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# THE DICHOTOMY BETWEEN TAX COMPETITION AND TAX COOPERATION: REGULATORY FRAMEWORK AND NEW FRONTIERS OF ACTION

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# INTRODUCTION

Nearly all measures to fight and reduce tax competition require some level of cooperation. Only those who advocate complete acceptance of all forms of tax competition – harmful or not – would see cooperation as irrelevant, though even for those who support competition, some joint advocacy of competing countries has been an important part of their so far quite successful attempts to maintain competitive practices.

The notion of tax cooperation unavoidably generates problems about its feasibility, breadth, and optimal context, as well as the fundamental concepts that underpin it. The difference between “fair” or “acceptable” and “harmful” tax competition is not straightforward but there is sometimes a fine line between the two notions.

There is no doubt that capitals can flow more and more freely in our globalized world. Asymmetries stemming from different legal systems can constitute an incentive for capital allocation and might contribute to the creation of convenient legal solutions for multinational companies. This could have severe impacts on budgets on multiple countries and on welfare programs. Nevertheless, it might also lead to efficient allocation of capital as it can trim wasteful spending and lead to better governance.

This thesis acknowledges the importance of sovereignty of individual countries with regard to tax policy but at the same time underlines the necessity of tax cooperation. It scrutinizes the recent routes used for cooperative efforts, and the link between inter-nation equality and competition. Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards or, in a single market like the European Union, some predetermined set of rules.

After all, the global system is dominated by sovereign nations. Since governments create different kinds of tax policy, it is pivotal to remember that sovereignty is also a reflection of international relations between countries. Regrettably, countries behave as monoliths, presenting a single point of view and speaking with a single voice. Yet, the state cannot be a monolith and needs to find cooperative routes with at least some countries, if not the entire international community. The country might sign a treaty to regulate relations with a specific country or might decide to introduce a withholding tax, but each action also bears consequences.

This had been recognized long ago in the 1998 initiative on "Harmful Tax Competition” of the Organization for Economic Cooperation and Development’s (“OECD”). The type of competition discovered and targeted in that initiative is substantially narrower than the wide definition of tax competition perceived today which takes into account more fundamental problems about society, justice, trade frictions, and investment.

In recent years, with a more globalized world where states compete for resources as well as wealthy taxpayers, taxes are increasingly boosting competitive behaviors between countries. It is perceived as a tool for encouraging an inflow of desirable residents, investments, and economic activities.

The existing international tax framework is decentralized. As a result, countries are free to choose their own tax regulations and rates in order to promote their national interests. Although ostensibly protecting nations' sovereign abilities to freely develop their own tax policies, such decentralization is, in fact, the root of many of the present difficulties in the international tax arena. This competitive system changes the state's traditional functions, diminishes its capacity to alleviate inequality, and generates both impediments to economic activity and possibilities for tax avoidance and evasion.

Given the problems caused by decentralized tax competition, many have advocated for increased cooperation and centralization among states as a solution to the various problems of the international tax regime, both in regional contexts (e.g., the European Union, characterized by a single market with free movement of goods, services, capitals and services) and in the international arena under the realm of the OECD.

Cooperation is hailed as a way to remove barriers to double taxation in cross-border scenarios, to control market failures such as transaction costs and externalities caused by loopholes and frictions between different legal frameworks. In an ideal world, governments would work together to optimize tax revenue collection and to optimize distributive justice under a democratically responsible international tax structure. For example, they may collaborate to grant each country the possibility to achieve more internal distributive justice while protecting global justice through transfer payments between affluent and poor countries. Such a world, however, is not only incredibly difficult to build but also clearly utopian. The complexity of the collective moral choices required by states, as well as the level of commitment to and solidarity with other states and their citizens (particularly in terms of interstate distribution), make this conclusion implausible.

If obtaining efficient and “just” global solutions is nearly impossible, one possibility is to urge cooperative measures that would coordinate and assist states' efforts to collect higher taxes and limit the problems linked to the “race to the bottom” of corporate income tax. The agenda of cooperation mechanisms is usually but not necessarily controlled by developed countries, resulting in unequal bargaining powers. The whole process might be tilted to favor developed countries, and this should be borne in mind when attempting to minimize minimizing gaps and frictions across jurisdictions.

In the international stage, the OECD is increasingly acting as an informal “World Tax Organization” to bolster cooperation. The OECD reform process, which emphasizes multilateral deliberation and consensus-building through “soft law” is likely to be the best available option for the development of international tax policy that promotes international dialogue in a legal and policy area where governments fiercely protect their sovereignty.

With regards to the role of the OECD in addressing the challenges posed by the digital economy, the Base Erosion and Profit Shifting Project's Action Plan has shown to be insufficient to address tax base erosion. In order to tackle harmful tax competition on a worldwide scale, the new OECD Two-Pillar plan will establish a global minimum tax on Multinational companies regardless of their place of incorporation or place of operations.

The OECD's Pillar One and Pillar Two are designed to solve the main tax issues brought on by the digitalization of the economy: how to establish taxable nexus for multinational companies when physical presence is no longer an appropriate linking element and how to divide earnings of companies operating internationally. These inquiries are addressed in Pillar One, which suggests a brand-new taxing authority over an enterprise's revenues depending on where the clients or users are situated. The concept is based on the arm's length principle, and the tax base allotted to a market state is determined by the global earnings of the multinational corporation. In a nutshell, the more clients, or users a company has in a certain country, the more of its tax base for profits is based there.

Pillar Two intends to establish a new global minimum tax system that tries to provide a minimum effective tax rate on company earnings across all jurisdictions and recommends an extra overlay of regulations to address any residual BEPS concerns[1]. In brief, if a state does not employ its taxing powers sufficiently, the regulations outlined in Pillar Two will reassign such powers to another state. The Pillar Two concept mandates a minimum tax rate on company earnings for all significant multinational corporations. These are desirable outcomes because they minimize BEPS loopholes that occur under the existing regulations. This agreement has been hailed by some as historic and revolutionary but effective harmonization seems to be rather difficult to achieve. For instance, by breaking up firms or underreporting income, tax evasion may result from the proposal to exclusively apply the global minimum tax to large corporations. Companies operating in emerging and developing economies indirectly seem to be the ones that the global minimum tax is intended to target. The priorities of developing countries also appear to have been relatively disregarded and this will lead to further breakdown of the system as countries look for ways to leave the agreement in order to minimize their losses.

From the perspective of the EU, the average statutory tax rate in the EU has fallen dramatically in recent decades, from around 35% at the end of the 1990s to 23% in 2008 and 21% in 2021.[2] In addition, identifying harmful EU tax regimes has been proved to be a challenge but tax harmonization has been used as a tool to prevent harmful tax competition.

The European Commission attempted to propose a series of measures to promote the development of a common consolidated corporate tax base for the largest global corporations. The measures, which were presented on 26 October 2016, include two directives ("CCTB" and "CCCTB"). Both establish common rules to calculate the corporate income tax base together with rules for profit allocation within a group. Despite a common Franco-German stance on the proposals, to date there has been no formal

[1] The February 2013 report entitled "Addressing Base Erosion and Profit Shifting" ("BEPS"), resulted in the OECD and G20 countries adopting an Action Plan in September 2013. The plan is made up of 15 actions to counter harmful practices.

[2] A. Thomadakis, *EU corporate taxation in the digital era, CEPS-ECMI Task Force Report*, Centre for European Policy Studies, 2023.

agreement and they have been withdraw following the tabling of the BEFIT proposal in September 2023.

In order to tackle the tax evasion, the EU has prioritized tax policy coordination, administrative cooperation and tax transparency. As part of its program to combat corporate tax evasion and harmful tax competition, following the OECD-two pillar solution, the EU adopted its Pillar Two directive at the end of last year and Member States are obliged to implement the rules by 31 December 2023.

In this complex context, this thesis intends to analyze the main actions adopted and ongoing against harmful tax competition. This study does not have the objective of being fully comprehensive, but to analyze the state-of-the-art of the key initiatives and explore new frontiers of action and focus on the role of the European Commission in its application of the State aid regime to tackle harmful tax competition.

Having explained the context in which our analysis in embedded, the thesis is articulated as follows.

Chapter one will describe the broad issue of tax competition, scrutinizing when it can be considered harmful and taking into consideration general economic principles. It highlights that national tax policy choices cause significant externalities for other countries: tax competition might weaken the integrity and redistribution principles of domestic tax systems and exacerbate the disparity between developed and developing nations.

Chapter two analyzes the international cooperation approach. As we have explained, the main efforts have been undertaken primarily by the OECD and, in spite of some problems connected to its practical implementation, the two-pillar solution marks a remarkable step forward in international tax cooperation.

Chapter three focuses on the main discussions within the European Union. The coronavirus outbreak has brought the issue back to the forefront. The budgetary disparities between Member States and limited supervision over tax competition at the European level might result in competitive distortions within the internal market. In order to tackle aggressive tax planning and profit-shifting strategies, the main tools that have been conceived are the Code of Conduct for Business Taxation and especially state aid law have been used. However, the recourse to the latter has called into question and the potential of “tax harmonization through the backdoor”[3]. The thesis shows that a comprehensive solution might only be achieved through more tax harmonization and commonly agreed legislative proposals, despite the hurdle represented by unanimity in direct taxation matters.

Finally, chapter four investigates the original connection between harmful tax practices and money laundering. This entail examining international cooperation to unmask complex legal structures, and hamper the actions carried out by facilitators in laundering of proceeds of tax crimes. At the end of the day, G7 actions to combat harmful tax competition tried to promote worldwide exchange of information on tax evasion and avoidance via tax havens in May 1998 and it was «*partly motivated by growing evidence that criminals can evade anti-money laundering systems by presenting their affairs as tax related to reassure their bankers, brokers and professional advisors*»[4]. The anti-money laundering and tax frameworks are often considered as monads, despite being strongly intertwined and the former can be a useful tool in addressing harmful tax competition.

[3] D.A. Kyriazis*, From Soft Law to Soft Law through Hard Law: The Commission's Approach to the State Aid Assessment of Tax Rulings*, in *European State Aid Law Quarterly*, 2016, p. 428-436.

[4] HM Treasury Press Release. G7 Initiative on Harmful Tax Competition. May 1998.

# CHAPTER 1

## *Notion of harmful tax competition*

### 1 Overview of the notion of competition

In economic terms, the term "*competition*" relates to the idea of the market, the mechanism through which, in almost all societies today, a major part of the satisfaction of collective and individual needs is achieved, the use of factors of production is regulated, economic growth is pursued, and the distribution of income is determined[5].

The ideal model for business-to-business competition is perfect competition. It is characterized first and foremost by the existence of a plurality of economic agents with roughly identical economic weight, on both the supply and demand sides. It is also be identified by product homogeneity, total mobility of production factors and transparency of information. It is presented as a process of interaction between equal economic subjects and the function of competition is not only to obtain the best results in the sphere of production and distribution, but also to prevent these economic subjects from gaining market power[6].

This model, however, is far removed from reality. Internationalization and concentration procedures have given rise to markets (for goods, capital, and labor) whose subjects are large organizations (economic, financial, trade union, etc.) rather than small companies, as postulated by the model of perfect competition. In comparison with this model, markets have lost two important characteristics: that of interaction between subjects of identical power, and that of their eminently private

[5] S. Raspiller, *Une analyse économique de la concurrence fiscale*, in *Revue française d'économie*, 2006, p. 53-85.

[6] It is a common mental construct in the social sciences derived from observable reality although not conforming to it in detail because of deliberate simplification and exaggeration. It is not ideal in the sense that it is excellent, nor is it an average; it is, rather, a constructed ideal used to approximate reality by selecting and accentuating certain elements.

nature. In a world of oligopolistic or monopolistic markets, the notion of perfect competition is maintained as an ideal type, in the Weberian sense of the term[7].

In reality, even if we continue to accept that competition in the market is the best form of resource allocation, the truth is that that markets have imperfections (imperfect markets, imperfect competition) or failures (market failures) and competition also functions as a mechanism for distributing or redistributing power.

In any case, it becomes clear that the survival of a certain competitive reality in the modern economic world (i.e., competition between companies) implies the institution of mechanisms to defend markets and competition. Competition and markets cannot survive without government regulation to safeguard the existence and effectiveness of competition, and to defend the structure of markets against the behavior of economic agents. This has historically been the best-known function of *antitrust* legislation.

When we talk about the economic action of states and the instruments that states have historically used, such as taxation, public services, subsidies, public enterprises, public monopolies, public markets, we already have theintuition that competition is not an exclusively economic phenomenon. In this sense, competition is a civic and political principle inherent to democratic systems, even before it is an economic principle, as well as in pluralistic societies[8].

In a broader sense, we can say that competition with an impact on economic life is not confined to the field of entrepreneurial activity, but also encompasses the field

[7] According to Wilson, ideal types in the Weberian meaning «*are constructed to present as clearly as possible formulations of social or cultural forms that can be used as patterns for organizing and comparing concrete phenomena in terms relevant to the investigator's particular investigation. Thus, the purpose of constructing ideal types is not to develop a universally valid scheme of interpretation for some given domain but to illuminate concrete phenomena, particularly with respect to how and why they resemble and depart from those patterns*». See T.P. Wilson, *The Problem of Subjectivity in Schutz and Parson*, in M. Endress, G. Psathas, H. Nasu, *Explorations of the life-world – Continuing Dialogues with Alfred Schutz*, Dordrecht, 2005, p. 19-50.

[8] According to Prof. Gutmann, «*it is especially appropriate to insist on the fact that neither the principle of residence nor that of territoriality cannot be evaluated by ignoring political reality international. It is clear, for example, that the principle of territoriality would be much less dangerous than it is now if there were closer coordination between tax policies national. It thus appears that the techniques for resolving the conflict of laws in tax matters do not can be judged in abstracto, but in light of the cultural and political context in which they are inserted. Tax matters are no exception to the history of internationalist doctrines; likewise, that the abstract conflict rule theorized by Savigny presupposed an ideological similarity between legal systems in conflict and has been discredited by the irruption onto the international scene of very different from Western culture, the tax conflict rule cannot be judged independently of all political and ideological considerations*». *See* D. Gutmann, *Globalisation et justice fiscal*e, in *L'année fiscale, Débats, Études, Chroniques*, 2003, p. 109-127.

of institutional action. There is competition between states, regions or municipalities, competition between jurisdictions that manifests itself at the level of institutions, in particular the legal order itself, and often helps to boost competitiveness[9].

There is no shortage of examples: the speed of the judicial system, the credibility of arbitration systems, corporate friendly tax incentives, labor legislation market, policies attracting foreign investment are all considered, among many others, to be instruments of competition between states and factors promoting competitiveness.

In this sense, the World Economic Forums Global Competitiveness Index, a highly comprehensive index, which captures the microeconomic and macroeconomic foundations of national competitiveness, assesses competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country[10].

This type of competition can have positive effects in certain areas, when it encourages states to observe rules of good governance. Yet, it can also have perverse effects when it translates into a race to meet minimum standards amongst different jurisdictions.

## 2 Notion of tax competition

### 2.1 Tax competition and liberalism

Economic liberalism advocates the free movement of goods and services, and free competition between states. Championed by Adam Smith and David Ricardo, this liberal doctrine translates into a total absence of barriers. Protectionism, on the other hand, relies on state intervention to protect the national market from foreign competition.

[9] Slemrod offers the following definition of country's competitiveness: «[a] *competitive economy would maintain (and preferably expand) the real incomes of citizens, fairly shared, in the face of global international markets and the policies of other countries, which vary in trade policy from a free trade orientation to aggressive promotion of exports, and vary in tax policy from domestically oriented and open to international cooperation, to aggressive courting of foreign investment, to the beggar-thy-neighbor behavior of tax havens*». This definition is focused on the effects rather than objectives of tax competition. *See* J. Slemrod, *Competitive Tax Policy*, in K.A. Hasset, *Rethinking competitiveness*, Washington, 2012, p. 32-67.

[10] The report has twelve pillars of competitiveness. These are institutions, appropriate infrastructure, stable macroeconomic framework, good health and primary education, higher education and training, efficient goods markets, efficient labor markets, developed financial markets, ability to harness existing technology, market size – both domestic and international, production of new and different goods using the most sophisticated production processes, innovation.

The controversy between protectionism and free trade is therefore lively, and this economic and political debate continues in the context of state tax competition. In a free market, economic agents are free to act and behave as they wish. In this environment, where the economic agent who produces goods and services plays an active role, tax competition amongst states thrives[11].

The economic phenomenon of state tax competition has been more and more regulated. However, such a role seems to run counter to the principles of economic liberalism. This school of thought advocates the idea that economic freedoms are necessary for the proper functioning of the economy, and that state intervention should be as limited as possible. Formulated as early as the XV century at the School of Salamanca[12], the concept of economic liberalism is now associated to the century of the Enlightenment and divided its supporters.

On the one hand, classical liberalism defends the rule of law. Supported in particulary by Locke, Montesquieu, Smith and Turgot, classical liberalism is hostile to state intervention in the economy. As the State's sole role is to uphold citizens' rights and protect individual freedoms, its actions are considered illegitimate if they affect another domain, such as the economy.

Neoclassical liberalism, on the other hand, is based on the search for a general equilibrium, and accepts state intervention in the economic sphere to achieve this goal, thus coming closer to protectionist policies[13]. With classical liberalism now in the minority, the protectionist aspect is assertingitself, and the State is thus legitimately intervening in the economy to regulate the phenomenon of state tax competition.

[11] *See* J. Slemrod, *Free trade taxation and protectionist taxation,* in *International Tax and Public Finance,* 1995, p. 471-489.

[12] The School of Salamanca is known as the Spanish school of natural law and the school of the law of nations. According to Schumpeter, the doctrines of Thomas Aquinas are elaborated by the Salamanca school with a political economy involved in morality and laws of economic liberalism orientation to determine just social relations. Economics is approached from a juridical orientation as a part of ethics and morality that determines the rules of justice. *See* J.G. Vargas-Hernández, *El liberalismo económico de la escuela de Salamanca y su influencia en el desarrollo institucional y organizacional*, in *Economía,* 2017, p. 51-84

[13] The main neoliberalists have been Luigi Einaudi and Guido de Ruggiero in Italy, Charles Renouvier, Alfred Fouillée, Léon Bourgeois, Charles Gide and Émile Durkheim in France, John Stuart Mill and Thomas HillGreen in England' William James, Herbert Croly, Walter Lippmann and John Dewey in the United States and Wilhelm Dilthey and Max Weber in Germany.

