WTO COMPATIBILITY OF THE OECD 'DEFENSIVE MEASURES' AGAINST 'HARMFUL TAX COMPETITION'

by

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1) Background

As a result of a mandate granted by the OECD ministers[1] in 1996, the OECD Secretariat prepared a report on Harmful Tax Competition[2] which outlined the features of taxation systems that the Secretariat viewed as distorting global taxation and finance decisions[3]. The report identified two separate types of regimes, that are deemed to be harmful, those that are tax havens[4] and those that have preferential elements[5]. Subsequent to the 1998 report the OECD has prepared a second report in June 2000 which has named 35 jurisdictions as being tax havens and unless these jurisdictions sign memoranda of understanding with OECD they shall be listed as uncooperative tax havens by 31st July, 2001[6]. Those jurisdictions failing to sign memoranda may then be subject to possible defensive measures which are in effect economic sanctions which can be instituted collectively or bilaterally by OECD members on those tax havens[7]. These proposed defensive measures and the WTO compatibility of their application are the subject of this paper.

The OECD is proposing to eliminate preferential tax systems amongst non-members as well as the OECD members which also maintain such measures. However, while preferential tax measures maintained by tax havens are defined unambiguously as

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1 OECD Ministerial Communiqué, May 1996

2 OECD 'Harmful Tax Competition: An Emerging Global Issue', Paris, 1998. The original OECD members include Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweeden, Switzerland, Turkey, the UK , the USA. The new members include Japan, Finland, Australia, New Zealand, Mexico, Czech Republic, Hungary, Poland and Korea.

3 OECD 'Towards Global Tax Co-operation-Report to the 2000 Ministerial Council Meeting and the Recommendations by the Committee on Fiscal Affairs' Paris, June 2000.

4 The OECD report indicates that tax havens can be identified by four characteristics. They have no or only nominal taxes , they lack effective exchange of information, they lack transparency and firms registered in these tax havens tend to have no substantial activity in the jurisdiction. OECD 2000, op.cit., p 23

5 The OECD defines harmful preferential elements as those with no or low effective tax rates, 'ring fencing' of domestic and off-shore regimes, lack of transparency and lack of effective exchange of information. ibid, p27

6 Six countries, the so-called advanced commitment jurisdictions, include Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and Netherlands Antilles have already made written public commitments to the OECD. Two other jurisdictions, San Marino and Isle of Man have sent letters but the commitments and undertakings in those letters appear to fall far short of OECD demands

7 At the time of writing the OECD has not completed the six application notes regarding transparency/exchange of information; transfer pricing, ring fencing, holding companies, fund management and shipping . These application notes will define commitments that those jurisdictions that the OECD deems to be tax havens will have signed by 31st July, 2001. Thus affected jurisdictions are expected to undertake commitments to implement measures that have not been clearly defined. Given that the applications notes will not be ready before OECD members can apply defensive measures this renders the process all more contentious.

harmful the OECD employs the precautionary adjective 'potentially' harmful when describing OECD measures[8]. The OECD is also embarking on a global dialogue with numerous jurisdictions in Asia and Latin America where preferential tax regimes are deemed to exist. The OECD expects that all remedial measures by OECD and non-OECD jurisdictions in regard to preferential tax regimes will be fully implemented by 2005. Again, the difference in treatment being afforded internal OECD preferential tax measures and non-tax haven measures will become significant in light of various exemption provisions of the GATT and GATS.

The paper considers several different areas of potential legal interface between the OECD punitive sanctions and WTO rules. This however is done in a context where the precise nature of those sanctions are unknown. The analysis considers the type of sanctions suggested and briefly the possible violations of GATT and also, more extensively GATS rules. In the case of the latter several types of possible WTO violations are considered and these include, violations of service sector commitments on mode 1 and 2 by OECD countries, Article XI.1 violations and possible violations of Article II (MFN) obligations and possible non-violation disputes. The defence in WTO rules of the proposed OECD sanctions are also considered.

2) Proposed Defensive Measures

The OECD in its 2000 report has indicated that defensive measures which are tantamount to punitive sanctions would be applied on a collective or bilateral basis against those jurisdictions that did not did not co-operate with the OECD initiative agree to the terms of the Memorandum of Understanding. The defensive measures that have been proposed by the OECD against those jurisdictions they define to be 'uncooperative' include[9]:

i) To disallow deductions, exemptions, credits, or other allowances related to transactions with Uncooperative Tax Havens or transactions taking advantage of their harmful tax practices,
ii) To require comprehensive information reporting rules for transactions involving Uncooperative Tax Havens or taking advantage of their harmful tax practices, supported by substantial penalties for inaccurate reporting or non-reporting of such transactions,
iii) For countries that do not have controlled foreign corporations or equivalent (CFC) rules, to consider adopting such rules and for countries that have such rules, to ensure that they apply in a fashion consistent with the desirability of curbing harmful practices,
iv) To deny any exceptions (e.g. reasonable cause) that may otherwise apply to the applications of regular penalties in the case of transactions involving entities organised in Uncooperative Tax Havens or taking advantage of their harmful tax practices,
v) To deny the availability of the foreign tax credit or the participation exemption with regard to distributions that are sourced from Uncooperative Tax Havens or to transactions taking advantage of their harmful practices,

[8] The OECD has identified seventeen OECD tax jurisdictions which are deemed to have potentially harmful features. see OECD 2000 ibid, pp. 12-14.
[9] ibid, page 25

vi) To impose withholding taxes on certain payments to residents of Uncooperative Tax Havens,
vii) To enhance audit and enforcement activities with respect to Uncooperative Tax Havens and transactions taking advantage of their harmful tax practices
viii) To ensure that any existing and new domestic defensive, measures against harmful tax practices are also applicable to transactions with Uncooperative Tax Havens and to transaction taking advantage of their harmful tax practices,
ix) Not to enter into any comprehensive income tax conventions with Uncooperative Tax Havens, and to consider terminating any such existing conventions unless certain conditions are met,
x) To deny deductions and cost recovery to the extent otherwise allowable, for fees and expenses incurred in establishing or acquiring entities incorporated in Uncooperative Tax Havens
xi) To impose " transactional" charges or levies on certain transactions involving Uncooperative Tax Havens.

