueled by the BEPS project.<sup>62</sup> Exchange of information and transparency also increased their importance from time to time.<sup>63</sup> Fair taxation and anti-BEPS implementation were also accepted in 2016 by the Council of the EU as part of the criteria to establish the lists of non-cooperative jurisdictions,<sup>64</sup> i.e. jurisdictions with harmful tax practices. All these elements add more to the complication to distinguish harmless tax competition from harmful tax competition. Yet, such distinction is really needed and is very important in the practice of tax competition.

## 7. CONCLUSION

Tax competition is a topic that is discussed in the forum of lawyers. Such discussions especially increased in the 1990s when the EU adopted a Code of Conduct on business taxation in 1997 that was followed by the OECD report of harmful tax competition in 1998. The discussions turn around a variety of topics and some of them are still unresolved. One of the discussed elements turns around the polarities that characterize tax competition.

This article provided a summarized discussion of six polarities that form some of the key aspects of tax competition. Such are the paucity of definitions versus elaboration of the components of tax competition; permissible practices versus impermissible practices; fair versus unfair tax competition; the leviathan hypothesis of

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<sup>60</sup> OECD 1998 Report (n 6) p. 22.

<sup>61</sup> Pinto (n 7) p. 226; OECD 2001 progress report (n 59) p. 10; Ambrosiano and Caroppo (n 59) p. 690; Seeruthun-Kowalczyk (n 52) p. 202.

<sup>62</sup> OECD 2015 Progress Report (n 1); OECD 2018 Progress Report (n 54) p. 38.

<sup>63</sup> P Baker (2004), 'The World-Wide Response to the Harmful Tax Competition Campaigns', *GITC Review*, 3(2), p. 5.

<sup>64</sup> CEU, Outcome of proceedings on criteria and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes, 14166/16, FISC 187 ECOFIN 1014, Brussels, 8/11/2016, pp. 4-7.

versus race to the bottom hypotheses of tax competition; the dichotomy between the principles and the practices of tax competition; and finally the distinction between harmless tax competition as opposed to harmful tax competition.

Supplementing the ongoing scholarly discussions, this article emphasized the current state of play over such discussions. It also proved how the discussions are still going as they shall also continue at least in the near future. Thus, the discussions presented in this article are continuous and this article invites law scholars in the field of international tax law to continue digging deep into the area of tax competition. More than that, the discussion of tax competition polarities in this article emphasized the validity of each polar. Thus, when studying the field of tax competition, no polar should be ignored. As a result, an effective study of tax competition should not be done in a one-way approach, rather in a two-way approach.