Hence, it is evident that the link between tax competition and economics is strong. In the final years of the XXVIII century, it was finally accepted that the movement of capital and people would be a feature of the globalization to come. As Adam Smith said, «*land is a subject which cannot be removed, whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business or enjoy his fortune more at his ease. By removing his stock, he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land, stock employs labor. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labor would necessarily be more or less diminished by its removal*»[14]. In other words, the taxpayer has the option of changing territory if he feels that the State in which he is established imposes too high a level of taxation. However, when he leaves, he takes with him the wealth that used to "benefit" his country.

Adam Smith's paradigm became increasingly concrete two centuries later. Unsurprisingly, tax competition was a particular hurdle when a common market was involved, and the European Economic Community created with the Treaty of Rome of 1957 was exactly the prelude to this. In the 1962 Report of the Fiscal and Financial Committee, known as the "*Neumark Report*", which analyzed the disparities existing in the financial and tax systems of the member states. It also had the objective of finding a rational compromise between the necessity of strongly reducing, in the interest of the optimum functioning of the Common Market, the fiscal or financial disparities hindering the free play of competition between the Member States on the one hand, and the expediency of not interfering in the policy of the Member States anxious to maintain national peculiarities arising from natural conditions and historical evolution on the other hand.

[14] A. Smith, *An inquiry into the nature and causes of the wealth of nation*, Glasgow, 1973, p. 674.

A few years later, the European Commission asked experts to examine the effect of differences in company taxation within the European Union on the functioning of the single market, and whether there were any significant economic distortions. In 1992, the Ruding Committee confirmed the point raised by the Neumark Report, stating that tax differences between Member States can affect the location of investments and lead to distortions of competition which are detrimental to the efficient allocation of resources within the Community[15].

This committee of experts put forward a number of suggestions to remedy the situation, and launched a process of reflection, but the Commission did not take up these proposals, leaving the issue to fade into oblivion. In addition, some economists initially spoke of horizontal tax competition, that is when neighboring local governments compete over the location of a mobile tax base or to set a tax rate. Such is the case of Keen and Kotsogiannis[16]; Boadway, Marchand and Vigneault[17] and Flochel and Madiès[18].

The debate about tax competition became more acrimonious with the financial crisis of 2008 and, more recently, the Nobel prize economist Thomas Piketty explored these issues. He talked about tax competition between countries and disputed the relationship between economic growth and prosperity, suggesting that financial liberalization, deregulation, and gaps in the worldwide tax code have benefited the wealthiest individuals at the expense of others, particularly those in the global South[19].

While the idea of tax competition has been around for years, the term "*tax competition*" itself first appeared in the 1997 European Code of Conduct[20] and the 1998 Report of the OECD entitled "*Harmful Tax Competition*"[21]. The aim is indeed to curb

[15] European Commission, Report of the Committee of independent experts on company taxation, 1992.

[16] M.Keen & C. Kotsogiannis, *Does Federalism lead to excessively high taxes,* in *American Economic Review,* 2002, p. 363-370.

[17] *R.* Boadway, M. Marchand & M. Vigneault, *The consequences of overlapping tax bases for redistribution and public spending in a federation,* in *Journal of Public Economics,* 1998, p. 453-478.

[18] L. Flochel & T. Madies, *Interjuridictional tax competition in a model of overlapping revenue maximizing governments,* in *International Tax and Public Finance, 2002,* p. 121-141.

[19] T. Picketty, *A brief history of equality,* Cambridge, 2022.

[20] Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy - Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation.

[21] OECD, *Harmful Tax Competition: an emerging global issue*, Paris,1998.

harmful tax competition, which is portrayed in its damaging form. The goal of the OECD Report is to increase knowledge about the detrimental effects that tax havens and harmful preferential tax regimes, also known as harmful tax practices, have on where financial and other service activities are located, the tax bases of other nations, trade and investment patterns, and the fairness, neutrality, and widespread social acceptance of tax systems as a whole. Such unfavorable tax competition is viewed as a cause for reducing global wellbeing and erodes the trust of taxpayers in the honesty of tax systems.

The existence of tax competition is now explicitly acknowledged, especially with the development of globalization and easier movement of capital and labor. It became an integral part of the work of several international organizations, such as the International Monetary Fund, the World Bank, the United Nations and more importantly the OECD.

## 2.2 The concept of jurisdiction

We will focus on tax competition between jurisdictions. By jurisdiction, we refer to a legal and political system with decision-making power over its own revenues and expenditure within a given territory. The interrelationship between various levels of jurisdiction, which constitute sub-central units subject to a central authority, is the main issue raised by the analysis of financial and fiscal federalism[22].

Competition between jurisdictions, whatever form it takes, depends on the extent to which the actions of the central authority influence the sub-central units. If the system is centrally defined in a common market, there is almost no room for tax competition. It can only manifest itself in the application of the law by the administrative authorities of sub-central jurisdictions.

[22] *See* H.R. Holderness, *Navigating 21st century tax jurisdiction*, in *Maryland Law Review*,2019, 1-55; R. Kerley, *New market tax credits, fiscal federalism & the dormant commerce clause*, in *Virginia Tax Review*, 2020, p. 111-144.

If, on the legislative level, there are shared or competing competences between central and sub-central authorities, or if the competence ultimately remains in the hands of these latter authorities,competition between jurisdictions is likely to occur[23].

Competition between jurisdictions, particularly for mobile production factors, can manifest itself in a variety of economic, financial, social and environmental policies. As far as states are concerned, it must be recognized that insofar as this competition ultimately concerns the overall performance of territories, the entire economic policy of states is concerned[24].

What is at stake, then, is the environment in which companies operate, designed by the State with a view to promoting economic development. This also entails the use of corporate and personal taxation, social security contributions, the stability of the regulatory framework, the attitude of public authorities, the degree of flexibility of the labor market, and the cost and productivity of the workforce.

### 2.3 Types of competition by level of jurisdiction

Two types of competition can arise between jurisdictions: horizontal and vertical. The globalization of economic and financial activity puts jurisdictions in a competitive situation. There are several levels of jurisdiction where competition can come into play.

In the European Union, for example, Salmon distinguishes four possible levels, depending on the degree of decentralization in which competition can take place:

*(i)* the local or municipal level, which is closer to the citizens and increasingly important;

*(ii)* regional, which assumes distinct forms, depending on the States;

*(iii)* the level of the central State, by far the most important at present, particularly in tax matters and, finally, the most controversial;

*(iv)* (*iv*) the level of the institutions of the European Union. Far from constituting a federal system (not least because of the limited resources available), the weight

[23] *See* V. Abballe, *Comparative Perspectives of the Articulation of Horizontal Interjuridictional Relations in the United States and the European Union: The Federalization of Civil Justice,* in *New England Journal of International and Comparative Law*, 2009, p. 1-40; S. Fabbrini & D. Sicurelli, *The federalization of the EU, the US and 'compound republic' theory: the convention's debate*, in *Regional & Federal studies*, 2004, p. 232-254.

[24] See D. Badré & A. Ferrant, *Les Rapports du Sénat, n° 386,* 2000.

of the latter level has nevertheless grownin recent years, mainly as a result of monetary union and the deepening of supranational elements in the decision-making process[25].

### 2.3.1 Horizontal competition

Horizontal tax competition is competition between neighboring subnational governments (counties, municipalities, special units of government, and school districts) over a moving tax base or, in the case of horizontal tax competition, over tax rates (similar levels of local governments). In other words, horizontal competition occurs when governments are placed at the same level of jurisdiction – competition between states, between regions, between municipalities. It can be broadly defined as «*any form of noncooperative tax setting by independent governments*»[26].

This form of competition is normally associated with the geographical mobility of factors of production between jurisdictions. With specific focus on tax competition, the latter can occur when there is horizontal spillover between jurisdictions at the same level, with the result being a "fiscal export" from jurisdiction A to other jurisdictions. In this case, non-residents in jurisdiction A end up contributing through their taxes to services enjoyed by residents in the same jurisdiction.

Yet the outcome of horizontal competition can also be a low level of taxation, due to the fear of a loss of tax base to other jurisdictions. As an example, US states have made greater use of tax incentives to attract new industries, and that recent tax changes have increased the incentive for tax competition between them. Nebraska lawmakers voted to lower the top marginal state corporate income tax rate to 7.25 % from 7.5 % as of January 1, 2023. The rate is projected to fall on average by 0.33 % points each year until it reaches 5.84 % on January 1, 2027, according to the Tax Foundation[27].

[25] P. Salmon, Decentralization and Supranationality: The Case of the European Union, Working Paper – Université de Bourgogne, 2000.

[26] J. Wilson & D. Wildasin, *Capital tax competition: bane or boon,* in *Journal of Public Economics*, 2004, p. 1065-1091.

[27] K. Loughead, *State Tax Reform and Relief Trend Continues in 2023*, Tax Foundation, 2023.

In this situation, a tax adjustment made by one state affects the tax base of another states – a horizontal externality – which in turn changes its tax.

### 2.3.2 Vertical competition

Vertical tax competition arises when governments that share jurisdiction over the same geographical area compete over a common tax base or a common tax rate where one level of government's change in tax policy causes another level of government to change as well[28]. Vertical tax competition exists because the tax base or the tax rate of a shared geographic area is, in some way, limited.

In this case, vertical spillovers can result from the interdependence of decisions, particularly tax decisions, when different levels of jurisdiction impose the same tax base, or if taxes collected at one level are deductible or credited at another[29].

As far as taxation within the European Union is concerned, vertical competition does not arise because the European Union has limited powers in direct taxation matters and no power to tax the bases imposed by the other levels of jurisdiction. It can manifest itself in the form of control, linked to forms of negative integration, as in the case of tax subsidies[30].

Since the tax hike imposed by one level of government reduces tax revenue for the other levels of government, these levels of government may need to raise their own taxes to balance their budgets. The tax base becomes a "common good" where each level of government is imposing a tax burden on the others. Vertical tax competition can be very common in countries where corporate income tax, personal income tax, sales and turnover taxes are all being taxed at the same time.

[28] *See* Y. Wu & R. Hendrick 2009, Horizontal and vertical tax competition in Florida local governments, in *Public Finance Review*, 2009, p. 289-311; G. Burge & P. Piper, *Strategic Fiscal Interdependence: County and Municipal Adoptions of Local Option Sales Taxes*, in *National Tax Journal*, 2012, p. 387-415.

[29] *See* M. Keen, *Vertical Tax Externalities in the Theory of Fiscal Federalism*, IMF Working Paper, 1997.

[30] F. Candau & J. Le Cacheux, *Taming Tax Competition with a European Corporate Income Tax*, in *Revue d'économie politique*, 2018, p. 575-611.

### 2.3.3 Horizontal and vertical externalities

If state governments ignore these effects of their own taxes on other states, then tax externalities will disrupt regional fiscal decisions, resulting in under- or over-provisioning of public services. In the case of state-to-state tax base mobility, positive horizontal externality drives the result that regional taxation and public provision are set ineffectively low.

Tax competition leading to a "race to the bottom" scenario is often cited as the main example, but there are other forms of tax exportation. When federal and state governments co-occupy tax bases, vertical externality enters the equation. Here, the externality is the effect on the "shared tax base", which may contract as a result of increased state taxation, resulting in a decrease in federal tax revenues[31].

The interaction between vertical and horizontal tax competition is significant. Vertical competition tends to increase tax rates, thus partially compensating for the effects of horizontal competition. However, the overall impact of vertical competition is contingent upon the tax mix and elasticity of the shared tax base, which can lead to over-taxation. For example, if a tax base is inelastic, such as a property tax, it may be less relevant when a more mobile base is shared, such as a corporate tax or personal income tax.

It is worth noting that government's objective functions in taxation and political economy constraints, such as voter's behavior, limit the scope of the joint tax base. Coordination of tax policy across government levels can further contribute to the reduction of vertical tax competition and excessive taxation[32]. When two or more tiers of government in a given country share a tax base, and the tax base is such that it reacts negatively to increases in the effective rate, when one of these tiers increases the tax pressure on the tax base, there is a reduction in the revenue of the other tier of government as long as the tax parameters do not change. Overall, the tax decisions of both tiers are not independent, and in worst-case scenarios, the coordination of tax

[31] W. Sas, *Commuting in a Federation: Horizontal and Vertical Tax Externalities Revisited*, in *KU Leuven Discussion Paper Series*, 2014.

[32] M. Devereux, B. Lockwood, M. Redoano, *Horizontal and vertical indirect tax competition: Theory and some evidence from the USA*, in *Journal of Public Economics*, 2007, p. 451-479.

decisions could lead governments to set tax levels that would result in negative variation in revenue from the increase in the tax rate[33].

Two interesting aspects of vertical tax externalities have been addressed in literature. The first is the interaction between the two levels of tax-setting. Theoretically, the optimal level of tax-setting by a lower-level jurisdiction is dependent on the base elasticity. In practice, the impact of a federal tax rate change is generally uncertain[34]. For example, Hayashi and Broadway show that higher federal corporate tax rates in Canada are correlated with lower provincial corporate tax rates[35].

The second is the relationship between vertical and horizontal tax externalities. Keen shows that the interaction between vertical and horizontal taxes is dependent on the relative magnitude of the elasticity (demand for capital) and the supply (savings) of the base elasticity (the responsiveness of the common tax base). The former implies that in most models, tax rates are too low, and the latter is too high[36].

In a two-way externality model, Devereux shows that the equilibrium between externality and externality is determined by the ease of international arbitrage and price elasticities of demand[37].

Furthermore, Garbarino explains how certain tax measures may operate to address the so-called "negative externalities" often associated with financial crises. The inability of the international community to come to reach an agreement on whether and how to create a globally coordinated tax on the financial sector may have been significantly influenced by competition between nations in luring money and investments. Some nations may have wanted to attract financial institutions by positioning themselves as a "financial tax haven" at the expense of others, assuming that

[33] A. Esteller-Moré & A. Solé-Ollé, *Vertical income tax externalities and fiscal interdependence: evidence from the US,* in *Regional Science and Urban Economics*, 2001, p. 247-272.

[34] *See* M. Keen, *Vertical Tax Externalities in the Theory of Fiscal Federalism*, IMF Working Paper, 1997.

[35] M. Hayashi, & R. Boadway, *An empirical analysis of intergovernmental tax interaction: the case of business income taxes in Canada*., in *Canadian Journal of Economics*, 2001, p. 481- 503.

[36] M. Keen, *Some international issues in commodity taxation,* in *Swedish Economic Policy Review*, 2002, p. 11–45.

[37] M. Devereux, B. Lockwood, M. Redoano, *Horizontal and vertical indirect tax competition: Theory and some evidence from the USA*, in *Journal of Public Economics*, 2007, p. 451-479.

those nations would still impose new domestic taxes on the institutions already present on their soil in the absence of an international agreement[38].

### 2.4 Implicit or explicit competition

There are several types of competition that jurisdictions can undergo or conduct. The first concerns a situation that can be called “implicit competition”. This refers to the way in which the free movement of goods, services, people and capital in a common market limits the actions of autonomous jurisdictions, particularly within a federal state[39].

This type of inter-jurisdictional competition applies, by definition, only to horizontal competition. It refers not only to a situation in which jurisdictions are placed at the same level and where they act non- cooperatively in establishing their policies, without however intending to compete, but also to a situation in which these jurisdictions are obliged to take account of the pressure linked to the mobility of economic factors. Indeed, their decisions, policies and actions can always give rise to externalities, whether positive or negative. Similarly, they may be subject to externalities produced by the decisions, policies or actions of third-party jurisdictions. It involves taxation, but not necessarily.

In the realm of taxation, tax competition is a «*strategic tax-setting in a non-cooperative game between jurisdictions – whether countries or states or provinces within a federation – with each setting some parameters of its tax system in relation to the taxes set by others*»[40].

However, Tannenwald makes a difference between implicit and explicit tax competition: «*governments engage in explicit tax competition when they enact tax laws and regulations expressly designed to enhance the attractiveness of their jurisdictions to businesses, residents, employees or consumers* [and] *in implicit tax competition when they modify their pursuit of other tax policy goals-such as equity, neutrality, simplicity,*

[38] C. Garbarino, *The Global Architecture of Financial Regulatory Taxes*, in *Michigan Journal of International Law*, 2018, p. 603-648.

[39] Members of the U.S. Advisory Commission on Intergovernmental Relations, *Interjurisdictional tax and policy competition*: *good or bad for the federal system?*, 1991.

[40] M. Keen, *The New Palgrave Dictionary of Economics*, 2008, p. 1-11.

*revenue adequacy, or tax exporting, in order to mitigate anti-competitive consequences*»[41].

While much of the literature on tax competition has focused on competition between governments to lure capital by reducing tax rates, other forms of intergovernmental competition exist that are not limited to fiscal variables. For example, if environmental standards are not regulated at the national level, local or regional governments compete with one another by lowering environmental standards[42]. Another form of intergovernmental competition is regulation of the quality standards of products produced within their jurisdiction. Sinn suggested that governments acting independently would set lower quality standards for domestic products as long as the majority of the production was exported[43].

A further example is described by Talpos and Crâşneac, who focused on different forms of competition among governments and particularly on the narrow sense of horizontal tax competition, designed to attract high mobility factors[44].

## 2.5 Active competition

Another shape of inter-jurisdictional competition emphasizes the active role played by governments in promoting global competitiveness of territories and their reputation.

This type of competition focuses on a jurisdiction's ability to attract or retain mobile factors of production – companies, capital and individuals, workers or consumers. It is also based on a non-cooperative attitude and can be defined as a situation of rivalry between governments in which they try to obtain certain favorable and scarce resources.

[41] R. Tannenwald, *The Encyclopedia of Tax Policy*, 1999, pp. 367-371

[42] W. Oates, *Fiscal Competition or Harmonization? Some Reflections*, in *National Tax Journal*, 2001, p. 507-512.

[43] H.W. Sinn, *The selection principle and market failure in systems competition*, in *Journal of Public Economics*, 1997, p. 247-274

[44] I. Talpoş & A.O. Crâşneac, *The Effects of Tax Competition*, in *Theoretical and Applied Economics*, 2010, p. 39-52.