The nature of the measures outlined by the OECD fall into three broad categories, first there are those that apply to income derived from a particular jurisdiction (measures i-vii). A second but slightly overlapping proposed measures are those aimed directly at various types of transactions involving that jurisdiction (measures i & xi) and third, measures of a general nature that would have no immediate trade or commercial impact (measures viii & ix). The OECD has also recommended that members review non-essential aid to such jurisdictions.[10] While this may be a particularly severe form of sanction it is significant to note that its application as a sanction appears not to violate any particular WTO provision.

3) WTO Compatibility Issue

Under GATT rules the defensive measures are not normally actionable until such time as they are announced by particular OECD/WTO members. Their announcement and implementation should in itself constitute grounds for consultation at the WTO should the measure be perceived to violate WTO rules or they nullify or impair the rights of other WTO members[11]. All OECD members are also members of the WTO and ten of the effected tax haven jurisdictions are members of the WTO[12]. Until an actual defensive measure is announced it is unlikely that there is a basis for a WTO consultation but whether any subsequent WTO challenge would be successful

[10] OECD Report 2000, ibid, p. 26

[11] The GATT jurisprudence on whether a WTO member is in a position to seek formal consultations prior to the application of the measure is ambiguous. The most recent case, the 1990 panel on the 'EEC-Regulation on the Import of Parts and Components 'L/6657 found that:

> …'the mere existence of the anti-circumvention provision in the EEC's anti-dumping Regulation is not inconsistent with the EEC's obligation under the General Agreement'

Earlier GATT jurisprudence indicated that the existence of mandatory laws made it possible for WTO members to take action prior to the implementation of an action . GATS definitions of 'measures' that nullify or impair rights include decisions GATS, Article XXVIII (a). It is uncertain whether a panel would view a decision by OECD ministers to be actionable under GATT or GATS rules prior to its implementation by individual OECD members.

[12] The following effected jurisdictions are also members of WTO: Antigua and Barbuda (became a member on 01.01.95),Bahrain (01/01/95),Barbados (01/01/95), Belize (01/01/95), Dominica (01/01/95), Grenada (22.02.96), Maldives (31/05/95), Panama (06/09/97), St. Vincent and the Grenadines (01/01/95), Liechtenstein (01/01/95). The following have observer status at the WTO: Samoa, Seychelles, Tonga, Vanuatu.

rests upon precisely what type of measures would be applied. It shall be assumed in this paper that three types of punitive sanctions or defensive measures are applied:

i) A tax or administrative measure based upon all or selected transactions involving the sale of a good or service of a WTO member
ii) A tax or administrative measure that would penalise the income of a company, domestic or foreign for trading in goods and services with a WTO member
iii) A measure designed to place pressure on uncooperative tax havens but with no direct trade distorting impact

WTO Rules Pertaining to Direct Tax Matters

I GATT Provisions

In the unlikely event that the OECD defensive measure or sanction that is ultimately imposed after July 2001 is in the form of a more general withholding tax targeted against a wide range of goods transactions ie option (i) above, in the so-called 'un-cooperative jurisdiction' then there are a number of GATT 1947 provisions that would be relevant to both the defensive measure and any litigation predicated upon a possible violation of WTO rules. Measures vi and xi described in section 2 above could well be such general tax measures. This section deals with potential violations as they pertain to the trade in goods only. This constitutes only one part of a potential defence against OECD punitive sanctions. In reality most of the proposed OECD sanctions will be against various service providers or will involve service sector transactions as has been the case with EU measures thus far. Potential GATS violations will be discussed in the next sections.

The GATT and the WTO have a long history of dealing with income and other direct tax matters. Those who drafted the original GATT 1947 agreement were of the view that income tax matters were not in the proper purview of the GATT and that the disciplines referred only to taxes directly on the good itself[13]. This raises a very serious definitional problem. Clearly both Article I and III were not intended to deal with taxes on income but on goods[14]. While the intention of the GATT draftsmen may well have been not to impose disciplines on income taxes, the reality of the subsequent jurisprudence has been that GATT panels have demonstrated a willingness to consider income tax provisions as violations of particular GATT obligations. This section is predicated upon the imposition by OECD countries of a withholding tax on transactions with what the OECD deems to be un-cooperative jurisdictions. However, if these withholding taxes are imposed on a wide range of transactions with a particular jurisdiction and are based on the value of those transactions then they are in effect ad valorem taxes. The fact these ad valorem taxes are intended to be withholding taxes in lieu of income taxes may not alter the perception of a panel as to whether they should be treated as taxes on goods or income derived from the sale of those goods.

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[13] At the Havana Conference which considered Article 18 of the charter (national treatment), it was stated that the sub-committee on Article 25 (XVI) 'had implied that exemptions from income taxes would constitute a form of subsidy permissible under Article 25 [XVI] and therefore not precluded by Article 18. It was agreed that 'neither income taxes nor import duties came within the scope of Article 18 (national treatment) since this article refers specifically to internal taxes on products'

[14] Article III.2 states, *inter alia:*

'The products of the territory of any contracting party imported into the territory of another contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied to like domestic products.'

The first case that has a bearing in this area was the Belgian family allowance case[15] in 1952 that any violation of MFN obligations based on differentiation of tax and benefit regimes of the Contracting Parties was not GATT compatible. A second complaint was brought by Austria in the same year against income tax remissions granted by Italy[16] . These disputes were followed by a series of the four so–called 'DISC disputes[17] of the 1970's all relating to the trade distorting effects of the application of various income tax measures. The subsequent passage of the US Foreign Sales Corporation legislation stems in large measure from early US attempts to deal with the GATT incompatibility of the DISC legislation. The most recent 1999 FSC case[18], while driven by other trans-Atlantic trade frictions, is a result of the earlier, non-WTO compatible changes to the DISC legislation by the US Congress. Thus there is a long history of GATT and WTO panels dealing with trade implications of direct tax measures.