This form of competition is usually favored by taxation to achieve different kinds of objectives[45]. It can be either offensive or defensive. As an example, with regard to taxation and beginning in 2012, politicians and the news media began to highlight aggressive tax competition measures, such as Ireland's 12.5% corporate rate[46] low or non-existent corporate tax rates in Cayman and Bermuda[47]. and administrative rulings that slashed effective tax rates to near zero. While news media stories focused on multinational companies such as Google, Amazon and Apple, they also highlighted that low tax rates or special tax schemes enacted by governments made these tax avoidance transactions profitable.

When a country faces tax competition from another jurisdiction, it has two main choices: engage in competition itself or pass defensive measures. By restricting the capacity of other jurisdictions to compete and shifting the competitive locus to an area in which they have a higher chance of success, countries with anti-tax competition measures are actually using those measures as offensive measures.

For instance, the nexus approach requires that an intellectual property regime only grants benefits where a taxpayer has conducted the underlying research and development in the jurisdiction offering the regime[48]. By requiring previously hidden rulings to be shared with other jurisdictions, non-secrecy-based jurisdictions can compete more effectively with jurisdictions that previously did not.

[45] This involves competition to attract factories. A notable example is Tesla. It was looking for a location to build its Model S gigafactory, with the promise of thousands of new jobs wherever the giant battery plant was built. The company sought to sweeten the deal by bribing local governments with millions of dollars in tax incentives. The state of Nevada was one of the four finalists for the gigafactory, offering a package of incentives that was the biggest in Nevada's history and one of the top 15 largest in the U.S. Over the next two decades, Tesla could benefit from nearly $1,300 million in tax credits for building its gigafactory in the state of Nevada, as jobs are made locally and across the country. Under the terms of the deal, Tesla will pay no sales tax for 20 years, and no property tax for 10 years, while receiving millions of dollars in additional tax credits.

[46] See, e.g., Tax Torment, The Economist, 19 March 2011.

[47] See, e.g., C. Duhigg & D. Kocieniewski, *How Apple Sidesteps Billions in Taxes,* N.Y. Times, Apr. 29, 2012.

[48] As a background reference, the nexus approach has been applied as a minimum standard through the BEPS Inclusive Framework in action 5 of the G20/OECD Base Erosion and Profit Shifting project.. In brief, it requires a country to apply preferential taxation of revenue from parent and patent-like intellectual property under patent box regimes solely to the amount related to that country. It thus concerns creating a link between expenditures, intellectual property assets and income. The advantage for revenue derived from IP exploitation would be proportional to the Research & Development expenses of the IP owner or a non-related entity to which the Research & Development was farmed out. *See* J. Englisch, *Steuer- un wirtschaftpolitische bedeutung von patenbozen in post-BEPS-zeitalter*, in *Wirtschaftdienst*, 2017, p. 577-583; R. Sanz Gomez, *The OECD's nexus approach to IP boxes: a European Union law perspective*, WU International Taxation Research Paper n. 2015-12, 2015.

Australia's and the United Kingdom's recent anti-abuse rules are also offensive measures. While these rules were designed to target tax avoidance by multinationals, Australia and the United Kingdom are also using them as offensive measures. Soon after the United Kingdom introduced the diverted-profits tax, for example, Amazon announced that it would start booking its online sales profits to the United Kingdom, rather than Luxembourg, where it had previously claimed to be earning its income for the past eleven years[49].

## 2.6 Performance-based competition

Another modality of competition relates more directly to the sphere of politics. In jurisdictions where the choice of leaders is made through free and democratic elections, citizens can compare the policy performance of competing jurisdictions and, from this, derive conclusions about how they will be able to exercise the right to vote in future elections. This can lead to what some authors call "yardstick competition"[50].

Political yardstick competition is the theory that comparing the level of public services and tax rates in local areas can give voters a tool to evaluate politicians. The mechanism of this type of competition can be described as follows: a voter in jurisdiction A compares the results of sectoral policies of interest to him, as he can observe them in his jurisdiction, with what he knows of the results in another jurisdiction B, situated at the same level (for example, municipal, regional or national). If he considers the relevant

[49] The DPT applies a 25% tax on the profits of a multinational that have been transferred from the UK to another jurisdiction. The DPT defines such profits by taking into account two factors: (a) whether there is a requirement to have a "permanent establishment" in the United Kingdom; and (b) whether there is sufficient evidence in another jurisdiction to support the transfer of the income to that jurisdiction. In 2016, Australia introduced a similar rule known as the Multinational Anti-avoidance Law. Like the diverted profit tax, the Multinational Anti-avoidance Law applies to the profits of multinational companies. However, the Multinational Anti-avoidance Law does not impose a tax on the profits, but doubles the penalties imposed on the taxpayer by the Australian authorities. The Multinational Anti-Avoidance Law applies where one of the main purposes of the transaction was to receive a tax benefit. It also applies where, although a foreign entity is providing goods and services to Australian consumers through an Australian entity, there is not sufficient income to have a permanent establishment. *See* L. Faulhaber, *The trouble with tax competition: from practice to theory*, in *Tax Law Review*, 2018, p. 311-365.

[50] A. Schleifer, *A theory of yardstick competition*, in *Rand Journal of Economics*, 1985, p. 319-327; T. Besley & A. Case, *Incumbent behavior: vote seeking, tax setting and yardstick competition*, NBER Working Paper n. 4041, 1992; M.A. Allers, J.P. Elhorst, *Tax mimicking and yardstick competition among local government in the Netherlands*, in *International Tax and Public Finance*, 2005, p. 493-513; E. Dubois & S. Paty, *Yardstick competition: which neighbours matter?*, in *The Annals of Regional Science*, 2010, p. 433-452.

outcomes in A to be higher than in B, this will, on average, increase the probability of voting for incumbents (those who support the government) in the next election.

If, on the other hand, he perceives his own government's performance in A to be relatively inferior to that of B, this will, on average, somewhat reduce the same probability. The incumbents of the governing party and the executive itself do not know how each voter will vote. They do not even know the voters' priorities, nor which jurisdictions each voter uses as a reference when comparing policies. But they are aware that all sorts of comparison are made by voters, and that these comparisons influence their votes. This is enough to motivate them to get involved in as many areas as possible[51].

In this sense, many countries have a system of intergovernmental grants that equalizes fiscal disparities to some degree. This system has traditionally been defended as improving locational efficiency as it eliminates the incentive to migrate to jurisdictions with more favorable fiscal conditions for equity reasons; or as a hedge against regional shocks[52]. Against this kind of competition, it has been argued that equalization can improve the decision-making process for subnational governments by equalizing fiscal disparities to the extent that each jurisdiction can provide the same level of service at the same level of tax sacrifice. The subnational government’s output levels, in combination with the tax rates, provides an unbiased indicator of the performance of the subnational government[53].

## 3 Institutional tax competition

### 3.1 Business-to-business competition and institutional tax competition

When we speak of “institutional” tax competition, the meaning of the term competition might not exactly be the same as that used for competition between companies. There is, of course, tax competition between companies, particularly

[51] A. Breton & H.W. Ursprung, *Globalisation, Competitive Governments, and Constitutional Choice in Europe*, CESifo Working Paper Series 657, 2002.

[52] R. Boadway, *Intergovernmental redistributive transfers: efficiency and equity*, in E. Ahmad, & G. Brosio, *Handbook of Fiscal Federalism*. Cheltenham, 2006, p. 355-380.

[53] M.A. Allers, Yardstick competition, fiscal disparities, and equalization, in *Economics Letters*, 2012, p. 4-6.

between transnational companies, between companies operating in different tax jurisdictions. This phenomenon has several dimensions.

One of the main ones is tax planning, based on the ability of these enterprises to obtain advantages from gaps or imperfections in the law or national tax disparities, thereby artificially lowering the costs of doing business[54].

In the latter case, faced with tax disparities between countries, multinational companies often develop strategies of relocating their real economic activity or simply relocating their tax base through accounting and legal engineering, with a view to lowering their production costs and thus improving their competitive positions[55]. There are a number of tax optimization techniques that enable companies to avoid being taxed in the countries where they do business. These usually concern financial relations within a group of companies, the transfer of profits in commercial transactions between countries or the payment of excessive royalties.

In addition, companies can also engage in tax evasion or tax avoidance, phenomena that cannot be confused with tax planning and which, by distorting production costs, also have a significant impact on competition[56]. The distinction between the two has become somewhat blurred in some countries[57].

[54] P. Adonnino, *La pianificazione fiscale internazionale,* in V. Uckmar, *Diritto tributario internazionale*, Padova, 2005, p. 64.

[55] The definition of "tax planning" will be further investigated in this thesis. At this stage, on definition of tax planning, *see* C.S. Armstrong, J.L. Louin, D.F. Larcker, *The incentives for tax planning*, in *Journal of Accounting and Economics*, 2023, p. 391-411; J.M. Calderon Carrero & A. Quintas Seara, *The concept of aggressive tax planning and the Eu Commission in the BEPS era: redefining the borer between legitimate and illegitimate tax planning*, in *Intertax*, 2016, p. 206-226; A. Mazz, I.J. Mosquera Valderrama, N. Quinones, C. West, *Tools used by countries to counteract aggressive tax planning in light of transparency*, in *Intertax*, 2018, p. 140-155; F. Cachia, *Aggressive tax planning: an analysis from an EU perspective*, in *EC Tax Review*, 2017, p. 257-273; P. Piantavigna, *The role of the subjective element in tax abuse and aggressive tax planning*, in *World Tax Journal*, 2018, p. 193-232.

[56] On the definition of tax avoidance and tax evasion, *see* R. Neck, J. Uwe Wachter, F. Schneider, *Tax avoidance versus tax evasion: on some determinant of the shadow economy*, in *International Tax and Public Finance*, 2012, p. 104-117; G. Melis, *Evasione ed elusione fiscale internazionale e finanziamento dei diritti sociali: recenti trends e propespettive*, in *Rassegna Tributaria*, 2014, p. 1283-1302, A. Contrino, *Elusione fiscale, evasione e strumenti di contrasto*, Milano, 1996; G. Marino, *Usi e abusi delle convenzioni internazionali in materia fiscale nel prisma dell'ordinamento italiano*, in E. Della Valle, V. Ficari, G. Marini, *Abuso del diritto ed elusione fiscale,* Torino, 2017, p. 307-314; J.P. Vidal, *La trasparence fiscale du contribuable dans un contexte international: faut-il* prévoir la fin de *l'évasion fiscale internationale?,* in *Revue française de finances publiques,* 2017, p. 89-101, J.G. Gravelle, *Tax havens: international tax avoidance and evasion,* in *National Tax Journal,* 2009, p. 727-753; K. Blafaus, J.Hundsoerfer, M. Jacob, M. Sundwoldt, *Does legality matter? The case of tax avoidance and evasion* in *Journal of Economic Behavior & Organization*, 2016, p. 182-206.

[57] J. McLaren, *The distinction between tax avoidance and tax evasion has become blurred in Australia: what has it happened*, in *Journal of the Australasian Tax Teachers Association,* 2008, p. 141-163.

These phenomena are normally regulated bilaterally, through double-taxation treaties, administrative cooperation, and information exchange, or unilaterally, through the intermediation of transfer pricing regimes, the use of anti-abuse clauses, the use of tax exemptions, etc. reinforcement of control activities or, in the case of fraud, criminal sanctions.

However, when we speak of tax competition, it is not this dimension we should concentrate on, but rather that of competition between tax jurisdictions, competition between tax states, systems, or policies, and above all active tax competition. In fact, a particularly important source of institutional competition stems from the tax system, in the broadest sense of the term. This is the main definition of tax competition which has been widely discussed because businesses are taking advantages of mismatches and loopholes caused by the absence of pervasive coordination amidst domestic tax systems, resulting in substantial loss in tax revenues for several jurisdictions.

In contrast to business-to-business competition, where the aim of tax planning is, in principle, to reduce costs so that companies can sell their products and services at more attractive prices and thus obtain a greater market quota, tax competition between states aims, at least in the long term, to obtain a greater amount of tax resources derived from the international division of the global tax base in order to increase the country's welfare.

Along these lines, it is interesting to note that case law has based its considerations to defend tax competition – even when directly or indirectly aimed at tax evasion. More specifically, the *Andolan* case involved triangular tax planning (the Netherlands–Mauritius–India) to achieve a triple international non-taxation opportunity in the capital gains arena. Strikingly, this planning was explicitly validated by the Supreme Court of India based on tactical considerations[58].

[58] Supreme Court of India, Union of India vs. Azadi Bachao Andolan, 7 October 2003, para 135-137: «*The Supreme Court of India grounded its decision in favor of the taxpayer on strategic considerations as follows: Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them. The use of Cyprus as a treaty haven has helped capital inflows into Eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investments in Southeast Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant funds through the 'Mauritius conduit'. Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the India–Mauritius tax treaty. Developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of revenue could be insignificant compared to the*

Hence, when a country opts for a tax competition strategy, its aim is to improve the territory's tax revenues to attract economic and financial activities. The actors and objectives of the two forms of competition are therefore very different but there are bridges between them. On the one hand, competition between states favors corporate tax planning and even opportunities for tax avoidance and evasion, it is rather difficult, in the end, to know in a certain situation what the reason is for a possible drop in revenue. On the contrary, business-to-business competition in international markets favors state tax competition situations and strategies.

In theory, the growing competition between countries in taxation could be due to tax base mobility[59]. According to North, it is a national "deliberate strategy" designed to improve an economy's competitive position vis-à-vis other countries. North views competitive pressures as a boon bringing the advantages of change to an institutionally stable economy[60]. He is of the idea that they are the «*rules of the game* in a society, or […] *humanly designed constraints that shape human interactions*»[61].

In order to build a model of institutional change, North first presents five ideas for change in institutions. First, institutional change develops as a result of ongoing interactions between institutions and organizations in a context of limited resources. Second, firms must spend in learning new skills and knowledge to be competitive, but the ones they choose to learn will determine the scope and depth of institutional change. Third, the types of skills and knowledge that are gained will be influenced by an institutional framework, which is the outcome of historical evolution of the institutional shift. Fourth, organizations seek for the knowledge and talents that will benefit them the most, but these are still founded on their "mental constructs". Fifth, institutional change is "overwhelmingly incremental and path dependent" due to elements like "economies of scope, complementarities, and network externalities".

We should now apply these five postulates of institutional change to the evolution of tax systems. Government-prepared tax systems are a product of historical institutional

*other nontax benefits to their economy.* [Treaty shopping] *is perhaps regarded in contemporary thinking as a necessary evil in a developing country». See* E.A. Baistrocchi, *Global Tax Hubs,* in *Florida Tax Review*, forthcoming, 2023.

[59] A. Kocia, *Tax system as a factor attracting investment into the European union member countries*, in *Argumenta Aeconomica*, 2009, p. 103.

[60] D.C. North, *Institutional competition*, Conference on Economic History, Econ WPA, 1994.

[61] D.C. North *Institutions, Institutional Change and Economic Performance*, Cambridge, 2006.

evolution and are formalized in taxation law concepts. Institutional change results through interactions between diverse organizations and their stakeholders. There are several steppingstones in this process, though. There may be factors at play in the shift. Even if there are merely opportunity costs lost, exogenous changes in the environment like those in the tax incentives provided by a foreign country will have an effect on an organization's operating expenses.

As an alternative, the relative costs for all parties involved will change as a result of interactions between organizations, such as the evolving communication styles between tax collecting agencies and businesses. In a multinational setting, like the European Union, where several organizations and businesses interact and are impacted by events in a global economy, the analysis becomes much more complicated. All firms make investments in knowledge and skill growth in this extremely complex environment in an effort to obtain the upper hand. A favorable outcome will rely on which talents are gained, what is historically route dependent, and the future direction of the productive improvements that will lead the country toward being wealthier. Skills and knowledge acquisition, however, will not provide a great outcome on its own.

## 3.2 The foundations of tax competition between jurisdictions

Globalization has increased competition not only between economic agents, but also between the governments, regional and municipalities. This globalization of economic activity is driven by the need for companies to expand into new markets, and to achieve economies of scale. The acceleration of the globalization of trade and investment has fundamentally altered the relationship between national tax systems[62].

The interdependence of these systems is, in general terms, at the root of global tax competition. Several factors have contributed to this situation: the removal of non-tax barriers to international trade and investment, the integration of national economies; the growing mobility of capital, the development of capital markets in general and financial markets, the intensification of competition between companies in the global market, technological innovation as well as changes in the way

[62] See S. Bucovetsky, *Asymmetric tax competition*, in *Journal of Urban Economics*, 1991, p. 167-181.

multinational companies are managed, which reduce the importance of the physical location where this management takes place. Tax competition, like the existence of a stronger incentive for international tax planning, evasion and even fraud, is therefore a sort of "side effect" of globalization[63].

In this context, one phenomenon deserves particular attention: new forms of corporate organization and the flourishing of multinational corporations in the international arena. Companies increasingly being transformed into more transnational organizations. All this makes cross-border tax issues, especially transfer pricing, and taxation in general as an increasingly relevant, competitive weapon. –

Globalization is just one of the factors. The ongoing digital revolution must also be taken into account because it threatens to seriously disrupt tax law and relations between companies and tax authorities[64]. Indeed, the digital revolution entails two main consequences: the disintermediation and dematerialization of economic activity. These phenomena pose new tax problems, either at the substantive level (e.g., teleworking, e-commerce, the definition of tax residence) or at the level of control (the anonymity of taxpayers increased ease of opening accounts and setting up offshore businesses).

In the European Union, the gradual completion of the internal market, the realization of economic and monetary union and its enlargement to twenty-seven countries are creating the conditions for increased tax competition. The extension and completion of the single market and the principle offree trade led to the creation of the European financial area, the privatization of Member States' assets and the opening up of public monopolies to competition, and the liberalization of telecommunications - all phenomena which, during the 90s, confirmed the deepening of market logics.

The creation of monetary union reinforced and accelerated the effects of the single market in several sectors and increased the distortions that were already being felt. In addition, it deprived member states of the ability to influence currency issuance and exchange rates, reducing the sphere of state action. This trend towards the creation of a common market space is, however, countered by a fragmentation, encompassing several

[63] See D. Park, G*lobalization, Erosion of Tax Base, and the Revenue Potential of Developing Asia's Foreign Exchange Reserve Build-Up*, Asian Development Bank Working Series No. 122, 2008.

[64] G.R. Zodrow, *Tax Competition and Tax Coordination in the European Union*, in *International Tax and Public Finance*, 2003, p. 651–671.

fiscally sovereign jurisdictions. This combination of fiscal sovereignty and the single market shows that there is a clear link between economic freedom and the existence of tax competition between states[65].

Finally, the enlargements of 2004, 2007 and 2013 have introduced greater economic and fiscal heterogeneity within the Union, with some new countries being considered tax havens such as Netherlands, Cyprus and Malta[66].

### 3.3 The diversity of tax system

The tax systems of individual jurisdictions are very different from one another. This diversity is at the root of the various forms of tax competition. However, even if this diversity sometimes stems from a deliberate policy to promote tax competition, it must be recognized that taxation is largely dependent on the specific cultures of different countries.

In fact, it is closely related not only to the economic structure and level of development of a given country, but also to its political history, its technical and administrative culture, the type of legal system – the structure, composition and operation of the taxes that make up the system, the organization of administration and tax justice, the collective psychology of taxpayers. Levels of taxation and tax pressure, as well as the financial structure of taxes, essentially depend on all these factors, and in part on the economic and fiscal policies of individual countries.

Between 1985 and 2019, the global average statutory corporate tax rate has fallen from 49% to 23%, largely due to the rise of international tax competition[67]. This heterogeneity is not observed in offshore financial centers where corporate income tax can be almost inexistent, but also within the European Union, even if there is a degree of convergence in taxation[68].

The first indicator of this diversity is the tax burden. Within the European Union, there are countries with a high tax burden, such as the Nordic and Central

[65] *See* EU Tax Symposium "*Road to 2050: A Tax Mix for the Future*", 28 November, 2022.

[66] L. Maftei, *An overview of the European tax havens,* in CES Working Papers, 2013, p. 41-50.

[67] K.A. Clausing, E. Saez, G. Zucman, *Ending corporate tax avoidance and tax competition: a plan to collect the tax deficit of multinations,* UCLA School of Law Law-Econ Research Paper n. 20-12, 2020.

[68] L. Hrehorovska, *Tax harmonization in the European Union,* in *Intertax,* 2006, p. 158.

European countries, and there are countries with a medium or even low tax burden, especially in Eastern Europe[69]. In terms of tax structure, there are also major disparities: some countries favor consumption taxes, while others prefer income taxes. There are still major disparities between EU Member Statesin terms of company taxation, both qualitatively and quantitatively.

When central and sub-central taxes are taken into account, Portugal has a statutory corporate income tax rate of 31.5 %, the highest among European OECD countries. Germany and France set the corporate income tax rates at 29.9% and 28.4% respectively. Hungary has the lowest corporate income tax rate at 9%, Ireland the lowest at 12.5% and Lithuania the lowest at 15%[70].

Accounting rules depend on the traditions of the countries concerned, some of which tolerate differences between accounting and tax treatment of certain items while others establish a very close relationship of dependence between the two. There are also major differences in depreciation rules, provisions, loss carry-forward regimes, capital gains treatment, intra-group compensation and consolidation, inter-company dividend regimes, inventories, and deductible expenses.

As a consequence of the presence of several jurisdictions with the power to determine taxes autonomously, the existence of highly disparate tax systems, particularly with regard to the taxation of corporate profits, leads to significant tax differentials for companies. It also opens the door to tax planning practices.

### 3.4 Harmfulness of tax competition

The role of tax competition still hinges on the question of the place reserved for taxation in the investment decisions of economic agents. Indeed, the importance given by some jurisdictions to tax competition implies that taxation is a decisive factor in the

[69] It has been highlighted that even where corporate income taxes are low, like in Eastern Europe, over the past two decades the statutory rates have substantially decreased in order to create a more attractive business environment. *See* G. Vintila, S.C. Gherghina, R.A. Paunescu, *Study of effective corporate tax rate and its influential factors: empirical evidence from emerging European markets*, in *Emerging Markets Finance & Trade*, 2018, p. 571-590.

[70] S. Bray, Corporate Income Tax Rates in Europe, Tax Foundation, 2022.

choice of investment and business location. Unfortunately, verifying this is an arduous task[71].

Taxation is not the only factor influencing the decisions of economic agents. The location of the territory, the size of the economy, development of policies the effects technological spillovers, the existence of good infrastructures and infrastructure workforce, the productivity, innovation, the provision of public goods, the allocation of subsidies, are, among others, relevant factors, notably in attracting direct investments and in firms' choice of where to be located. Also, it is not easy to know the weight of each of these factors.

Despite the difficulty of measuring the effects of tax competition, there is considerable controversy in economic, legal and political literature about the nature of those effects that are triggered by tax competition[72]. One distinction that has come to the fore is that between fair, healthy, or "good" tax competition and tax competition that is "bad".

Most authors draw this distinction from the work and experience of the OECD and the European Union[73]. According to Rubens, any competition aimed solely at attracting foreign investors to the national territory to the detriment of States and public services of general interestand allowing multinationals to set up tax structures facilitating malpractice and any other form of fraud is harmful[74].

Healthy tax competition, on the other hand, would consist of a reduction in tax burden aimed at strengthening the competitiveness of domestic companies, for example by lowering the taxes levied on their profits, but without harming neighboring states by entering into a policy of tax undercutting which, in itself, would be harmful. This form of competition incentivizes governments to maintain a certain balance between a lower but acceptable level of funding for public spending and reduced tax

[71] This is an arduous task which have been used as an argument by international organizations to assess the compliance of decisions taken by individual states. *See* P. Boria, *Taxation in European Union*, New York, 2017, p. 165-171.

[72] *See* M. Keen & K.A. Konrad, *The Theory of International Tax Competition and Coordination*, in A.J. Auerbach, R. Chetty, M. Feldstein, E. Saez, *Handbook of Public Economics*, Elsevier, Amsterdam, 2018, p. 257-328.

[73] *See* C. Pinto, *EU and OECD to fight harmful tax competition: has the right path been undertaken?*, in *Intertax*, 1998, p. 386.

[74] E. Rubens, *La fiscalité des entreprises. Aspects financiers de la concurrence fiscale dommageable au sein de l'Union européenne*, Bruxelles, 2002, p. 76.

burdens for taxpayers and allows them to retain a certain freedom in determining tax levels, which is a decisive question of fiscal sovereignty.

The problem of harmful tax competition is, however, inseparable from three questions. The first concerns the meaning of the phenomenon. The second is who is damaged. The third is which entity should have the power to regulate this tax competition, that is the power to decide when there is a fair orunfair form of competition and, in the latter case, how to proceed.

It is worth noting that, in federal states, all forms of competition are in principle concerned. Furthermore, the question of who should evaluate tax competition to determine whether it is harmful or not is clearly answered by the federal system. Similarly, when asked who has the power to regulate, the answer is equally clear: the federal government.

The issue is more complicated, however, when dealing with the tax systems of independent states that are part of an international organization such as the OECD, or even a *unicum* organization such as the European Union.

As a way of background, on the international stage, the OECD has been working on global initiatives since the 1990s to define what constitutes acceptable and undesirable tax competition. The OECD defines a "harmful tax practice" as one that has no or minimal effective tax rates, as well as a lack of effective information sharing, transparency, or ring-fencing. The OECD consequently highlighted five key factors as "potentially harmful tax practices"[75]:

*(i)* no taxation on the relevant income[76]

*(ii)* lack of transparency

*(iii)* lack of effective exchange of information

*(iv)* ring-fencing, as a consequence of which certain preferential tax regimes are partly or fully isolated from the domestic markets of the country with the regime; and

*(v)* lack of substance A regime is to be considered harmful in case it «*encourages purely tax driven operations or arrangements*» and is

[75] *See OECD report on Harmful Tax Competition – An emerging global issue, p. 23.*

[76] *See R. Altschuler & H. Grubert, Taxpayer responses to competitive tax and tax policy responses to competitive taxpayer: recent evidence, in Tax Notes International,* 2004, p. 13

> *«designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities»*[77].

Taking these criteria into consideration, "harmful tax competition" can be defined as a fiscal policy put in place by a nation that offers a variety of tax incentives[78] and advantages to entice mobile factors to that nation without transparency or an efficient information exchange with other nations. Therefore, "fair tax competition" may be summed up as a country's decision to lessen the tax burden, either by decreasing tax rates or by offering tax credits to both resident and non-resident firms. Additionally, the sharing of data with other tax authorities and complete disclosure of the tax system are other necessary aspects to consider[79].

Therefore, the OECD takes a broad view of tax competition. It distinguishes taxcompetition and the interaction of tax systems but recognizes that both canhave effects that some countries consider negative or damaging, but others do not. So, the question of who can be damaged is seen on a case-by- case basis. There are states which may consider themselves affected by a competitive situation, and others which, whether voluntarily or not, take advantage of this situation.

But the OECD goes further. It considers that harmful effects can arise from unintentional mismatches, which does not mean that a country deliberately exploits the interaction of tax systems to erode another country's tax base. These fortuitous mismatches can be exploited by taxpayers to the detriment of one or both countries. It is above all the question of the use by companies of forms of tax planning or optimization that is at stake in this case. This type of situation appears to be similar to implicit tax competition[80].

[77] *See OECD report on Harmful Tax Competition – An emerging global issue, p. 34.*

[78] See J. Weiner & H.J. Alt, *The OECD's report on harmful tax competition*, in *National Tax Journal*, 1998, p. 601-608; A.P. Moriss, L. Moberg, *Cartelizing Taxes: Understanding the OECD's Campaign against Harmful Tax Competition*, in *Columbia Journal of Tax Law*, 2013, p. 56.

[79] P. Lampraeve, *Fiscal competitiveness versus harmful tax competition in the European Union*, in *Bulletin of International Taxation*, 2011, p. 4; C. Pinto, *Tax Competition and EU Law*, Alphen aan den Rijn, 2003.

[80] *See* R.S. Avi-Yonah, *The OECD harmful tax competition report: a retrospective after a decade,* in *Brooklyn Journal of International Law*, 2008, p. 783-796.

Unlike cases of mismatch, where the effects on other countries are of a secondary or incidental nature, there are forms of active competition, intentional, «*when the interaction of tax systems is exploited by enacting special tax measures that essentially reduce the tax base of other countries*»[81]. The effect here is for one country to divert from other jurisdictions capital and financial flows, as well as the corresponding revenues, from other jurisdictions, by aggressively bidding against other countries' tax bases[82].

Within the European Union, in the Code of Conduct for Business Taxation and in several Commission documents, we also find the distinction between harmful and non-damaging tax competition. According to Rubens, «*the term harmful tax competition refers to tax measures that discriminate against the common legal*», which is the *benchmark).* This idea of discrimination is well translated in Article B of the Code of Conduct as «*effective taxation lower than the normal regime of the State in question*». The main element of the definition is the fact that a Member State grants tax advantages to a sub- group of taxpayers compared to the common law system that applies to all taxpayers[83].

The following criteria must be taken into account when determining whether such measures are harmful:

*(i)* the Code of Conduct on Business Taxation, which the Council endorsed, as well as the practice and recommendations reached by the Code of Council working group; and

*(ii)* the results of the framework «*to be put in place by the OECD/G20 early 2016 to monitor the implementation of BEPS by OECD/G20 countries and other interested jurisdictions but also jurisdictions of relevance whose participation is essential to ensure a level playing field*»[84].

[81] OECD, Harmful Tax Competition – An emerging global issue, 1998, p. 16.

[82] *See* R. Mason, *The Transformation of International Tax*, in *American Journal of International Law*, 2020, p. 352-402.

[83] E. Rubens, *La fiscalité des entreprises. Aspects financiers de la concurrence fiscale dommageable au sein de l'Union européenne, Bruxelles, 2002, p. 77.*

[84] Communication from the Commission to the European Parliament and the Council on an external strategy for effective taxation, COM(2016), Annex I.

The recent developments of the OECD and the EU in the field of tax competition will be further described in chapters 2 and 3 of this thesis, respectively.

### 3.4.1 Tax havens

The term “tax haven” has been around since the 1950s[85]. Governments exercise their sovereign power to pass laws to help existing sectors in their economies compete in the global economy or, on the other hand, to encourage the growth of new, competitive sectors. In doing so, they often use a combination of tax incentives (e.g., reduced tax rates) and the removal of “bureaucratic barriers” (e.g., regulations) to retain foreign capital.

Countries that want to attract capital from abroad face considerable international pressure to minimize the taxation of the income earned by foreign investors. Because reducing the tax on investment income earned by foreigners may involve unappealing budgetary or political compromises, not every country seeks to attract foreign investors in this way. The term “tax haven” refers to a location with extremely low tax rates.

Tax havens are jurisdictions that offer low or zero tax rates to foreign investors. They have been a topic of public concern since the emergence of the world after World War I, due to their alleged role in facilitating money laundering, evasion, and corruption of the political elite.

In recent years, government investigations and leaked documents such as the Pandora papers[86] and the Panama papers[87] have raised the profile of tax havens.

[85] R. Palan, R. Murphy, C. Chavagneux, *Tax heavens: how globalization really works*, Ithaca, 2010, p. 17.

[86] Pandora Papers is a leak of approximately 12 million papers that expose the hidden wealth, tax evasion and money laundering activities of some of the world’s wealthiest and most powerful individuals. More than 600 journalists from more than 117 countries scoured 14 sources’ data for months, uncovering stories that were published in 2021. See D.J. Hemel, *The United States as the Ultimate Tax Haven: Testimony Before the House Ways and Means Subcommittee on Oversight*, University of Chicago Public Law Working Paper No. 793, 2022, p. 1-3; J. Alice, *Pandora Papers will increase scrutiny on MNE tax affairs*, in *International Tax Review*, 2021

[87] The Panama Papers is a collection of 11.5 million leaked documents that were made available to the public on 3 April 2016. The documents contain information on more than 214, 488 offshore entities. The documents are owned and published by the Panamanian law firm Mossack Fonseca. The documents reveal a network of more than 214, 000 tax havens including individuals and businesses from more than 200 countries. *See* A. Cockfield, *How tax havens exacerbate inequality*, in *Columbia Journal of Tax Law*, 2021, p. 45-76.

The current focus on tax havens is due to the sheer scale of the phenomenon. While accurate data on tax havens are still hard to obtain, Bank of International Settlement quarterly statistics show that since the 1980s, about half of all global banking assets and liabilities have gone through offshore financial centers[88].

About one-third of all foreign direct investment flows through tax havens. Gross tax evasion perpetrated through tax havens is difficult to estimate. There is no hard data on corporate tax avoidance, which is probably the main reason for so much foreign direct investment going through tax havens. It is estimated that individual tax avoidance and evasion amounts to between $800 billion and a trillion dollars annually[89].

Most of the major tax havens today have developed along one of the two main geostrategic poles. The first pole has developed along with close ties to the city of London. These include the British Crown Dependencies (Channel Islands, Jersey, Guernsey, Isle of Man) and the British Overseas Territories (Cayman Islands, Bermuda, British Virgin Islands, Turks and Caicos, and Gibraltar), as well as the recently independent British Imperial colonies (Hong Kong, Singapore, the Bahamas, Bahrain, and Dubai) and the newly independent British Pacific territories. The second pole has developed in the European Union (Belgium, Netherlands, Luxembourg. Ireland, Cyprus), Switzerland and Liechtenstein. The other important tax havens today that do not form part of the two poles are, to some extent, Panama, United Arab Emirates, Hong Kong, and Singapore[90].

The current focus on tax havens is due to the sheer scale of the phenomenon. In 1957, the Bank of England noted that England was no longer the world's leading power: the United States had dethroned it and succeeded in imposing its currency, the dollar. Rather than try to restore sterling its status as a world currency, the Bank of England the Bank of England decided to organize, from the of London, the market for dollars deposited and loaned outside the United States, known as Eurodollars –

[88] P. Wollridge, *The outsize role of cross-border financial centres*, in *BIS Quaterly Review*, 2022, p. 1-15.

[89] *See* P. Yanski & A. Prats, *International Profit-Shifting out of Developing Countries and the Role of Tax Havens*, in *Development Policy Review*, 2015, p. 271-292.

[90] M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, in *Intertax*, 2004, p. 95-111.

a global offshore financial market, transacting in dollars and allowing unlimited sums to be borrowed and lent, but under the control of no single country[91].

While accurate data on tax havens are still hard to obtain, the Bank of International Settlement quarterly statistics show that since the 1980s, a prominent all global banking assets and liabilities have gone through offshore financial centers[92]. Multinational companies also transfer paper profits between various subsidiaries, including subsidiaries incorporated in tax havens with no or close to zero tax rates. As a result, corporate tax base erosion is a growing concern. Gross tax evasion perpetrated through tax havens is difficult to estimate but the extent of this problem is considerable. For example, in 2017, US multinational companies reported offshore accumulated earnings of $4.2 trillion, $3 trillion of which were in tax havens[93]. Besides, Tax havens are used as the main route for laundered money to escape developing countries[94].

As a phenomenon inherent in this globalization, the principle of offshore finance has followed exactly the same path and took on the same abrupt contours. The phases of acceleration of globalization which, over time, have been increasingly close together are essentially based on three factors: the dynamism of the businesses, the improvement of transport and communication techniques, and the willingness of political authorities to promote exchanges with the outside world.

Commercialization of state sovereignty, weight and influence of multinationals, ever-increasing integration of exchanges and shrinking of space geographical area made possible by technical progress, the aggressiveness of free trade and financialization of the economic sphere, exploitation of the weaknesses inherent in bilateral and multilateral

[91] C.R. Schenk, *The Origins of the Eurodollar Market in London: 1955–1963*, in *Explorations in Economic History*, 1998, p. 221-238.

[92] *See* R. Palan, *History of tax havens*, in *History & Policy* Papers, 2009; M. Gonzalez-Miranda, *Offshoe financial centers : to be or not to be?*, in A. Schipke, A. Cebotari, N. Thaker, *The Eastern Caribbean Economic and Currency Union*, Washington, 2013, p. 350

[93] N. Johannesen, D. Reck, M. Risch, J. Slemrod, J. Guyton, P. Langetieg, The Offshore World *According to FATCA: New Evidence on the Foreign Wealth of U.S. Households*, Working Paper of the 38th Annual NBER Tax Policy and the Economy Conference, 2023. This idea will be further investigated in the fourth and final chapter of this thesis.