There are several important provisions in the GATT rules that refer directly or indirectly to internal taxation measures. These include the provisions of Article I.1 (MFN), Article III.2 (National Treatment) and XVI (Subsidies) and Article XX(d) (Exceptions). As has been argued above the GATT jurisprudence indicates that panels have consistently seen direct tax measures that have trade effects as being within the proper purview of the GATT and the WTO. However, in the past GATT panels that have considered taxation related issues have by-and-large dealt with aspects of taxation regimes as possible subsidies to exports. Any WTO panel that would be created to consider the application of OECD defensive measures would be considering taxation issues in a manner quite different from previous panels.

II GATS Provisions

The reality of the application of any as yet undisclosed defensive measures is that OECD members will attempt to avoid broad ranging discriminatory taxes and administrative measures against goods transactions precisely because such measures are of highly questionable GATT legality. The experience with EU measures along with Controlled Foreign Corporation legislation[19] indicates that tax jurisdictions which impose punitive or discriminatory measures tend to target income or service transactions on a selective basis, as outlined in the second option above. Even selective measures against transactions with what the OECD calls 'un-cooperative jurisdictions'

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15 The 1952 panel report on "Belgian Family Allowances" discusses a Belgian system of tax exemptions for products imported from countries considered to have a system of family allowances similar to that of Belgium, in relation to Article 1. G/32 adopted 7 November,1952 IS/59

16 L/875. see SR.13/12., SR15/17, SR 16/9, SR 17/5.

17 EC v. US- Income Tax Legislation- Here, the claim was that the 1971 DISC Legislation, by allowing a deferral of income taxes on certain portion of export income, for unlimited period and without interest, constituted export subsidy in violation of Article XVI:4. The Panel ruled that by not taxing export income equally with income from domestic sales, the US DISC law in some cases, had effects that were not in accordance with US obligations under article XVI:4. BISD 235/98, 285/114. The subsequent series of DISC tax cases which followed were US-Belgium BISD 23S/127, US v France BISDF 23S/114, US v Nethrelands BISD 23S/137

18 The recent decision of the WTO Panel and Appellate Body in the EC-US Tax treatment for Foreign Sales Corporations is noteworthy. This decision stated that the foreign sales corporation provisions of sections 921-927 of the Internal Revenue Code Constitute an illegal subsidy of US exports. WT/DS108/AB/R (24 February 2000) para 7.34 and footnote 602.

19 Controlled Foreign Corporation (CFC) rules stipulate that certain income of a CFC is attributed to and taxed currently in the hands of its resident shareholders.

that violate GATS Article II (MFN) provisions may be potentially actionable.

The problem that arises with the proposed OECD defensive measures against savings and income related transactions with un-cooperative jurisdictions is that these transactions while being income transfers are simultaneously banking or financial sector transactions. Thus a measure which imposes a withholding tax on savings to a particular jurisdictions may constitute a violation of GATS depending on the nature of the transaction and the service sector commitments that have been made by the jurisdiction imposing the tax measure. If for example a particular OECD country has made commitments in Banking and other financial service sectors in mode 1 and 2[20] a withholding tax on a banking transaction with another jurisdiction may constitute both an Article XVII violation (National Treatment) and GATS Article II (MFN) violation as well as a violation of sector specific commitments.

GATS Article XIV(d) - Tax Carve Out Provisions

GATS Article XIV (d) provisions provide what appears to be a clear and incontrovertible national treatment tax carve-out[21]. The tax carve out states that:

> '….nothing in this agreement shall be construed to prevent the adoption or enforcement by any member of measures:
>
> > (d) inconsistent with article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members

Uruguay Round negotiators recognised that tax measures differentiating between nationals and foreigners could be construed as a violation of GATS National Treatment obligations. The relatively loose language employed in the tax carve out differs sharply from that found in GATT Article XX exemptions in that the measures envisaged suffer from none of the strict Article XX chapeau requirements that they be 'necessary to assure compliance'.

However, even the GATS national treatment tax carve out which appears to be ironclad, is subject to the Article XIV chapeau provisions which mimic those of GATT Article XX. Thus the measures that are applied must not 'constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail'[22]. An example may be worth considering. The application of a withholding tax on a transaction with say Tonga which has had no finance centre activity since 1988 but is nonetheless listed by the OECD as a tax haven along with the failure to apply a similar tax on an identical domestic transaction would be difficult to sustain. The potential violation of the chapeau provisions will be more evident when we come to consider the MFN violations.

GATS Article XIV (c) provisions

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[20] Mode 1 means supply of services from the territory of one member into the territory of any other member. Mode 2 refers to the supply of services in territory of one member to the service consumer of any other Member. GATS Article 1.2

[21] Footnote 6, GATS, Article XIV (d) stipulates in detail what type of measures are in violation of Article XVII provisions.

[22] This particular portion of the GATS Article XIV chapeau differs only by one word from the GATT Article XX chapeau which the uses the word 'same conditions' as opposed to 'like conditions'.

OECD punitive sanctions or defensive measures that violate either MFN or National Treatment provisions of the GATS could be justified under the provisions of GATS Article XIV(c) provisions allowing measures:

> 'necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this agreement , including those relating to….the prevention of deceptive practices…..

This provision is identical to its GATT antecedent and could be used in a similar manner for GATT MFN or Article III violations[23]. It could be argued that the OECD defensive measures are aimed at preventing such deceptive measures and indeed much of the recent thrust of the OECD work program in this area has been aimed at three aspects of the tax systems of tax havens that the OECD feels to be particularly harmful, ie the absence of transparency, discrimination between on-shore and off-shore activities, and the absence of an effective exchange of information between jurisdictions. While the language of the OECD demands appears deceptively reminiscent of the principles underlying the multilateral trading system, this is only so at a superficial level. In fact GATS provides for the protection of commercial confidentiality[24] and GATS provisions which permit discrimination between nationals and non-nationals on tax matters[25]. Thus the apparent similarity between the most recent OECD demands from tax havens and the principles of the multilateral system is apparent rather than real.

There are several legal questions that arise from a defence of sanctions based on GATS Article XIV(c) . First, is the use of a finance centre for the avoidance of tax within the gamut of what is normally defined as 'deceptive practices'? The OECD has been clear that these defensive measures are aimed at dealing with both criminal and civil tax matters[26]. There is little jurisprudence in this regard but that which exists suggests that the deceptive practices were intended to refer to commercial fraud rather than any civil tax matters. It should also be noted that the tax haven jurisdictions are in general willing to co-operate on matters pertaining to criminal tax fraud but in general reserve their sovereign rights on civil tax issues.