[94] G. *Lénártová, The Economic and Social Consequences of Tax Havens in the World*, in SHS Web Conf. – Current Problems of the Corporate Sector, 2020.

agreements concluded between state actors, the arguments advanced to justify the appearance and persistence of this phenomenon are many.

Admittedly, these reasons appear legitimate, but − beyond the questions they raise − it should be emphasized that they are not part of the irruption of a sharp, sudden and recent movement[95].

On the contrary, they are part of a slow trajectory manifesting itself from antiquity, and which will have seen the gradual affirmation this fertile ground for the deployment of the offshore economy during the XX century. Tax havens are often cited as evidence of contemporary capitalism's "borderless world". The last decades of the XX century have been described by many actors and observers as being those of the "globalization" of exchanges. The very term "globalization" being both an elusive concept in which engulf all attempts to apprehend the internationalization of trade, and the upheaval of the relationship between politics and economics, the notion of "tax heaven" came to be grafted quite naturally on the debates which animates the partisans and detractors of a phenomenon called "offshorization" of the sphere of contemporary economy[96].

The major financial crisis triggered in 2007 brought back to the spotlight the recurring debate on the place occupied by tax havens, and more largely the offshore finance sector, within the contemporary economy globalized. Supporters and detractors of this system clash over the question of whether this one must be considered as the parasite or − on the contrary − the symbiont of the modern economic sphere given that attracting foreign investment is a top priority for most policy makers and globalization has an effect on the utilization of tax havens[97].

### 3.4.2 Treaty shopping

[95] R. Palan, *Tax Havens and the Commercialization of State Sovereignty*, in *International Organizations*, 2002, p. 151-176.

[96] O. Maslak, N. Grishko, O. Hlazunova and K. Vorobiova, *The offshorization of economy: the present realities*, in SHS Web Conf. – Innovative Economic Symposium, 2017.

[97] *See* F. Barthel, M. Busse, E. Neumayer, *The impact of double taxation treaties on foreign direct investment: Evidence from large dyadic panel data*, in *Contemporary Economic Policy*, 2010, p. 366-377, , M. Casanegra de Jantscher, *Tax havens explained: The advantages and disadvantages of tax havens, and how they operate*, in *Finance & Development*, 1976, p. 31-34.

The ease with which taxpayers can migrate geographically are putting international tax competition to the test. Loopholes in the system of bilateral tax treaties provide opportunities for tax base erosion and profit shifting through treaty shopping to minimize their taxes, multinational corporations frequently use complex corporate structures that span multiple countries.

Companies frequently use subsidiaries in nations with well-established bilateral tax treaties to route international transactions through. Businesses can combine the benefits of various treaties and avoid taxes that would otherwise be deducted on overseas payments by conducting transactions indirectly through carefully chosen conduits. The capacity of multinational companies to transfer money along such routes gives them a powerful exit threat: if governments continue to impose high taxes on cross-border payments, businesses can employ treaty shopping to avoid those costs[98].

Treaty shopping is closely linked to tax competition as it generally refers to tax arrangements designed to access treaty benefits that are not available directly. It takes place when the taxpayer is not entitled to the benefits of a tax treaty but employs of another juristic person, for example an intervening holding company, to obtain those benefits.

An analogous term is "forum shopping", which describes a situation in in which the litigant sought to "buy" from the jurisdiction in which they expected a more advantageous decision to be made. David Rosenbloom defined treaty shopping as «*the practice of some investors of borrowing a tax treaty by forming an entity – usually a corporation – in a country having a favorable tax treaty with the country of source – that is, the country where the investment is to be made and the income in question is to be earned*»[99]. In other words, treaty shopping involves buying into a contract that is otherwise unavailable through complex structures.

The concept of treaty-shopping has never been included in any version of the OECD Model, nor has it been clearly defined or elucidated in the OECD Commentary

[98] *See, ex multis,* V. Arel Bundock, T*he Unintended Consequences of Bilateralism: Treaty Shopping and International Tax Policy*, in *International Organizations,* 2017, 349-371; R. Avi-Yonah – C. Hju Panayi, *Rethinking Treaty Shopping: Lessons for the European Union*, in *Law & Economics Working Paper*, 2010; C.A. Brown & J. Bogle, *Treaty Shopping and the New Multilateral Tax Agreement - Is It Business as Usual in Canada*?, in *Dalhousie Law Journal*, 2020, p. 1-17.

[99] D. Rosenbloom, *Derivative Benefits: Emerging US Treaty Policy,* in *Intertax,* 1994, p. 83-86.

itself. Instead, the focus has always been on removing treaty-shopping, and the measures available to combat it. Most references to it are by default, that is when discussing anti-shopping provisions. For instance, references to «*problem commonly referred to as 'treaty-shopping*»[100].

Reference is first introduced in the OECD Commentary for Article 1, where it is discussed in relation to the existence of limitation on benefits provisions and how those provisions are «*intended to resolve the issue [of] treaty-shopping in a comprehensive manner*»[101]. The description of treaty-commerce is provided indirectly and in a very general way. Said that the limitation on benefits provisions are there «*to prevent persons who are not resident of either of the Contracting States from being able to benefit from a Convention by using an entity which would otherwise be resident of one of those States*»[102].

The 2006 US Model has a similar ambiguity in its definition of "treaty shopping". The term "treaty" is also used in the new Technical Explanation to describe the function of 'anti-treaties' provisions. The new Technical Explanation to the limitation on Benefits' clause found in Article 22 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries.

This confusion is further exacerbated by the OECD Commentary. Paragraphs 9-20 of the Commentary to Article 1 appear to capture general treaty-shopping (i.e., treaty-shopping with no tax haven or conduit connotations). On the other hand, the examples in paragraph 11 seem to capture more specific and abusive treaty-shopping: treaty-shopping through conduits or/or base companies.

This corporate governance structures of multinational companies that seek to take advantage of treaty shopping that can vary significantly. For instance, it is possible to use multiple tax treaties and transfer funds through multiple countries, in which the funds may be altered in nature (for example, dividends transformed into loans).

However, this is just one aspect of the structure. There may be various levels of artificiality in a treaty shopping structure. For instance, the intermediary company may

[100] 2008 OECD Commentary to Article 1, paragraph 20.

[101] *Ibid*.

[102] *Ibid*.

be a total sham, have minimal economic value, or be a legitimate commercial arrangement. It is important to note that not all cases of third-country residents benefiting from tax treaties that their own countries do not have access to are instances of improper use.

Only more recently, international organizations such as the OECD have explored more the issue of treaty shopping. Only recently, the OECD is monitoring the implementation of the BEPS package to tackle international tax avoidance and assesses the actions taken by jurisdictions to prevent tax treaty shopping and other forms of treaty abuse under Action 6 of the OECD/G20 BEPS Project, but this aspect will be further analyzed later in this thesis.

Many authors in the international tax community have tried to address the problem of treaty shopping, specifically referring to its nature and the reason why it is to be deemed as objectionable[103].

It has been claimed that the practice of 'treaty-shopping' is an example of tax avoidance, thus contrary to the purpose of the tax treaties. It has also been claimed that it disrupts the principle of reciprocity between the contracting States, as when a resident of a third country “shops” into a treaty, the concessions granted by the treaty are extended to the resident of a Contracting State which has not taken part in the agreement and is not likely to reciprocate with appropriate benefits (such as information exchange). As a result, the usual 'quid pro quo' of the treaty is jeopardized and the process is subverted. Another argument has been made that, in the context of a tax treaty, the taxable base is attributed to the jurisdiction to which the economic existence of the third country is deemed to be attributed. However, this is not the case with treaty concessions, as they are personal in nature and do not extend to non-residents[104].

[103] *Ex multis,* D. Rosenbloom & S. Langbein, *United States Tax Treaty Policy: An Overview*, in Colum. J. Transnational Law, 1981, p. 359; D. Rosenbloom, *Tax Treaty Abuse: Policies and* Issues, in Law & Pol’y Int’l Bus, 1983, p. 763-832; H. Becker & F.J. Würm, *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries,* Deventer, 1988; K.A. Grady, *Income Tax Treaty Shopping: An Overview of Prevention Techniques*, in *Nw. J. Int’l L. & Bus*., 1984, p. 626; J.A. Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems,* in *Virginia Law Review,* 1995, p. 1753; A. Lejour, *The Role of Conduit Countries and Tax Havens in Corporate Tax Avoidance,* in *CentER Discussion Paper Nr. 2021-014*, 2021; L.O. Terr, *Treaty Routing v. Treaty Shopping: Planning for multi-country investment flows under modern limitation on benefits articles,* in *Intertax,* 1989, p. 521; P. Burandt, *Methods of Tax Optimization with the Use of Tax Havens*, in *Financial Law Review*, 2021, p. 78-93.

[104] D. Rosenbloom & S. Langbein, *United States Tax Treaty Policy: An Overview*, in *Colum. J. Transnational Law*, 1981, p. 359-398.

A second argument against treaty-shopping is that it discourages countries from negotiating tax treaties. If non-resident investors can take advantage of the benefits of a tax treaty for their residents without receiving reciprocal benefits for non-residents, then treaty-shopping does not need to take place, particularly if there are worries that the treaty may be "unbalanced"[105]. This can put countries that follow their obligations of fiscal cooperation resulting from a tax treaty (e.g., exchange of information) at an international disadvantage. Lack of tax cooperation also increases the risk of international tax avoidance.

Treaty-shopping has also been claimed to have often been associated with revenue losses. A tax treaty is based on a perception of the balance of real and potential revenue and capital flows from one country to another. When the advantages of a given treaty are misused, the balance of those flows is distorted, resulting in a distortion of the proportionate share of the respective chargeable revenue channeled towards each State. Treaties-shopping extend the traditional bilateral relationship of a tax treaty. A generous treaty with a single trading partner turns into a global treaty. It is believed that this de facto multi-lateralization of a tax treaty results in a large and indefinite cost to the originating country.

According to Prof. Avi-Yonah is of the opinion that the economic argument connected to revenue losses is not pivotal because «*there is no concrete evidence that treaty-shopping actually cause revenue loss and economic distortions*»[106]. Also, he expresses the idea that a Contracting State may be both a Contracting State and a country of origin and may receive benefits or bear costs in both capacities. Consequently, determining the costs and benefits a Contracting State receives from a tax treaty involves complex calculations for which agreement may not exist. Other authors also argue that it could be argued that «*when treaty-shopping increases economic activity, the overall economic gain might exceed source country losses*»[107].

Prof. Avi-Jonah also claims that it is always difficult to differentiate between tax evasion and tax planning. However, not all treaty shopping structures can be described

[105] H. Becker – F. Wurm, *Treaty shopping : an emerging tax issue and its present status in various countries*, Boston, 2008.

[106] R.S. Avi-Yonah – C. HJI Panayi, Rethinking Treaty Shopping: Lessons for the European Union, in Law & Economics Working Paper, 2010.

[107] B. Bracewell-Milnes, *Economics of International Tax Avoidance,* Deventer, 1980, p. 23.

as “artificial”. For example, the intermediary company may be a company of some substance, carrying out its own commercial activities, not under the control of the parent company, and liable to a certain amount of tax in the home country. It is important to note that an agreement may be of some economic value which is not immediately visible to the tax authorities.

As regards the “reciprocity” argument, although convincing, it is based on the supposition that there is reciprocity for every benefit of the treaty. However, this is not always the case. For example, some concessions in a treaty may be unilateral, provided that they are already provided for in the domestic legislation of the contracting State. In addition, a tax agreement may not equally benefit two countries, and, for example, may be favoring the economically stronger country[108].

The disincentive to negotiate argument appears to be a strong argument. Even if unilateral measures can be taken to reduce double taxation, there are certain mutual benefits that can only be achieved through the negotiation of tax treaties (for example, provisions on pensions or dispute resolution). Tax treaty networks guarantee that tax cooperation between contracting States is reinforced and adapted to the emergence of new methods of tax avoidance and evasion. Thus, the argument that treaty shopping creates a barrier to negotiating tax treaties is valid, insofar as the treaties are concluded to pursue international tax convergence and cooperation, rather than allowing one country to coerce another into granting tax concessions.

### 3.4.3 Aggressive tax planning

The tools of international tax planning are represented by the «*complex of organizational initiatives on the plan operating by enterprises, in order to make optimal, for enterprises themselves, the tax burden that follows, and this considering the characteristics of the individual tax systems in which to operate, the interrelationships between them, the possibilities that the optimization of the burden tax may be a consequence of the lawful use of differences and interconnections between the systems.*

[108] R.S. Avi-Yonah – C. Hju Panayi, Rethinking Treaty Shopping: Lessons for the European Union, in Law & Economics Working Paper, 2010.

*In fact, the taxpayer's right to choose the form of business that allows you to limit tax burdens is recognized and guaranteed, falling within the so-called business planning*»[109]. In the face of this legitimate use, therefore, there is a broad gray sphere of legitimacy, in which elusive interventions can be hidden.

Basically, an operation demonstrates evasive intent when theoretically it is at all legitimate, but it was put in place with the sole purpose of receive tax savings. This business planning phenomenon takes on more and more often international connotations, through the use of companies offshore and, therefore, resulting in real planning situations aggressive taxation, in the context of a global tax law. With global tax law, therefore, the aspiration to the coordination of the positive juridical dimensions assumed by the norms tax: noting the insufficiency of an isolated approach e individualistic of the various States, a search for a unified position at the international level is carried out, which allows for the full realization adherence of the tax levy to the objectives of fairness and taxation in compliance with displays of economic strength[110].

In this context, the definition of aggressive tax planning takes on nuanced characters, since this constitutes a social notion, not a category of law. It has been described as a very broad concept but «*is a very vague concept which blurs the fundamental differences between legal tax planning*»[111]. In fact, it does not express a disvalue with respect to the values protected by our legal system, because it does not violate any law. Its illegality derives, instead, from its deleterious economic effects for the interests of the tax authorities and by the incapacity of the States to fight it effectively, in the absence of an «*international tax system*»[112].

The concept of "aggressive tax planning" was, however, openly analyzed within the BEPS, which will be analyzed in the second chapter of this thesis. According to Prof. Pistone[113], the elements that, therefore, characterize aggressive tax planning are the exploitation of disparities between different systems in order to draw an undue tax

[109] P. Adonnino, *La pianificazione fiscale internazionale*, in *Corso di diritto tributario internazionale*, Padova, 1999.

[110] P. Pistone, *La pianificazione fiscale aggressiva e le categorie concettuali del diritto tributario globale*, in *Rivista Trimestrale di Diritto Tributario*, 2016, p. 395-439.

[111] P. Essers, *International Tax Justice between Machiavelli and Habermas*, in *Bulletin of International Taxation*, 2015, p. 57.

[112] M.S. Knoll, *Competitiveness and International Taxation*, in *Tax Law Review*, 2012, p. 349-373.

[113] P. Pistone, *Diritto Tributario Internazionale*, Torino, 2021, p. 73-78.

advantage[114], the misalignment between the place of production and the place of taxation of the wealth[115], the result of an international double non-taxation which the states concerned did not intend to concede[116].

Aggressive tax planning strategies, which will be covered in the following paragraphs, are implemented through “loopholes” and “gaps” in tax systems. It is important, however, to underline the difference between the two: the first are considered an involuntary imperfection of the law, if a taxpayer takes advantage of a tax provision by exploiting a legislative loophole, taxpayer behavior can be contested by the tax authorities.

On the contrary, gaps in tax laws imply the inapplicability of a rule and the impossibility of making up for this lack by analogy. In other words, the line between loopholes and gaps is that the former can be countered through a hermeneutic activity, while the latter are not.

From a theoretical point of view, the difference between tax abuse and strategies of aggressive planning is distinguishable[117]. Tax abuse is a concept linked to the idea of "limit": this is, in principle, legitimate, since the tax benefit appears to be consistent with the boundaries drawn of the tax rules, although, in any case, not consistent with the object e purpose thereof. Tax abuse is not a "*mala in se*” but is a "*mala quia prohibita*" (i.e., illegal because prohibited). Consequentially, tax abuse is “*intra legem*” behavior, but “*not secundum legem*” (i.e., according to the law): the concept of abuse constitutes the threshold beyond which taxpayers could no longer count on the protection of the principle international tax neutrality. When taxpayers overcome this threshold, tax evasion occurs.

[114] It is the characterizing element of planning aggressive tax, since there is no express violation or circumvention of any rule but exploits the differences (so-called "*asymmetries*") between in different legal systems.

[115] The second element is represented by the effect of “misalignment”: aggressive tax planning leads to one disconnection between the place of production and the place of income taxation, that is weakening the fiscal sovereignty of the State and causing distortions in the market.

[116] It occurs when a given income item is neither taxed nor in the jurisdiction of origin (State of the source) nor in that of residence of the final recipient (State of residence), due to a lack of coordination of the various internal rules of the jurisdictions thus involved, but not foreseen by the legislators.

[117] *See* P. Piantavigna, *Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD Are Establishing a Unifying Conceptual Framework in International Tax Law, despite Linguistic Discrepancies*, in *World Tax Journal*, 2017, p. 37-98; C.H.J. Panayi, *Is Aggressive Tax Planning Socially Irresponsible?*, in *Intertax*, 2015, p. 544-558.

Aggressive tax planning strategies, however, follow another logic: such strategies do not go beyond the limits set by the rules, but they act "*inter leges". This gives rise to an "*aggressive*" tax planning, which involves exploiting loopholes in the architecture of existing tax legislation, misalignments, and disparity (i.e., the differences resulting from the concomitant exercise of two or multiple tax jurisdictions) of the international tax system. In other words, it refers to situations when the taxpayers take advantage of «*loopholes, as well as gaps, frictions, or mismatches in the interaction of countries' domestic tax laws in order to lower their tax obligation. Multinational companies in particular use these strategies, operating in the legal void between sovereign states and using planning paradigms resulting from treaty models, transfer pricing guidelines, and domestic laws developed in a non-integrated legal environment, without evading the tax regulatory regimes of their own countries*»[118].

Multinational companies in particular use these strategies, operating in the legal void between sovereign states and using planning paradigms resulting from treaty models, transfer pricing guidelines, and domestic laws developed in a non-integrated legal environment, without evading the tax regulatory regimes of their own countries. They are often incentivized by States, which seek to increase their revenues and become attractive locations for corporations[119].

In this framework, EU institutions became actively involved in order to limit the distortions that were being reacted in the internal market. Since 2012, when the European Commission announced the creation of an action plan outlining specific steps «*of an action plan setting out concrete steps to enhance administrative cooperation and to support the development of the existing good governance policy, the wider issues of*

[118] OECD Action Plan on Base Erosion and Profit Shipping, p. 13.

[119] As an example of notable aggressive tax planning techniques, the Dutch Sandwich and Double Irish strategies are categorized as international tax avoidance strategies that are typically used by high-tech multinational corporations to transfer significant profits through the layer of intellectual property licenses to low- or no-tax jurisdictions via Ireland. We first established a Dutch corporation as well as two Irish businesses. the first Irish firm through which you transmit earnings. The Dutch firm receiving those earnings is then compensated. The proceeds are then transferred to a second Irish business with headquarters in a tax haven. Some businesses have been able to essentially eliminate corporation taxes thanks to this commonly employed tactic. Once more, the money is transferred to an Irish firm first, then a Dutch business, and finally another Irish corporation. This tactic has been abandoned in 2020 as a result of external pressure. See R.S. Avi-Yonah, *Three steps forward, one step back? Reglection on Google Taxes and the destination-based corporate tax*, in *Nordic Tax Journal*, 2016, p.69-76.

*interaction with tax havens and of tackling aggressive tax planning and other aspects, including tax-related crimes*»[120].

A country's transparent and indiscriminate application of a preferable tax regime does not mean that the resulting negative taxation cannot be regarded as a harmful measure. On the other hand, a transparent tax regime alone does not mean that there is no harmful competition. Other forms of competition than simply offering zero tax rates can be seen. For example, states can manipulate the definition of "residential" and "source" factors. The traditional dividing line between "global" and "territorial" jurisdictions has blurred, so that it is now common for most countries to tax "domestic" passive income of residents, but not their "active" foreign-source income which is entitled to a deferral or exemption[121].

In particular, states have adopted uncontrolled preferable regimes to become "hosting jurisdictions" for mobile multinational companies based on "connecting factors enhancing relocation" even if these factors are irrelevant. These states' measures have not received the same attention as the public debate surrounding multinational companies' structures.

Even though such practices not only affect the transparency, predictability and certainty of tax laws for businesses, but also the consistency of corporate income tax at the international level, as these practices use gaps and inconsistencies. To avoid this and to ensure corporate income tax coherence at the global level, the OECD has developed the "tax policy" concept of aggressive tax planning.

Aggressive tax planning is not a "discriminatory" criterion but rather a "benchmark" for the design of national tax-competition measures. It comes into play when a national measure is "distributed" from the "international legal system" to a particular arrangement or entity and multinational companies take advantage of technicalities in a tax system or uses beneficial differentials in a country's statutory corporate tax system as an allocation mechanism[122].

These purposes are embodied also by the European Commission, according to which «*aggressive tax planning includes the use of artificial operations or structures*

[120] European Parliament, Own-initiative procedure, 2013/2060(INI).

[121] R.S. Avi-Yonah, *Back to the Future? The Potential Revival of Territoriality*, in *Law & Economics Working Papers*, 2008, p. 2-13.

[122] OECD BEPS Action 1: Address the tax challenges of the digital economy, p. 42.

*and the exploitation of mismatches between tax systems with the effect of undermining Member States' tax rules and exacerbating the loss of tax revenues*»[123]. Even in this way, aggressive tax planning has been used «*as a (vague) concept very much linked to a call to new policy developments and coordinated international action*»[124].

The unfair over or under taxation of cross-border investment might lead to distortion, which stem from differences in tax base definition and tax allocation mechanisms. Prior to the introduction of the debate on aggressive that planning, particularly within the OECD[125], such situations and, in particular, the artificial distribution of taxable income, had only been viewed in relation to tax avoidance and tax abuse.

Artificiality refers to facts, agreements, and deeds, taken individually or in conjunction, that are not intended to produce significant legal effects but rather to generate tax saving. In other words, artificiality involves the abuse of legal devices, even if it does not contravene any particular provision. To determine whether there is an undue advantage, one must compare two conduct types: the conduct that is less burdensome and the conduct that is more burdensome but avoided.

It is important to note that the habitual alternative must be actual, available, and not dependent on the will of others. If the two alternatives presented to the taxpayer are tax-fiscally equivalent, there can be no artificiality, but it is important to focus on the purpose of entering into an arrangement. Artificiality means that the taxpayer deliberately takes advantage of the rules in order to obtain a benefit as a result of applying them by creating conditions for obtaining that benefit. Therefore, the anomalous nature of the legal system adopted should be assessed in relation to the objective pursued[126].

International organizations like the OECD are aiming to tackle this problem with a more coordinated and standardized approach with regard to taxation of cross-border investment so that a state measure a tax competitive measure) should only be considered legitimate if it is imposed by the state in which the economic activity takes place.

[123] Commission Recommendation of 6 December 2012 on aggressive tax planning (2012/772/EU).

[124] A. P. Dourado, Th*e base erosion and profit shifting (BEPS) initiative under analysis*, in *Intertax*, 2015, p. 44.

[125] See chapter 2 of this thesis.

[126] *See* F.D.M. Laguna, *Abuse and Aggressive Tax Planning: Between OECD and EU Initiatives - The Dividing Line between Intended and Unintended Double Non-Taxation*, in *World Tax Journal*, 2017, p. 189.

## 4 Effects of tax competition

The problem of effects is an objective question, albeit a difficult one, as it depends on the resolution of various methodological issues. *A priori*, it is very difficult to predict the concrete consequences of decisions concerning a state's tax policy. In a context of open economies, these effects may be internal or external, having, in particular, consequences on the tax base, tax revenues and welfare of other jurisdictions or of a union of jurisdictions as a whole. The reactions of economic agents and other jurisdictions to a state's tax policy decisions must also be taken into account.

The literature normally distinguishes between effects at the level of efficiency in the allocation of productive resources and at the level of equity between individuals and between states. An important question in this context is the relationship between tax competition and the crisisof the tax state and the *welfare state*[127]. Ultimately, however, the question of effects is primarily an empirical one. Theory can show the kinds of effects that can occur. But it is empirical studies that indicate the real extent of these effects.

The question of whether or not to assess the effects of tax competition depends, to a large extent, on the perspective of the analysis, and in particular, on the idea we attribute to the State and its functions. The distinction between good and bad competition thus has an important subjective or even political dimension. Yet, from a strictly economic point of view, it is challenging to identify objective criteria between “good” and “bad” competition, “fair” competition and “harmful” tax competition.

### 4.1 Effects on the allocation of resources

The importance of tax neutrality is normally emphasized by the neo-classical model, particularly in terms of realizing the benefits of completing the internal market (free movement of factors of production, abolition of barriers)[128].

From this point of view, taxation must be as neutral as possible. In free and competitive markets, economic agents will choose the most efficient applications of

[127] R.S. *Avi-Yonah, Globalization, Tax Competition and the Fiscal Crisis of the Welfare State,* in *Harvard Law Review*, 2000, p. 1576.

[128] R. Boadway, *Corporate Taxation and Investment: A Synthesis of the Neo-Classical Theory*, in *Canadian Journal of Economics*, 1980, p. 250-267.

productive resources, that is those that will provide them with the greatest income. The more profitable the application, the greater its efficiency.

If the taxation of capital income leads to a certain investment location,  mainly for a tax rationale, it will be ineffective in terms of allocation of resources.

In this context, investment decisions and business location decisions are likely to be overdetermined by tax considerations. In this context, decisions to invest or locate economic activities are likely to be overdetermined by tax considerations.

This is the perspective of the Ruding Report, a milestone on the winding road of corporate tax developments in the European Community, according to which there is misallocation of resources when capital investments are diverted from their most productive uses – those with the highest pre-tax rates of return – to others where they are less productive but have a higher after-tax return due to their relatively favorable tax treatment[129].

The resulting economic inefficiency manifests itself in reduced capital productivity, which undermines the Community's international competitiveness, as well as in lower total productivity and a lower standard of living throughout Community.

Tax competition can therefore lead to economically inefficient results. Unregulated tax competition gives rise to complex, costly anti-avoidance regulations, which increase the cost of tax administration and can have perverse effects by discouraging certain companies from developing international activities.

Another effect of tax competition would be to shift the tax burden from capital to fewer mobile factors, notably labor. This shift would have a harmful effect on economic efficiency, in addition to serious social costs. It can penalize employment and create unemployment, insofar as it modifies the relationship between the cost of labor and capital factors, with a relative increase in the former[130].

The increase in the relative cost of labor may lead companies to invest in labor-saving production methods, beyond the point of economic efficiency. In countries with highly flexible labor markets, this trend will lead to a reduction in real wages. In

[129] F. Vanistendael, *The Ruding Committee Report: A Personal View*, in *Fiscal Studies*, 1992, p. 85-95; M. Devereux, *An Economic Assessment*, in *Fiscal Studies*, 1992, p. 96-107.

[130] B. Grand, *L'évolution des systems de taxation dans l'Union Européenne*, in *Revue française de Finances Publiques*, 1999, p. 101-117.

countries with highly rigid labor markets, as is the case in most European countries, the consequence could be rising unemployment.

### 4.2 Effects on social and tax justice

The tax system can contribute to a fairer society in two ways: either by generating revenues that correspond to the democratically expressed necessities of a population, particularly social needs (social justice), or by introducing elements of justice, whether commutative or distributive, into its own structure (tax justice). Tax competition can exert a double pressure on states, on social justice and on tax justice[131].

Firstly, it can erode tax revenues, as it becomes more difficult to tax the most mobile factors and it can have a substantial impact on state budgets and deficits. This reduction may affect the possibility of redistributive policies, either through public spending or through the tax system.

Another possible consequence of tax erosion resulting from tax competition is the growth of fiscal risk. This is because the financing of public expenditure is based on a smaller variety of bases, and the tax system is more sensitive to an exogenous shock due to “less mutualization of risk". Yet tax competition can still reduce spending that is of less value to the holders of less mobile factors[132].

The mobility brought about by globalization enables companies, in particular, to demand from governments the public services best suited to their needs and, at the same time, a reduced level of taxation on their income, on pain of abandoning the territory. The consequence is that «*tax competition may force governments to tax incomes and activities more in line with the principle of equivalence*»[133].

This makes taxation similar to royalties, where a price is paid for a service rendered. A number of difficulties may therefore arise: «*first of all, this amounts to denying the specificity of collective goods that are often indivisible; secondly, the redistributive role of taxation would be considerably reduced; thirdly, the principle of*

[131] For a more detailed analysis, *see* A. Perrone, *Tax competition e giustizia sociale nell’Unione Europea*, Padova, 2019, p. 10-21.

[132] F.R. Andrade, *Concorrência fiscal internacional na tributação dos lucros das empresas*, in *Boletim de Ciência Económicas*, 2002, p. 177.

[133] P. Marini, *La concurrence fiscale en Europe: une contribution au débat, rapport d’information du Sénat*, n. 483 (1998-1999), Commission des finances, 1999, p. 64.

*benefit is difficult to implement, because if economic agents are mobile, they may find ways of evading taxation while benefiting from public spending*»[134].

The principle of ability to pay, which aims to achieve a certain degree of tax justice, may therefore be challenged by tax competition. The most pessimistic forecasts even suggest that tax competition will force a race to the bottom. In this sense, tax competition could lead to an exemption for the most mobile bases, while immobile bases would be heavily taxed[135].

This extreme tax dumping would mean that, in the end, «*unbridled tax competition between states would lead to zero taxation of companies if they were perfectly mobile*»[136].

This effect would contradict the principle of horizontal equity in tax systems. However, tax competition can also undermine vertical equity, insofar as capital income is concentrated among the most privileged social categories. It is large companies, the most skilled workers and the owners of large fortunes who benefit most from this situation. Indeed, given the limitation, either of the possibility of taxing capital income at a personal level, or of the practical possibility of a tax on corporate profits, the vertical equality of the system would also be damaged. The proportion of capital income in total income is normally higher among people with higher incomes. And the tax on corporate profits, which is borne by the taxpayers, contributes to the overall progressivity of the tax system[137].

There may be room for competition for capital and savings based on tax policy given the wide disparities in statutory and effective tax rates among nations. These differences may really be the result of governments actively competing for savings and mobile capital. This suggests that the distortionary consequences of taxes are amplified by globalization. Taxation can drive a wedge between the marginal intertemporal rate of substitution of the consumer-saver and the marginal capital productivity of the producer-investor in a closed economy. The distribution of capital across industries and activities

[134] *Ibid*, p. 68.

[135] E. Schon, *Tax competition in Europe - the legal perspective*, in *EC Tax Review*, 2000, p. 94.

[136] E. Rubens, *La fiscalité des entreprises. Aspects financiers de la concurrence fiscale dommageable au sein de l'Union européenne*, Bruxelles, 2002, p. 32.

[137] F.R. Andrade, *Concorrência fiscal internacional na tributação dos lucros das empresas*, in *Boletim de Ciência Económicas*, 2002, p. 179.

may be impacted by this. There are two more potential tax-related distortions in the setting of an open economy[138].

Due to variations in taxes between their home nation and the rest of the globe, people of any country are now able to take advantage of rate of return on capital and savings through tax arbitrage. Regardless of the nation in which they decide to put their assets and distribute their savings or earnings, their goal is to maximize the returns on saves and capital. Due to inequalities in the intertemporal marginal rate of substitution caused by taxes, savings may not be distributed equally throughout nations. Similar to this, inequalities in taxes may be the cause of variances in the marginal product of capital, leading to improper international capital or investment allocation.

From a social viewpoint, tax competition is a multilevel phenomenon in that it involves different actors. First, the different jurisdictions, since it is often the asymmetry between the tax regimes of the different countries that allows the most aggressive practices of erosion of the tax base or involves the shifting of profits from one state to another to enjoy more favorable regimes. Second, it involves the financial administrations of the states since some of the most aggressive forms of tax competition are based on rulings in which the very administrations intervene as a party. Third, it involves businesses and, primarily, the multinationals of the modern globalized market and - first among them - the multinationals of the so-called new economy. Finally, in terms of indirect effects, it involves a range of actors who, although they do not play a role as players in tax competition, suffer the consequences[139].

The reduction in revenue that can be drawn from the taxation of corporate income, especially when this reduction is particularly large, negatively affects public expenditures and thus also the expenditures allocated to social policies.

Cross-referencing the data resulting from the 2016 Oxfam report on tax havens with those that can be retracted from Unesco documents shows, for example, that the elusive practices implemented by multinational companies alone rob developing countries annually of approximately $100 billion, a figure more than sufficient to

[138] A. Razin & E. Sadka, *International tax competition and gains from tax harmonization*, in *Economics Letters*, 1991, p. 69-76.

[139] A. Perrone, *Tax Competition e Giustizia Sociale nell'Unione Europea*, Padova, 2019, p. 5.

provide education to all 124 million children who currently do not have access to it and to finance health interventions that could save the lives of six million children[140].

From a more theoretical framework, public goods must be financed by taxes. The institutional framework of the state, which is outlined in constitutional provisions, is the most significant public benefit supported by taxation. The constitution may be seen as a "complex exchange" between people to allow them to provide the public goods required to accomplish their own goals[141].

They decide what each person must contribute in order to preserve the shared institutional order. The defining of a system of property rights and a market system, both supported by the taxes that residents pay, are also included in the institutional infrastructure. Individuals decide how to distribute wealth in their society by doing this. If everyone voluntarily agrees on a social compact, distributive justice will be realized. Overall, the nation-state is a joint cooperative endeavor, and the social contract establishes the normative terms (i.e., the moral responsibilities people have toward one another). The focus on company taxation is justified given its critical importance for the integrity of national tax systems. There is a fully established multilayer taxation plan for multinational corporations that would alleviate many of the disparities brought on by tax competition: unitary taxes with formula apportionment is one example[142].

In the context of the European Union, there seems to be full awareness that the diversion of wealth caused by tax competition affects social policies in a particularly negative way. And this awareness comes from the EU institutions themselves. In the report, several reasons are identified as to why the revenue shortfall caused by tax competition can create a serious counter to welfare policies. For instance:

*(i)* Tax competition can lead to a scarcity of "public goods," and hence of public goods and services. This is because de-taxation (or reduction in taxes) of movable wealth components (such as capital, so-called intangibles, intellectual property, and so on)

[140] *See* Unesco, Education for people and planet: creating sustainable futures for all, Global education monitoring report, 2016; Oxfam, Tax Battles - The dangerous global Race to the Bottom on Corporate Tax, 2016; A. Perrone, *Tax Competition e Giustizia Sociale nell'Unione Europea*, Padova, 2019, p. 13.

[141] J.M. Buchanan, *The limits of liberty: between anarchy and Leviathan*, Chicago, 1976; F. d'Agostino, G. Gaus, *Contemporary approaches to the social contract,* in E. Zalta, *The Stanford Encyclopedia of Philosophy*, Stanford, 2021.

[142] A. Roland, *Multiple streams, leaked opportunities, and entrepreneurship in the EU agenda against tax avoidance*, in *European Policy Analysis*, 2019, p 77-99.

implies that taxation is concentrated on local forces of production, resulting in an unavoidable fall in total income. This diminishes the funding for government services, which will certainly decline.

*(ii)* Tax competition and the resultant revenue loss have a detrimental impact on wealth redistribution plans. The fact that damaging behaviors mostly benefit the world's largest revenue providers (primarily multinational businesses) has the effect of increasing wealth concentration in the hands of those who already have it. This exacerbates economic inequality on the one hand while reducing the redistributive benefits logically associated with increased (corporate) income taxation on the other. This has ramifications for social programs, which are struggling to combat prevalent problems like as poverty, unemployment, marginalization, a lack of access to proper medical care, suitable education, and so on, in part owing to insufficient financial assistance.

There has been a perceived relationship in Europe since the mid-1990s between «*the diversion of tax revenues from states determined by the phenomena of international tax evasion and avoidance, facilitated by processes of globalization, and the very possibility of ensuring adequate welfare systems*»[143].