Second the jurisprudence on interpretation of GATT Article XX (d) on this issue suggests that the measure must be taken *to prevent* a particular practice. Panels have strictly interpreted these as enforcement measures rather than punitive measures[27]. The strict interpretation of Article XX(d) provisions in this regard is further supported by the shift in language used in the 1946 Suggested Charter for an International Trade Organisation which used the language 'to induce compliance' as opposed to the stricter GATT language which uses 'to secure compliance with'. In this light the proposed

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[23] GATT Article XX(d) . The GATT provision is somewhat broader covering customs measures and enforcement of monopoly not relevant to the context of the GATS.

[24] GATS Article III bis

[25] GATS Article XIV(d)

[26] OECD 'An Agreed Interpretation of the three broad principles of Transparency, Non-Discrimination and effective Exchange of Information' Paris, January 2001. the OECD has requested that the tax haven jurisdictions abide by these three principles. In its definition of Effective Exchange of Information' the OECD includes both criminal and civil tax matters. It defines the latter to include all matters 'pertaining to the determination, assessment, collection and enforcement of all tax matters'.

[27] Panel Report 'EEC-Regulation on Imported parts and Components' L/6657,adopted 16 May 1990,37/s 195-197 paras 5.14 –5.18

defensive measures may be difficult to support under the provisions of Article XX(d) or GATS Article XIV (c) as none actually secure compliance with tax laws but rather attempt to induce such compliance and thus fall within the precedence already established by GATT panels. Moreover, a panel may not view the use of finance centres in tax havens as deceptive practices in light of the existing but limited jurisprudence[28]. A defence on the OECD sanctions based on either GATT XX(d) or GATS XX(c) may prove difficult to sustain.

Potential Violations of Service Sector Commitments by OECD Countries

It must be reiterated that any challenge to the GATS compatibility of defensive measures by OECD countries can be predicated upon a violation of market access commitments provisions or based on a general or sector specific MFN violation. In the case of the former the success or otherwise will rest on which service sector commitments have been made and the limitations that exist to those commitments. If mode 1 or 2 commitments are unrestricted for banking and other financial services then a withholding tax measure, one of the more probable defensive measures may be inconsistent with GATS obligations because national treatment provisions are subject to the offers in the service sector schedules[29]. It may also violate more general MFN obligations. The success or otherwise of a challenge to punitive sanctions or defensive measures will rest upon the nature of individual OECD service sector commitments. Table I in the annex outlines the sector specific commitments made by WTO members in one important sector, banking and other financial services in the relevant modes of supply.

It would appear from the above sample that the most important OECD members have left unbound their market access commitments in mode 1 in the banking and other financial services sector. This means they are at liberty to introduce new measures with regard to the supply of banking and other financial services from the territory of another member into own territory. However, OECD countries have generally imposed few market access limitations on mode 2 ie supply of a service in the territory. Thus if an OECD service consumer which is purchasing banking services in a listed tax haven which is deemed to be an uncooperative jurisdiction has a discriminatory withholding tax imposed on their financial transactions inside an OECD country then this could be viewed as a limitation of mode 2 market access as well as a more general MFN violation. Any challenge to the WTO compatability of the sanctions will rest crucially on a definition of what constitutes mode 1 and mode 2. While the WTO Secretariat has produced important explanatory notes on the subject the matter of an accepted and unambiguous definition of mode 1 and 2 in a world of electronic commerce does not yet exist. A challenge to sanctions based on violations of sector specific commitments would necessitate a panel deciding on a clear and unambiguous definition of precisely what constitutes mode 1 and 2 in the financial services sector [30].

While the provisions of banking and financial services constitute the most significant part of economic activity of many finance centres there are other important areas of service sector activity that are particularly important to tax havens and could

[28] At the London Session of the Preparatory Committee the discussions indicated that the words deceptive practices were broad enough to cover cases of false geographic markings. EPCT/C. II, p.5,9; EPTC/C.II.54/Rev.1,p.37 Other limited references include similar fraudulent practices.

[29] GATS Article XVII.1

[30] WTO, Committee on Trade in Financial Services, 'Technical Issues Concerning Financial Services Schedules' S/FIN/W/9 Derestricted 22nd April, 1997

be the subject of OECD sanctions or punitive measures. The provision of insurance and reinsurance services from tax havens is one of the most important sources of commercial activity. Under the terms of the *Understanding on Commitments on Financial Services* some thirty-one members of the WTO have entered into the more disciplined commitments under the terms of the understanding which governs the trade in insurance services[31]. If the OECD countries impose sanctions through measures nullifying or impairing the rights of WTO members under their mode 1 and 2 in insurance and reinsurance there may also be the basis for a challenge. Significantly in the trade in insurance services the commitments of OECD members on mode 1 are far stronger than in the banking and financial services.

There exists another important issue pertaining to the application of defensive measures that relate to the stipulated limits of measures that can be taken by WTO members with regard to payments and transfers in sectors in which they have made specific commitments. The provisions state that[32]:

> 'Except under the circumstances envisaged in Article XII (Balance of Payments) , a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments.(parentheses added)

Should OECD countries impose sanctions that are based on withholding taxes on banking and other financial services transactions with uncooperative jurisdictions as outlined measure xi in section 2 above then these could be viewed as violating GATS Article XI.1 provisions. However the provision is more likely to temper the choice of OECD sanctions rather than be basis for litigation. It will however severely restrict the OECD choice of effective measures.

There are several caveats in regard to the comments made on the OECD commitments as they pertain to the terms of the GATS. There are several MFN exemptions that may be relevant in regard to the question at hand and some OECD members, as we shall see, have imposed horizontal MFN limitations which may justify some of the threatened defensive measures. (See Table II in the Annex)

Violations of GATS MFN Obligations on Taxation Matters

GATS Article XIV contains no general provisions for an MFN carve-out for taxation purposes unless these happen to be part of a double taxation agreement[33]. members may limit the extent of the MFN coverage of their service sector offer by providing a schedule of Article II Exemptions which supplement the WTO members' obligation to extend Article II MFN Treatment to the services and suppliers of other WTO members and applies to all service sectors. However, the GATS MFN exemption is in effect a negative list whereas the national treatment obligations are in the form of a positive list. Countries which did not notify MFN exemptions during the Uruguay Round or upon accession may not introduce new measures. Thus unless a particular sector or activity is listed in a country's MFN schedule the MFN obligation exists irrespective of whether that WTO members has undertaken sector specific market

[31] Paragraph 3 and 4 of *The Understanding on Commitments on Financial Services* contain relatively strict disciplines on cross-border trade in insurance services in mode 1and 2.
[32] GATS Article XI.1
[33] GATS Article XIV(e)

opening commitments.

A WTO member may maintain measures that are inconsistent with the obligation to accord immediate and unconditional treatment that is no less favourable to the services and service suppliers of other members than the treatment extended to the services and service suppliers of any other country. The Annex permits WTO members to breach, under prescribed conditions, one of the basic tenets of the GATS and provides members with the flexibility to withhold liberalization commitments from those members that fail to offer reciprocal market access.

The Lists submitted pursuant to the annex are derogations from the MFN principle and the trade liberalizing spirit of the GATS. Thus, exemptions are normally narrowly interpreted to advance the object and purpose of the GATS. The burden of establishing that a measure maintained or introduced is within the member's Article II exemption should be on the member asserting the exemption. While the annex on Article II exemptions states that these exemptions should normally be of ten year duration there are abundant examples of MFN exemptions of indefinite duration[34]. A member that has determined that the need exists to exercise an exemption from its article II MFN obligations may also be a member that has extended extensive market-opening commitments in its schedule. Of significance in this regard is the indefinite MFN exemption found in the US schedule which provides for measures of indefinite duration which are intended to foster efficient international taxation policies. These MFN exemptions include[35]:

> "measures permitting less favourable taxation of citizens, corporations or products of a foreign country based on discriminatory or extraterritorial taxes, more burdensome taxation, or other discriminatory conduct"

Even by the relatively lax standards of Uruguay Round GATS offers, not renowned for their discipline, this particular MFN exemption is exceptional in terms of its effective denial of the most fundamental WTO rights and obligations. This in effect means that any challenge to the WTO compatibility of defensive measures imposed by the USA which violates either MFN or national treatment obligations in the service sector would be difficult to sustain. No similar general MFN limitation exists in the schedules of other OECD members. The US negotiators foresaw that in order to implement legislation such as controlled foreign corporation legislation it would be necessary to carve out MFN for taxes in their service sector commitments. Nevertheless the US schedule of MFN exemptions does not extend to measures that effect the taxation of goods[36] and so general taxation measures which are discriminatory and nullify or impair the rights of members to trade in goods remain open to GATT challenge as discussed above.

The only other possible justification for the defensive measures can be found in the carve out for prudential measures which authorises each WTO member to establish 'prudential' regulatory measures to protect purchasers and beneficiaries of financial services, as well as its domestic financial system. Whether a panel would view so broad

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34 Annex on Article II Exemptions, Article

35 USA-List of Article II (MFN) Exemptions (GATS/EL/90) 15 April, 1994

36 The US carve-out refers measures on 'products' which normally include goods and services but as this MFN limitation is annexed to a service sector offer it cannot be deemd to apply to GATT provisions.

a use of the prudential carve–out to facilitate MFN violations for the purpose of dealing with harmful tax measure especially when those measures are only applied to what the OECD deems to be non-co-operative tax havens is questionable[37]. Indeed given that exemptions for tax measures are dealt with under the tax carve-out to Article XIV then the use of the prudential carve-out would be very difficult to sustain for application of taxation or defensive measures.

Non-Violation Disputes under the GATT and GATS

OECD members can be expected to consider at length the WTO compatibility of any defensive measure that is applied after 31st July, 2001. Nevertheless even if the punitive sanction that is imposed is not inconsistent with WTO obligations there remains the potential for non-violation dispute if WTO members feel that a measure has nullified or impaired the benefits accruing under an agreement.

Both GATT[38] and GATS provisions[39] provide for the possibility of non-violation disputes. These disputes, in the case of the trade in goods relate to the nullification and impairment of members rights even where there has been no violation of GATT rules. The jurisprudence in this area is relatively expansive and indicates that the intention of GATT Article XXIII(1b) was to protect the balance of tariff concessions[40]. The question arises as to whether a punitive tax measure, in the form of a withholding tax or other discriminatory measure designed to lower the net income derived by those trading with a particular jurisdiction that is considered to be practicing harmful tax competition would be seen by a panel as altering, directly or indirectly, the balance of tariff concessions and thereby nullifying or impairing benefits of a WTO member.

Read in light of the sector specific commitments of WTO members, the GATS provisions pertaining to non-violation disputes tend to limit the extent to which WTO members can use non-violation disputes. These are limited to the nullification and impairment of a 'specific commitment of another member under Part III…'Clearly the need to resort to such non-violation disputes is diminished under the GATS as sector specific obligations limit the policy flexibility of individual members and thus disputes can arise from measures pertaining to sector specific commitments.

The Chapeau of GATS Article XIV and GATT Article XX

Defensive measures that may be applied against tax havens can be justified by the exemptions contained in GATT Article XX and GATS Article XIV as has been discussed above. However all defensive measures are subject to the chapeau provisions

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[37] Once a WTO member extends recognition to another country's prudential measures, the member must afford adequate opportunity for other interested members to negotiate their accession to such agreements or arrangements, or to negotiate comparable ones. If recognition has been afforded autonomously, WTO members must be afforded the opportunity to establish that similar circumstances exist in their countries warranting recognition of their prudential measures. Measures deemed prudential are not precisely defined but may include measures taken for 'the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier or to ensure the integrity and stability of the financial system'.

[38] GATT Article XXIII (1b)

[39] GATS Article XXIII:3

[40] BISD 37S/86

of both articles which are similar but not identical. The chapeau provisions of the GATT Articel XX constitute the guiding principles of exceptions to GATT rules and has been interpreted strictly in the past. The chapeau provision states, *inter alia* that:

> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade.....