Tax competition has also been strictly linked to the concept of level playing field. According to this point of view, fairness refers only to non-distorted competition, which is still seen as a positive incentive for investment and fiscal discipline: «*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 Member States to consider both their market competitiveness and budgetary needs in fixing their tax rates*[144]».

Yet, more recently, this specific concept of fairness is fading as references to fair tax competition and a level playing field fade and are replaced by more general explanations of fairness. This comment from Pierre Moscovici regarding the Anti-Tax Avoidance Directive exemplifies the larger definition of fairness in terms of universal social justice: «*Billions of tax euros are lost every year to tax avoidance – money that*

[143] G. Melis, *Evasione ed elusione fiscale internazionale e finanziamento dei diritti sociali*, in *Rassegna tributaria*, 2014, p. 128.

[144] European Commission, Proposal for a Council Directive on A Common Consolidated Corporate Tax Base (CCCTB), 2011.

*could be used for public services like schools and hospitals or to boost jobs and growth. Europeans and businesses that play fair end up paying higher taxes as a result. This is unacceptable and we are acting to tackle it. Today we are taking a major step towards creating a level-playing field for all our businesses, for fair and effective taxation for all Europeans»*[145].

## 5 Tax competition and tax coordination: review of literature

Tax harmonization and tax competition have come under attack as a result of the present economic crisis, and as a result, the concept of tax coordination is now more prominently on the horizon. Tax harmonization and tax competition are intertwined because the former helps to reduce tax evasion, to remove barriers to competition, to increase labor, capital, goods, and services mobility, while the latter helps to improve tax systems, to lower tax burdens, to better balance taxes and public goods, and to take into account the differences in GDP levels between nations.

Tax harmonization and tax competition are discussed extensively in the literature: tax harmonization and tax competition are widely debated topics and present a number of problems that need to be examined and researched, particularly in relation to the key factors that cause these occurrences[146].

[145] European Commission, Fair Taxation: Commission presents new measures against corporate tax avoidance, Press Release, 2016.

[146] *See, ex multis,* A. Fourçans & T. Warin, *Tax harmonization versus tax competition in Europe: a game theoretical approach*, Cahiers de Recherche CREFE, 2001, p. 132; P. Van der Hoek, *Tax harmonization and competition in the European Union*, in *eJournal of Tax Research*, 2003, p. 19-36; R. Baldwin & P. Krugman, *Agglomeration, integration and tax harmonization*, in *European Economic Review*, 2004, 1-23; E. Mendoza & L. Tesar, *Why hasn't tax competition triggered a race to the bottom? Some quantitative lessons from the EU*, in *Journal of Monetary Economics*, 2005, p. 163-204; S. Killian, *Where's the harm in tax competition?: Lessons from US multinationals in Ireland,* in *Critical Perspectives on Accounting*, 2006, p.1067-1087; K. Behrens, J. Hamilton, G. Ottaviano, J. Thisse, *Commodity tax competition and industry location under the destination and the origin principle,* in *Regional Sciences and Urban Economics*, 2009, p. 422-433; P. Conconi, C. Perroni, R Riezman, Is partial tax harmonization desirable?, in *Journal of Public Economics*, 2008, p. 254–267; A. Kocia, *Tax System as a Factor Attracting Investment into the European Union Member Countries*, in *Argumenta Oeconomica*, 2009, p. 103-124; J. Slemrod & G. Wilson,*Tax competition with parasitic tax havens*, in *Journal of Public Economics*, 2009, p. 1261-1270; A. Junevičius & B. Šniukštaitė, *Tax harmonization and tax competition in European Union*, in *European Integration Studies*, 2009, p. 69-75; I. Szarowska, *Tax burden and competition in the European Union*, in *Public Administration & Regional* Studies, 2009, p. 18-39; M.R. Surugiu & C. Surugiu, *Tax Competition, Harmonization and Development: Challenges and Consequences*, in *Argumenta Oeconomica*, 2012, p. 139-154.

In their analysis of tax competition and harmonization in Europe, it has emphasized that in nations with «*sound public finances, tax competition would not lead to a race to the bottom*»[147].

While tax burdens in the European Union have grown significantly over the previous 35 years, they did not converge, and there is little indication of the "race to the bottom" in taxing income from capital, according to Hoek's analysis of tax harmonization and competition in the EU[148].

Mendoza and Tesar discussed the subject of tax competition and the idea of the "race to the bottom" and they noted that the harmonization of indirect taxation is undesirable because it compels countries to increase highly distorted labor income taxes in order to counteract the negative effects of tax competition on tax revenues[149]. In their discussion on tax harmonization and competition in the EU, Juneviius and Šniukštaitė stated that «*tax competition can lead to inefficiency in providing public services*»[150].

Behrens investigated the advantages of commodities taxation and tax harmonization, as well as short- and long-term effects of non-cooperative tax settings, tax harmonization, and changes to the tax principle. He thinks that the origin principle, as compared to the destination principle, causes a fairer distribution of economic activity in space while also escalating tax competition and eroding tax revenues. This implies that federations that are concerned with geographical inequality, like the European Union, must make a difficult decision on their tax policy that goes above and beyond the typical factors of tax revenue redistribution[151].

[147] A. Foruçans & T. Warin, T*ax harmonization versus tax competition in Europe: a game theoretical approach,* Cahiers de Recherche CREFE, 2001, p. 132

[148] P. Van der Hoek, *Tax harmonization and competition in the European Union*, in *eJournal of Tax Research*, 2003, p. 19-36.

[149] E. Mendoza & L. Tesar, *Why hasn't tax competition triggered a race to the bottom? Some quantitative lessons from the EU,* in *Journal of Monetary Economics,* 2005, p. 163-204.

[150] A. Junevičius & B. Šniukštaitė, *Tax harmonization and tax competition in European Union,* in *European Integration Studies*, 2009, p. 69-75.

[151] Commodities entering international trade are often subject to taxes under the destination principle, which means they are taxed in accordance with the country where ultimate consumption takes place. Border tax adjustments are necessary to guarantee that imports are included in domestic taxation and exports are excluded in order to implement the destination principle. See M. Keen & S. Lahiri, *The comparison between destination and origin principles under imperfect competition*, in *Journal of International Economics*, 1998, p. 323-350.

Tax competition, even that which is not deemed damaging by the OECD, can impact not just the home country of the fleeing multinational but also the host country obtaining the investment, local residents, and the environment, according to Killian[152].

In their analysis of the struggle to draw in foreign investment, Pieretti and Zanaj concluded that for moderate mobility costs, small economies can attract foreign capital by providing higher levels of public goods than larger jurisdictions, without engaging in tax undercutting[153].

Tax harmonization is another significant issue in the context of taxes, and the literature provides several definitions of this concept. All still have their flaws, though. Combining the best definitions from the most pertinent sources, tax harmonization is described as «*the process of removing fiscal barriers and discrepancies between the tax systems of the various countries comprising the European Union*»[154] or «*adaptation of each Member State's legislation to a standard which is common to all Member States and which has been set forth by the EU supranational bodies*»[155].

There are two types of tax harmonization: complete harmonization, which results in the same tax bases, rates, systems, etc., and partial harmonization or approximation, which entails something less, such minimum or maximum tax rates, or the removal of double taxation. In their study on agglomeration, integration, and tax harmonization, Baldwin and Krugman found that greater economic integration may result in a "race to the top" rather than a "race to the bottom"[156].

Three different scenarios for tax harmonization were examined by Conconi: no tax harmonization (all nations set taxes independently), global tax harmonization (all nations coordinate their capital taxes), and partial tax harmonization (just a portion of all nations coordinate capital taxes). The subject of whether a group of nations may benefit by harmonizing capital taxes even if the rest of the globe does not do the same is

[152]S. Killian, *Where's the harm in tax competition?: Lessons from US multinationals in Ireland,* in *Critical Perspectives on Accounting*, 2006, p.1067-1087.

[153] P. Pieretti – S. Zanaj, *On tax competition, public goods provision and jurisdictions' size,* in *Journal of International Economics*, 2011, p. 124-130.

[154] OECD, Glossary of Tax Terms.

[155] A. Steichen, *Tax Competition in Europe or the Taming of Leviathan*, in W. Schön *Tax Competition in Europe*, Amsterdam, 2003, p. 313-336.

[156] R. Baldwin & P. Krugman, *Agglomeration, integration and tax harmonization*, in *European Economic Review*, 2004, p. 1-23.

addressed in this study. According to our study, creating a partial tax agreement is preferable to neither no tax coordination nor worldwide coordination when capital taxation has a commitment problem. This conclusion is based on the fact that partial harmonization lessens damaging tax competition while keeping policymakers in check, who may otherwise be tempted to impose capital tax rates that are higher than necessary. Thus, notwithstanding rather than in light of its partial character, a group of nations' corporation tax harmonization may be acceptable[157].

Domestic and structural factors influence the decision between competitive and cooperative tactics: asymmetric environments, in which there are many varied and disparately sized countries, favor competition whereas symmetric settings, in which there are a few homogeneous and equally sized countries, favor cooperation. By ensuring that all nations experience tax competition equally, symmetry makes it easier to come to an agreement on cooperative responses[158].

In principle, of course, large countries can induce the cooperation of small countries through appropriate side-payments or threats. However, in reality, this is frequently challenging since it is difficult politically for democratically elected governments to compensate foreign nations for not stealing their domestic tax bases. When seeking to force Switzerland into cooperating on tax transparency in 2009, former German finance minister Peer Steinbruck had to learn that bullying tiny governments frequently results in normative anger and strong fighting discourse rather than submissive behavior[159].

Even if some small nations refuse to be coerced or intimidated into tax cooperation, other nations can still work together. Of course, limited cooperation is only partially successful, and tax rivalry will persist as long as non- participating third nations are able to undercut harmonized tax rates or standards for information sharing and openness. In practice, those who do not cooperate could get more from it than those who

[157] P. Conconi, C. Perroni, R Riezman, *Is partial tax harmonization desirable?*, in *Journal of Public Economics*, 2008, p. 254–267.

[158] *See* P. Genschel & T. Plumper, *Regulatory competition and international co-operation*, in *Journal of European Public Policy*, 1997, p. 626-642; K. Holzinger, *Tax Competition and Tax Co-Operation in the EU: The Case of Savings Taxation*, in *Rationality and Society*, 2005, p. 475-510.

[159] J. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, Ithaca 2006.

do. Being one tax haven among others seems less desirable than being the final tax refuge in a world free of tax havens.

The motivation to implement extreme tax-cut or secrecy measures grows if collaboration decreases the number of low-tax jurisdictions. The growth of cooperative tactics is hampered by this negative feedback effect, especially if there are many possible "third nations"[160].

Therefore, tax cooperation is likely to be challenging and weak in an asymmetric multi-country situation. Large nations will lead the way in implementing cooperative measures, while others will be hesitant to do so. Fear of losing a competitive edge to nations without such legislation prevents unilateral anti-avoidance laws from spreading. Low-tax nations either refuse to engage or condition their involvement on expensive ancillary payments and/or substantive concessions diminishing the efficacy of the partnership, preventing it from spreading.

The nature of tax competition affects the likelihood of tax cooperation in addition to structural and domestic factors. In contrast to generic competition, cooperation may be more frequent when it is focused[161]. In order to increase national revenues, collaboration involves fostering cooperation between nations that have similar interests in tax-related issues[162].

A reduction in present inefficiencies brought on by a lack of collaboration in taxation matters may lead to an improvement in revenues. Therefore, despite the fact that certain nations that profit from offering tax havens may suffer from the loss in sheltering options, efficiency benefits might result in an improvement in global welfare[163].

[160] *See* P. Genschel & T. Plumper, *Regulatory competition and international co-operation*, in *Journal of European Public Policy*, 1997, p. 626-642; M. Keen & J. Ligthart, *Incentives and Information Exchange in International Taxation*, in *International tax and public finance*, 2006, p. 163-180.

[161] P. Genschel & E. Seilz, *The Regulation of Redistribution: Managing Conflict in Corporate Tax Competition*, in *West European Politics*, 2009, p. 756-773.

[162] *See* M. J. Graetz & I. Grinberg, *Taxing International Portfolio Income*, in Tax Law Review, 2003, p. 538-586; M. Desai & D. Dharmapala, *Investor Taxation in Open* Economies, in *International Tax Policy Forum Working Paper n.* 3, 2009.

[163] The governments that would suffer the most from the loss of sheltering options are those of the very wealthy nations that have long investigated the international tax arena's loopholes. It is uncertain if the inefficiency they create justifies the distributive benefit and whether there are other methods to achieve distributive aims and concurrently encourage economic growth in these nations, even though some destitute countries that rely on tax havens would also suffer.

Gains from collaboration are certainly possible. First, countries now confront a danger to their competitiveness: if a nation enacts stringent tax laws that its rivals do not, investors may relocate their money, and even if that does not happen, local enterprises may be forced into a less advantageous competitive position.

Therefore, despite the fact that present tax policy is ineffective and results in social waste, governments continue to adopt it due to a lack of coordination. Countries with comparable policy goals may be able to effectively stifle unwelcome competition through cooperation.

Moreover, collaboration offers a defense against domestic political lobbies and pressures. Domestic lobbyists in each member country have the potential to disrupt multilateral agreements on policies. However, when the policy is the product of cooperation across comparable nations, the dynamics of the domestic legislative process may change – no one country may want to stand out as opposing the anti-abuse measures implemented by other countries[164].

[164] H.D. Rosenbloom, N. Noked, M.S. Helal, *The unruly world of tax: a proposal for an international tax cooperation forum*, in *Florida Tax Review*, 2014, p. 57-87.

# CHAPTER 2

## *The OECD two-pillar solution as a new paradigm to tackle harmful tax competition*

### 1 Background

The Organization for Economic Cooperation and Development ("OECD") has emerged over the United Nations as the main tax forum to solve tax policy challenges in the international arena. The idea is that this perception of taxes is sustained by a binary perspective which renders the OECD's work more technical in contrast to the UN's purportedly political setting. In the last few decades, the discourse has shifted from being only focused on preventing international double taxation and tax evasion to including addressing "harmful" tax competition. Indeed, the proliferation of aggressive tax planning mechanisms has undoubtedly been fostered by the tax competition practices put in place by some states that have attempted to make up for the erosion of their tax sovereignty vis-à-vis large corporations by offering them substantial, selective tax advantages in exchange for investments within their territories.

The digitalization of the economy has highlighted the weaknesses of the current international tax regime, which has traditionally been anchored in the notions of territoriality and permanent establishment. This "digital revolution", which entails the mobility of intangible factors and the ability to dislocate business functions, exacerbates base erosion and profit shifting techniques employed by multinational tech companies. In this context, the OECD has long been a pioneer in addressing the opportunities and challenges of the digital economy.

Thus, the issue of fair taxation of corporations is deemed to be connected with that of fair taxation of digital multinational. Indeed, the latter are perceived as subjects which enjoyed a lower level of taxation due to the exploitation of loopholes in international taxation and brings to a policy debate on reforming the existing regime in a full-blown reconsideration of its fundamental tenets[165].

[165] *See* P. Hongler & P. Pistone, *Blueprints for a new PE nexus to tax business income in the era of the digital economy*, in *WU International Taxation Research Paper Series*, 2015, p. 2-63; A. Turina, *The progressive policy shift*

After years of negotiations, a landmark moment was the adoption of the OECD/G20 BEPS project delivered in 2015 and the recent two-pillar solution reached in October 2021.

The players involved in any narrative concerning foreign taxes are often high-income individuals and businesses on the one side, and tax authorities on the other. Given that international tax issues are generally less understandable for the general public due to their inherent technical nature, they have historically received little attention in the majority of countries until recently.

Within this context, the article seeks to illustrate the rise of the OECD as the informal "World Tax Organization"[166] and critically assess the OECD Two-Pillar solution which attempts to address the tax challenges arising from the digitalization of the economy.

## 2. The OECD as the principal advocate for international tax cooperation

Until the 1990s, interstate cooperation in the matter of international tax law was limited, in substance, to the elimination of double taxation, as established in the interwar period within the League of Nations.[167] In order to create international tax conventions during the interwar years, the League of Nations entered the realm of international taxation.

By 1928, the predecessor of the United Nations ("UN") had published a sample bilateral treaty for the reciprocal relief of double taxation of international income, which heavily drew on US national experience and official guidance. [168]

*in the debate on the international tax challenges of the digital economy: a "pretext" for overhaul of the international tax regime?*, in *Computer Law & Security Review*, 2020, p. 1-17.

[166] *See* A.J. Cockfield, *The Rise of the OECD as Informal World Tax Organization through National Responses to E-Commerce Tax Challenges*, in *Yale Journal of Law & Technology*, 2006, p. 136-187.

[167] For a more comprehensive approach, *see* S. Jogarajan, *Double Taxation and the League of Nation*, Cambridge, 2018, p. 3; M.B. Carroll, *Allocation of Business Income: The Draft Convention of the League of Nations, in Columbia Law Review*, 1934, p. 473-498; K.C. Wang, *International Double Taxation of Income: Relief Through International Agreement 1921-1945*, in *Harvard Law Review*, 1945, p. 73-116.

[168] M. J. Graetz, *Taxing International Income: Inadequate Principles, outdated Concepts, and unsatisfactory policies*, in *Brooklyn Journal of International Law*, 2001, p. 1390-1391.

After the Second World War, these fundamental principles proved to be structurally sensitive to tax planning for three main reasons

First, taxation is founded on the domestic legislation of each jurisdiction and the tax regimes are generally characterized as strongly resistant to a radical encroachment on sovereignty. Taxation is a stronghold of state sovereignty and tax treaties restrict the ability of government to exercise its tax power, but no actions is taken at the bottom the pyramid with the regards of the actions performed by economic agents. This is changing only very recently increasingly since countries are slowly ceding sovereignty over the interpretation of international tax agreements from domestic courts to panels of transnational tax adjudicators.[169]

Second, the distribution of the right to tax in tax treaties is based on a binary logic of residence and source, which also substantially limits the source state's right to tax, instead of following, for example, a logic of proportional distribution. The result is that the State of residence is granted substantial taxing rights, while corporate residence is a concept that is itself devoid of economic substance, either entirely when it is based on the pure incorporation criterion, or almost entirely when it is based on the real seat criterion.[170]

Third, intra-group transactions are not neutralized from a tax perspective. Although their value is subject to the transfer pricing arm's length concept, this principle is sufficiently flexible to allow profits to be transferred to the target business to some extent.[171] Most aggressive tax planning techniques are based on the premise that a significant portion of the group's base would be attributed to a structure resident in privileged tax jurisdictions.