The only significant difference between the GATS and GATT provisions, as mentioned above, is the use of the word 'like' in the GATS chapeau in the place of 'same' which implies a lower standard of similarity between situations. As we shall se much of the jurisprudence is involved in determining whether an action is arbitrary or discriminatory behaviour. There exist few useful guides on the interpretation of the chapeau of GATS Article XIV. There is substantial jurisprudence on the chapeau of GATT Article XX and would almost certainly be called upon by any panel reviewing whether the proposed OECD defensive measures violate the chapeau provisions.

Potential Sources of Discriminatory Treatment in the OECD Proposal

Perhaps one of the more difficult aspects of the OECD's position has been that some of its own members have displayed an apparent unwillingness to co-operate with the harmful tax iniative. In particular Switzerland and Luxembourg initially abstained from supporting the OECD recommendations[41] as a significant proportion of their economic activity rests upon what the OECD refers to as 'potentially' harmful tax competition. While both countries have now nominally agreed to support the OECD measures it has by no means been wholehearted. The subtle difference in language in the OECD report between its dealings with OECD members' preferential regimes as 'potentially' harmful measures[42] and those of non-OECD measures which are deemed unambiguously harmful may be seen as the genesis of arbitrary and discriminatory behaviour which could sustain a WTO challenge to many of the defensive measures proposed by the OECD. The differential treatment in terms of the OECD and non-OECD jurisdictions practicing harmful tax competition has no basis in economics or in taxation law. While the OECD members are practicing potentially harmful tax measures, Tonga, for example which does have legislation but does not actually operate a finance centre is listed in the OECD study as a tax haven with a harmful regime. In any panel the OECD will have to offer a justification for such differential treatment.

In a field such as avoidance and evasion of income taxation, where information and economic analysis are, by the nature of the subject, in acutely short supply it is worthy of note that Switzerland maintains a taxation regime which has several potentially harmful preferential features[43]. Recently the EU has pursued, in its negotiations with Switzerland co-operation on information exchange and has offered to impose withholding taxes on uncooperative jurisdictions that do not wish to exchange

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41 Recommendation of the OECD Council on Counteracting Harmful Tax Competition, 9th April, 1998

42 OECD 'Towards Global Tax Co-operation- Report to the 2000 Ministerial Council Meeting and the Recommendations by the Committee on Fiscal Affairs' Paris, June 2000. page 12

43 Switzerland maintains an Administrative companies regime which results in preferential regimes for financing and the establishment of headquarters. OECD 2000, pp. 13 and 14. The potentially harmful features of the Swiss system covered by the OECD are by no means exhaustive and there other aspects of the system that may prove to be harmful

information[44]. The Swiss Bankers Association have publicly indicated that 'banking secrecy was non-negotiable' and that they would be likely to accept the withholding tax regime but only once EU Members states and associated territories have dealt with their own regime[45]. Switzerland is reported to have total bank deposits of Euro 1,970 billion– an estimated 1,056 of which is for non-Swiss clientele[46].

The difficulty the EU confronts with Switzerland is replicated with other jurisdictions where OECD compliance consultations are not as advanced as those on the tax haven jurisdictions. At the time of writing OECD consultations on harmful tax matters with WTO members such as Singapore, Hong Kong, China and Latin American jurisdictions has only recently begun. Thus an element of arbitrary and discriminatory behaviour would appear to exist in the application of measures against the harmful tax treatment of tax havens as opposed to the deferral of any measures against those jurisdictions which practice 'potentially harmful' measures.

The Swiss-EU discussions raise several issues and also point to ways forward to the resolution of the harmful tax issue. First, WTO members which face withholding taxes similar to those of Switzerland may have a basis for a WTO dispute based upon the EU market access commitments for banking and other financial services. The imposition of a withholding tax on a banking sector transaction by a Swiss banking service consumer in the EU may constitute a violation of the EU's mode 2 commitments found in the EU Banking and other financial services commitments.

Second, and more significantly the question arises of how such a bilateral system of withholding taxes would work in practice where there is the potential for financial flows through third parties is entirely unclear. Moreover, how if the EU defensive measure is intended only to be a tax on savings could it effectively be enforced without becoming a more generalised tax upon all transactions and hence of the most doubtful WTO compatibility. An effective and non-discriminatory regime of taxes is only likely to be resolved within a genuinely multilateral and co-operative context.

Relevant Jurisprudence on the Chapeau of GATT Article XX

One of the most significant WTO panel reports pertaining to the interpretation of the chapeau of GATT Article XX is the US- Shrimp-Turtle Case[47] where the Appellate Body was of the opinion that the chapeau of Article XX interpreted within its context and in the light of the object and purpose of GATT and WTO Agreements, only allows members to derogate from GATT provisions so long as in doing so, they do not undermine the WTO multilateral trading system, thus, abusing the exceptions contained therein. Such undermining and abuse would occur when a member jeopardizes the operation of the WTO Agreement in such a way that guaranteed market access and non-discriminatory treatment within the multilateral framework would no longer be possible. The Appellate Body found that when considering a measure under Article XX, one must determine not whether the measure on its own undermines the WTO multilateral trading system, but whether such a measure, if it were to be adopted

44 Directive on Taxing Savings Income, EU Finance Council, 27th November, 2000
45 European Report, 13th December, 2000,p12
46 ibid p.13. This includes the Channel Islands and the Caribbean islands.

47 WT/DS58/AB/R 12 October 1998

by other members, would threaten the security and predictability of the multilateral trading system. Market access for goods could become subject to an increasing number of conflicting policy requirements that would lead to the end of the WTO multilateral trading system[48].

The US imposed a section 609 measure which the Appellate Body said constituted 'unjustifiable discrimination' between countries where the same conditions prevail and thus, was not within the scope of the WTO Agreement[49]. In the US Gasoline[50] case, the Appellate Body also pointed out that the chapeau of Article XX

> "by its express terms addresses, not so much the questioned measure or its specific contents as such, but rather, the manner in which that measure is applied. The Panel noted that where a member has taken unilateral measures, this could put the multilateral trading system at risk and could therefore constitute "arbitrary and unjustifiable discrimination where the same conditions prevail".

The Appellate Body in this case said "it is important to underscore that the purpose and object of the introductory clauses of Article XX is generally the prevention of the abuse of the exceptions".

It is significant to note that there exists only one significant drafting difference between the chapeau of GATT Article XX and GATS Article XIV. Whereas the former refers to the same conditions, the GATS exception significantly has the proviso that 'like' conditions prevail. This difference implies that drafters of the GATS agreement were requiring a higher level of discipline with regard to the exemptions under GATS than those of the GATT as the demonstration of the same conditions prevailing is generally more onerous than like conditions.

Unjustifiable discrimination

In the Shrimp-Turtle, the Appellate Body recognised that the most conspicuous flaw in the application of the measure by the US relates to its intended and actual coercive effect on the specific policy decisions made by foreign governments, members of the WTO. The WTO Appellate Body saw the section 609 measures as an economic embargo that requires all other exporting members, if they wish to exercise their GATT rights, to adopt essentially the same policy[51]. Clearly, the US negotiated with some, but not all other members. This is in effect, discriminatory and in the view of the Appellate Body unjustifiable. This was a unilateral measure, which the Appellate Body saw, as disruptive and discriminatory and had the potential to influence and underscore the policies of other members[52].

There are parallels with the OECD's defensive measures. Here the imposition of uniform and unilateral taxation rules with limited negotiations with selected WTO members could be seen to closely parallel the precise situation of the Shrimp Turtle case and could be viewed as unjustified discrimination within existing precedent.

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48 ibid, para. 112, Panel Report, paras. 7.44 – 7.55
49 Panel Report, para 7.49
50 WT/DS2/AB/R 20 May 1996, Panel Report, para. 7.60.
51 Appellate Body Report, para. 161.
52 ibid, para. 172.

Arbitrary Discrimination

The US section 609 measure was seen as 'rigid' and 'unbending' and did not inquire into the appropriateness of the program for the conditions prevailing in exporting countries. Furthermore, it was said that there was little or no flexibility in how officials make the determination for certification pursuant to these provisions. It was therefore concluded that the US measure was applied in a manner that amounted to not just "unjustifiable discrimination", but also of "arbitrary discrimination" and is contrary to the chapeau of the GATT provision[53].

Again the parallels to the case of the OECD defensive measures support the argument of arbitrary discrimination. The OECD's delineation between those WTO members that practice harmful tax practices ie tax havens and those that apply 'potentially harmful' preferential measures has no foundation in economics or in taxation law. Moreover the OECD has presented no empirical evidence for such a delineation. Sanctions will only be imposed on those WTO members that are deemed un-cooperative in July 2001. However, the OECD has just begun work on those Latin American and Asian jurisdictions outside the OECD that practice what are deemed to be harmful tax practices but are not tax havens. Moreover, there are no sanctions imposed on OECD jurisdictions that practice harmful tax measures[54]. It would remain for a panel to decide whether the proposed OECD defensive measures fall within the precedent on 'arbitrary discrimination'. This would rest in part on whether a panel saw the distinctions created and ensuing differences of treatment as arbitrary.

Necessary Measures

A GATT Panel examined the issue of 'necessary measures' in the "Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes[55]". In considering the provisions on general exceptions, the panel said that "parties cannot justify a measure inconsistent with other GATT provisions as 'necessary', in terms of Article XX(d), if an alternative measure which could reasonably be expected to employ and which is not inconsistent with other GATT provisions is not reasonably available, a contracting party is bound to use, among the measures reasonably available to it, that which entails the least degree of inconsistency with other GATT provisions. The panel commented that there was no reason why under Article XX, the meaning of the term 'necessary' under paragraph (d) should not be the same as under article (b). It said that the same objectives were intended in both paragraphs.

Here to there exist parallels to the proposed OECD defensive measures. As discussed in the introductory sections of the paper the OECD has itself outlined several measures (measures viii & ix) including withholding aid which, while potentially quite severe in terms of their economic repercussions on tax havens, are entirely compatible with the WTO obligations of individual OECD member states. The existence of clearly WTO compatible defensive measures, will in light of the WTO jurisprudence requiring that Article XX measures be the least trade distorting would

[53] ibid. para 177, 184.
[54] The OECD views acceptance of the 1998 report by its members as equivalent to the signing of an MOU by tax havens. However this does not cover harmful tax measures of non-OECD countries which are not tax havens.
[55] DS10/R adopted 7 November 1990, 37S/200, paras. 70-80.

make it difficult for OECD members to impose other measures without violating their WTO obligations.

4) Conclusion

It is difficult to speculate as to whether the proposed OECD defensive measures which may be applied collectively or individually by OECD members will be in violation of their WTO obligations and nullification and impairment of the rights of effected WTO members. There exist punitive measures that are WTO compatible, such as the termination of aid. Moreover, as only 10 jurisdictions are WTO members then a policy of targeting these for agreement would minimise the OECD's risk of possible WTO disputes. General withholding taxes on transactions with tax havens are likely to be those measures most likely to be viewed as violating GATT or GATS obligations. Sector specific measures, which are the most likely and most common form of defensive measure could also be violations of GATS obligations. The legality or otherwise of specific defensive measures will depend upon the sector specific as well as horizontal service sector commitments of particular WTO members. In the case of WTO members such as the USA its MFN carve out on taxes will permit precisely such measures against others.

The resolution of the question of harmful tax competition can only be found through multilateral dialogue. At present the OECD remains steadfastly opposed to such an inclusive and reciprocal multilateral process and prefers instead a tax forum run by the OECD without peer review. In a world of hyper-mobile capital international tax issues will only be resolved through genuine multilateral co-operation. Instead the current OECD process is based on threats of punitive sanctions to those refusing to comply to the OECD's demands. There is no taste in the global community for yet another international organisation yet there exists a clear demand for international governance in this area. Here either the IMF or the World Bank working with other relevant international organisations such as the OECD and the Commonwealth Secretariat could provide an appropriate and inclusive but ad hoc international forum for resolving global tax issues. Unless such an inclusive approach is taken to the resolution of this dispute then two possible outcomes exist. Either a confrontation will occur in July 2001 or the effected jurisdictions will grudgingly comply. In the event of the former then the credibility of the OECD will be eroded. In the event of the latter the credibility of the process of globalisation as an inclusive and consultative process will be further undermined.

There are however two very significant issue that are of far greater importance than the issue of sanctions on small WTO members. First, if the sanctions are brought before the WTO then a panel at the WTO will adjudicate on the decisions of another international organisation, albeit one with limited membership[56]. To those who have watched the steadfast opposition since the Singapore Ministerial Conference of the WTO of the developing world to the introduction of new issues into the agenda of the multilateral system the possibility of a WTO panel sitting in judgement on the decisions of the OECD should surely resonate with those concerned about the possibility of the WTO sitting in judgement over trade aspects of the rules and standards of the International Labour Organisation or on Multilateral Environmental Agreements.

[56] Strictly speaking this is not entirely unprecedented. The WTO panel on the Canada/Brazil subsidy case have held that they have the right have held that they had the right to review the OECD's Export Credit Arrangement.

Paradoxically it may be the developing world that opens up an entirely new area of international public law with quite unintended and possibly undesirable consequences.

Second and perhaps more significant is the fact that the OECD clearly has a much larger tax and capital market agenda than just harmful tax competition. This was made abundantly clear in the 1998 report where the OECD indicated that incentives on the movement of physical capital are also on their agenda[57]. Given the nature of its tax and regulatory program the OECD has a long term strategy of imposing its standards and regulations on the movement of capital in a wide range of areas. Following the relative success of the widely accepted interventions of the Finance Action Task Force (FATF) in dealing with money laundering and criminal issues, should the harmful tax initiative succeed without a major political confrontation the next step would be to move to international tax regulations that will prove far more politically intrusive and will have more serious implications for the ability of developing countries to attract capital through the use of tax incentives.

[57] OECD Report 2000, page 8
'The Report focuses on geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Tax incentives designed to attract investment in plant, building and equipment have been excluded at this stage, although it is recognised that the distinction between regimes directed at financial and other services on the one hand and at manufacturing and similar activities is not easy to apply. The Committee [Fiscal Affairs Committee of the OECD] intends to explore this issue in the future.

ANNEX

TABLE 1

SELECTED SECTOR SPECIFIC COMMITMENTS IN BANKING AND FINANCIAL SERVICES

WTO/OECD MEMBER	SECTOR OR SUB-SECTOR	**MODES OF SUPPLY**	**LIMITATIONS ON MARKET ACCESS**
USA	Financial Services limited to banking and other services and excluding insurance	Mode 1 Mode 2	Unbound Michigan limits, according to the country of their home charters, the bank in which corporate credit unions may place deposits.
European Union	Banking and Other financial services excluding insurance	Mode 1 Mode 2	Unbound [Limitations are applied in Germany, Greece, Italy, Finland, Portugal, Sweden and the UK][58].
New Zealand[59]	Banking and Other Financial Services (excluding insurance and related services)	Mode 1 Mode 2	Unbound None

[58] [ ] means it is not the wording in the schedule.

[59] Has no commitments on provision and transfer of financial information.

WTO/OECD MEMBER	SECTOR OR SUB-SECTOR	**MODES OF SUPPLY**	**LIMITATIONS ON MARKET ACCESS**
Japan	Banking and Other Financial Services (excluding insurance and related services)	Mode 1 Mode 2	Unbound Overseas deposits and trust contracts denominated in foreign currencies, the sum of which are over 100 million yen value, and those denominated in yen are subject to approval. Business corporations which satisfy the standards of in-house systems relating to legal affairs, risk management and financial management set out by the Ministry of finance may be given an approval effective for an indefinite period of time with respect to overseas deposits denominated in foreign currencies 1 million yen value for the purpose of the portfolio investment subject to only ex post reporting.
Australia	Banking and other financial services (excluding insurance and related services):	Mode 1 Mode 2	Unbound None
Canada	Banking and other financial services (excluding insurance and related services)	Mode 1 Mode 2	Unbound. None, other than: Trading in securities and commodity futures – persons (all provinces): there is a requirement to register in order to trade through dealers and brokers that are neither resident nor registered in the province in which the trade is effected.

TABLE 2
SELECTED MFN EXEMPTIONS

Country with exemption/Sector	Countries to which measure applies	Duration	Description of measures indicating its inconsistency with Article 11
Australia/financial services (securities)	All countries	Indefinite	Members of foreign stock exchange who wish to become members of the Australian Stock Exchange are only able to do so if the foreign stock exchange provides access to Australian Stock Exchange members on terms and conditions, which are reasonable and not more onerous than those applying to applicants for membership of the Australian Stock Exchange.
USA/ All sectors Taxation Measures	All	Indefinite	Differential treatment under direct tax measures at the federal level Sub federal tax measures affording differential treatment to service suppliers or to services when the differential treatment is based on a number of identified criteria Sub-federal measures substantively incorporation provisions of federal law subject to an MFN exemption under the GATS agreement.
USA/Financial Services	All	Indefinite	Differential treatment of countries due to application of reciprocity measures or through international agreements guaranteeing access or national treatment

Banking and Other financial services excluding insurance	Canada	Indefinite	A broker-dealer registered under US law that has its principal place of business in Canada may maintain its required reserves in a bank in Canada subject to the supervision of Canada
Canada/Financial Services, including lending of all types and trading for own account of certain securities by loan and investment companies.	Great Britain and Northern Ireland, Republic of Ireland	Indeterminate	Preferential treatment in Quebec for allocation of licences is provided by the Province of Quebec to loan and investment companies incorporated under the laws of the Parliament of the United Kingdom and Ireland for purpose of obtaining a licence to carry on business
Air and Maritime Transport – Exemption from tax.	All countries	Indeterminate	Exemption from taxes on income and capital of a non-resident person earned in Canada from the operation of a ship or aircraft in international traffic on the basis of reciprocity with the country in which the person resides
European Community/ Financial Services	States in Central, Eastern and South-Eastern Europe, and all Members of the Commonwealth of Independent States	10 years	Measures granting favourable tax treatment (off-shore regimes) in Italy to service suppliers trading with the countries to which the measure applies.
Japan			No MFN exemptions.