In addition to those hurdles, the Second World War and the dissolution of the League of Nations forcibly halted the formation of a worldwide discussion on taxes. As

[169] *See* M. Hearson & T.N. Tucker, *An Unacceptable Surrender of Fiscal Sovereignty: The Neoliberal Turn to International Tax Arbitration*, in *Perspective on Politics*, 2021, p. 225-240.

[170] *See* B. Starink, *Source versus Residence State Taxation of Cross-Border Pension Payments: Trouble Shared Is Trouble Halved*, in *Intertax*, 2016, p. 6-13; H.E. Kostense, *The Saint-Gobain case and the application of tax treaties. Evolution or revolution?*, in *EC Tax Review*, 2000, p. 220-232.

[171] The *Arm's Length Principle* requires that related companies agree on their transactions as unrelated companies would in comparable circumstances. For the limits of this principle, *see* L. Samuelson, The multinational firm with arm's length transfer price limits, in *Journal of International economics*, 1982, p. 365-374; H. Rogers & L. Oats, *Emerging Perspectives on the Evolving Arm’s Length Principle and Formulary Apportionment*, in *British Tax Review*, 2019, p. 150-165

a result, the post-war dialogue was very different. It was not the League's projected successor which was entrusted with such dialogue and a preferable tax forum was found in the OECD – founded in 1961 « *in order to strengthen the tradition of co-operation and apply it to new tasks and broader objectives* ».[172] In a context of booming trade, the OECD has successively established three model tax treaties accompanied by a commentary in 1963, 1977 and 1992. The 1992 Model Tax Convention has been regularly revised.[173] It has also fine-tuned the principle of full competition leading in 1995 to the publication of the *Transfer Pricing* Guidelines for Multinational Enterprises and Tax Administrations.[174]

However, tangible developments in international taxation have unquestionably been gradual and sometimes rather stagnant and lackadaisical for few reasons. First of all, taxation is based on the domestic law of each tax jurisdiction which is the expression of its sovereignty.  In general, although there are several bilateral tax treaties binding nations, these agreements try to define the individual sovereign states' jurisdictional limits. The transfer of wealth internationally entails that both the country of origin and the country of destination may claim taxation rights. This might lead to double taxation and, accordingly, countries have attempted to seek common ground through bilateral tax agreements and more general tax treaties. However, in spite of their practical usefulness, tax treaties do not necessarily create a fair international tax system. They might limit the right to impose taxes in some instances but, for example, do not necessarily require states to effectively exercise their tax jurisdiction.

Moreover, the distribution of the right to impose taxation based on tax treaties hinges on the binary logic of “residence” and “source,” instead of proceeding with the logic of proportional distribution. The result is that the State of residence is granted relevant rights to tax but corporate residence is a concept that is somewhat devoid of economic substance either completely when it is based on a pure incorporation criterion

[172] Convention on the OECD, 14 December 1960.

[173] The Model Convention has undergone ten revisions in 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010, 2014 and 2017. The most recent update of 2017 incorporated a significant number of changes brought about by the Base Erosion and Profit Shifting (BEPS) Project, particularly the final reports on Actions 2, 6, 7, and 142. The initiative aims to close loopholes in international taxation for businesses that purportedly engage in tax inversions (moving operations) or migrate intangibles to lower tax jurisdictions in order to avoid paying taxes or reduce their tax burden in their home country

[174] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 20 January 2022.

like in the United States or the United Kingdom or almost completely when it is based on the "actual seat of management" or "real seat" theory like in France, Germany or Italy.

Additionally, intra-group transactions produce tax consequences. Taxpayers and tax authorities can determine them by analyzing comparable transactions between unrelated parties, but the arm's-length standard[175] has come under heavy criticism because arm's-length comparable transactions are frequently not easily identifiable and other techniques for determining appropriate transfer prices can be unreliable or highly subjective. Governments have had trouble convincing judges that their estimates of arm's-length pricing should take precedence over taxpayers' estimates.[176]

Particularly in the last fifteen years, the OECD has had a leading role to address concerns about international tax policy by functioning as a sort of "informal" international organization shaping consensus in the global arena. While the World Trade Organization, the United Nations, the World Bank, and the International Monetary Fund have shaped international tax rules, the OECD is widely recognized as the most influential international organization dealing with tax matters.[177]

The OECD has proven to be the best available option for the development of international tax policy that promotes international cooperation while allowing nations to continue adopting tax laws in their perceived national self-interest and in a world where governments jealously protect their tax sovereignty. By developing a formal, streamlined outreach program to offer a more inclusive venue for discussion between OECD member and non-member governments, the OECD continues to legitimize its action.

This is also true in terms of guiding principles and tax standards to control the tax treatment of international e-commerce transactions, which had an impact on the lack of action at the national level. The global framework envisaged by the OECD is pivotal because – without a multilateral approach to international tax issues – bilateral tax agreements usually tend to lead to the recognition of jurisdiction, but then individual

[175] According to IRS regulations, taxpayers must use the arm's length principle while negotiating commercial deals with other managed companies. If the agreed results are the same as those occurring under similar conditions between two independent parties, then a regulated transaction fulfills the arm's length standard.

[176] R. S. Avi-Yonah, *The Rise and Fall of Arm's-Length: A Study in the Evolution of U.S. International Taxation,* in *Virginia Tax Review*, 1995, p. 89-160.

[177] For a discussion of the history of the OECD and its predecessor organizations, *see* M.J. Graetz & M.M. O'Hear, *The "Original Intent" of U.S. International Taxation,* in *Duke Law Journal,* 1997, p. 1021-1066.

nationals are free to create tax policies that suit them, including guidelines for establishing the tax base and tax rates.[178]

Also, some jurisdictions were not even taking any concrete steps despite acknowledging the existence of several problematic international tax issues and no effective solutions could be sought if not shaped by an international organization in the international arena. For instance, regarding the taxation of the digital economy, national tax authorities recognized that international e-commerce resulted in revenue losses or other unfavorable outcomes, such as incentivizing tax evasion or tax avoidance but nevertheless very little has been done on a national basis.[179]

Besides, the fact that most countries are typically willing to follow the OECD views suggests that the effectiveness of these initiatives minimized the need for legislative action by individual states[180].

## 3. The OECD as the global playmaker against harmful tax competition

### 3.1 Overview of the global efforts to counter harmful tax competition

The OECD has also deeply focused on the phenomenon of "harmful tax competition", which is the unifying thread of this paper. Although researchers and policymakers have attempted to elaborate a more precise definition[181], their efforts have

[178] T. Rixen, *The Political Economy of International Tax Governance*, London, 2008, p. 11-29.

[179] The first national report of this kind is titled "Selected Tax Policy Implications of Global Electronic Commerce" and was drafted by the Department of the Treasury Office of Tax Policy in November 1996. *See* Selected Tax Policy Implications of Global Electronic Commerce, Department of the Treasury Office of Tax Policy November 1996. Yet, as of today, in the European context some countries have recently enacted "Digital Service Taxes". While Belgium, the Czech Republic, and Slovakia have published proposals to enact one, and Latvia, Norway, and Slovenia have either made official announcements about or indicated intentions to implement such a tax, only Austria, France, Hungary, Italy, Poland, Portugal, Spain, Turkey, and the UK have implemented a tax. The scope and structure of the proposed and actual digital service taxes are very different.

[180] A. J. Cockfield, *The Rise of the OECD as Informal World Tax Organization through National Responses to E-Commerce Tax Challenges*, in *Yale Journal of Law & Technology*, 2006, p. 142.

[181] On doctrinal analysis of what makes tax competition harmful, *see* F. Brugger & R. Engebretsen, *Defenders of the status quo: making sense of the international discourse on transfer pricing methodologies*, in *Review of International Political Economy*, 2022, p. 307-310, A. Easson, *Fiscal Degradation and the Inter-nation Allocation of Tax Jurisdiction*, in *EC Tax Review*. 1996, p. 112; A. Daphne & A. Kenyon, *Theories of Inter-jurisdictional Competition*, in *New England Economic Review*, 1997, p. 13; C. Pinto, *EU and OECD to Fight Harmful Tax*

only yielded patchy success. The lack of a consensus on harmful tax competition has not prevented countries from attempting to bring this phenomenon to an end.

From an international perspective, the OECD has been leading the charge in formulating normative positions regarding what counts as harmful tax competition, what qualifies as a tax haven, which nations should be marked as "uncooperative" in matters of international tax policy, and to what extent tax transparency and information exchange should be incentivized.

As a brief overview of the steps implemented by the OECD, in January 1997, following the requests made in the G7 of Lyon of June 1996, the Committee on Fiscal Affairs launched the project to combat harmful tax competition and constituted a task force dedicated to this issue.[182]

After being requested by OECD countries to « *develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases* », the OECD published in 1998 its first report on harmful tax competition, where it recognized that globalization has produced a new environment that favors tax policies intended to draw foreign investment at the expense of rival nations, distorting trade and eroding tax bases. In the report, four factors are considered essential in order to identify harmful tax measures: inexistent or low effective tax rate, isolation from the domestic economy, lack of transparency and lack of effective exchange of information regarding the tax system.[183] The OECD has also identified eight

*Competition: Has the Right Path Been Undertaken*, in *Intertax*, 1998, p. 386-410; L.V. Faulhaber, *The Trouble with Tax Competition: From Practice to Theory*, in *Tax Law Review*, 2018, p. 311.

[182] Communiqué issued by the Heads of State at their 1996 Lyon Summit: «*Finally, globalization is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices. We will follow closely the progress on work by the OECD, which is due to produce a report by 1998*».

[183] With respect to the four essential factors: (*i*) the effective tax rate must be zero or low to qualify a tax practice as unfair. This comparison is made in relation to income from geographically mobile activities such as financial and service activities; (*ii*) the fact that the tax system in the country of origin is not based on the same principles as the one in force in the country of origin is not a factor in determining whether a tax practice is unfair. Second, the fact that the preferential tax regime is limited in relation to the global economy is another key factor. According to the 1998 Report, this ring-fencing can take two forms. It can either be a regime that is exclusively reserved for non-residents, thus prohibiting resident taxpayers from setting up entities under the regime, or a regime that formally prohibits beneficiaries from operating in the domestic market; (*iii*) the lack of transparency in the preferential tax regime is characterized by the fact that the regime is not clearly explained to the tax authorities; (iv) the criterion that there should be no effective exchange of information concerning the regime highlights the importance of cooperation

secondary factors: artificial definition of the tax base, failure to comply with international transfer pricing principles, exemption of foreign source income from home country taxation, the ability to negotiate the tax rate or base, the existence of secrecy provisions, access to a wide network of tax treaties, promotion of the regime as a tax minimization tool, and encouragement of activities or arrangements that are exclusively tax motivated.[184]

The OECD also created the Forum on Harmful Tax Practices, which has been conducting reviews of preferential regimes since its creation in 1998 in order to determine if the regimes could be harmful to the tax base of other jurisdictions.

It released a second report in 2000 which focused on harmful tax competition regimes,[185] and set a one-year period for tax havens to eliminate their harmful tax practices, otherwise those jurisdictions would be included on a list of “uncooperative” tax haven jurisdictions. The OECD has continued to pay close attention to unfair tax competition in other reports published in 2001, 2004, and 2006 and 2011, highlighting the necessity of international cooperation as a possible means to seek a solution. Such cooperation could be reflected through information sharing and the fight against banking secrecy and the lack of transparency of tax practices in tax havens. More specifically, OECD countries developed strategies to counter aggressive tax planning and emphasized the need to put in place « *properly targeted disclosures initiatives* » or even more effective « *mandatory early disclosure rules* » that would « *provide governments with timely, targeted and comprehensive information on aggressive tax planning schemes and compliance responses* ».[186]

between countries and their willingness and ability to exchange information; the existence of secrecy provisions, when tax authorities do not have access to information because of bank secrecy or the non-misuse of financial instruments, among other things.

[184] Access to a vast network of tax treaties is another element of the co-incidence of a harmful tax measure. Although the purpose of such a network is to combat double taxation, this multiplication of links may also be harmful in the sense that a harmful tax system may reach more targets. The promotion of the system as a tax minimization tool is a further indication of the presence of a harmful tax measure despite not necessarily being the benchmark for determining whether a tax system is harmful.

[185] The 2000 Report also identified 47 "potentially" harmful preferential tax regimes in OECD member countries. A harmful preferential regime is a regime that provides for low or no taxation of financial or other mobile services income *and* also meets one of three other criteria: (1) the regime lacks transparency; (2) the country does not engage in effective information exchange with respect to taxpayers utilizing the regime; or (3) the regime is "ring fenced".

[186] OECD Report on disclosure initiatives, Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure, February 2011.

The historical context in which the first reports were adopted by the OECD is profoundly different from the current political and economic quagmire. Indeed, economic crises – most recently the one related to the Covid-19 pandemic – and globalization are creating serious budgetary problems for states. While in the 1990s the OECD seemed to point the finger mainly at certain states considered to be tax havens, today some large multinational groups are in the spotlight, "guilty" of maximizing their profits by using the law of the jurisdictions that guarantee them the most advantageous tax conditions. Harmful tax competition has thus truly acquired a dual nature. On the one hand, some countries intend to attract capital and businesses into their territory leveraging on tax considerations in a selective and non-generalized manner to favor only certain types of economic activities. On the other hand, businesses are taking advantage of mismatches and loopholes caused by the absence of pervasive international and EU coordination among domestic tax systems, resulting in significant overall loss in tax revenues for multiple jurisdictions.

In this context, given that aggressive tax planning also results from the inadequacy of the current international tax system to the digital economy,[187] a role of absolute prominence must be acknowledged to the Base Erosion and Profit Shifting ("BEPS") project, conceived within the OECD/G20 framework,[188] which has the underlying goal of creating an alignment between taxing power and value creation. In this way, profits of multinational companies are taxed where the profit-generating economic activities are carried out and where value is created. In order to oversee and evaluate the application of the BEPS basic standards, the OECD also created the OECD/G20 Inclusive Framework on BEPS in 2016. The BEPS package was intended

[187] *See* OECD Interim Report, Tax Challenges Arising from digitalization, March 2018.

[188] The report "Action Plan on Base Erosion and Profit Shifting" was presented by the OECD at the G20 held in Moscow on July 19-20, 2013. Moreover, already at the June 18-19, 2012, G20 meeting in Mexico, states had committed themselves "to prevent base erosion and profit shifting"; a commitment that, at the conclusion of the G20 Finance Ministers' meeting on November 5-6, 2012, was reflected into an explicit mandate to the OECD to look into the issue. It should be noted that the term "Base Erosion and Profit Shifting" is used to refer to tax planning strategies implemented, in particular, by large multinational corporations to exploit asymmetries in national tax laws with the aim of shifting profits to low- or no-tax countries (profit shifting), while lowering the tax base (base erosion) in higher-tax countries. *See* P. Saint-Amans & R. Russo, *The BEPS Package: Promise Kept*, in *Bulletin of International Taxation*, 2016; E. Traversa & A. Flamini, *The Impact of BEPS on the fight against harmful tax practices: risk and opportunities for the EU*, in *British Tax Review*,2015, p. 396-407; L. Wagenaar, *The effect of the OECD Base Erosion and Profit Shifting Action Plan on Developing Countires* in *Bulletin of International Taxation*, 2015; C. Garbarino, *L'impatto sulle convenzioni fiscali del progetto OCSE in materia di Base Erosion and Profit Shifting*, in *Rivista di Diritto Tributario internazionale*, 2019, p. 47-88.

to be implemented through modifications to domestic legal systems, customs, and tax treaties. Almost 90 countries are signatories of the Multilateral Instrument ("MLI"), whose negotiations were completed in 2016 with the goal of facilitating the implementation of the treaty-related BEPS measures.

At the Buenos Aires summit in 2018, the G20 has emphasized that all jurisdictions should sign and ratify the multilateral convention. At the same time, inspired by the success of the FATCA and progress in the field of exchange on request, the OECD has been building, since 2013, a comprehensive framework for the automatic exchange of tax information relating to financial accounts, together with the IT infrastructure enabling data transfers.[189]

Nonetheless, following criticism that the BEPS final Actions do not go far enough in addressing the issues of BEPS,[190] the OECD responded with a landmark 2021 global tax deal which will be thoroughly analyzed in the following section. The multilateral cooperation involving the OECD, G20 and the EU, and the BEPS Inclusive Framework has been at the forefront of the dialogue over an international minimum tax on multinational corporations. This deal is certainly a step ahead in the fight against harmful tax competition but affirming that a comprehensive and effective solution has been found is easier said than done.

## 3.2. OECD/G20 BEPS Project

The 2008 crisis elevated tax issues to the status of a major political issue. The loopholes that have marked the past decade have greatly contributed to this, regularly

[189] Paragraph 25 of the "G20 Leaders' declaration – Building consensus for fair and sustainable development" states that «*all jurisdictions should sign and ratify the multilateral Convention on Mutual Administrative Assistance in Tax Matters*».

[190] *See, inter alia*, M. Herzfeld, *The Case against BEPS: Lessons for Tax Coordination*, in *Florida Tax Review*, 2017, p. 3-59; R. S. Avi-Yonah & H. Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, in *Harvard Business Law Review*, 2016, p. 185*;* I. Burgers & I. Mosquera, *Corporate Taxation and BEPS: A Fair Slice for Developing Countries*, in *Erasmus Law Review*, 2017, p. 29; S. Fung, *The Questionable Legitimacy of the OECD/G20 BEPS Project*, in *Erasmus Law Review*, 2017, p. 76.

mobilizing the interest of public opinion and brought a major shift in policymaking.[191] Among the new initiatives, the BEPS is probably «*the most expansive internationally coordinated effort aimed at preventing tax avoidance*».[192]

In 2012, the G20 invited the OECD to study ways of preventing base erosion and profit shifting and approved its action plan at the 2013 St. Petersburg summit.[193]

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima on 8 October, the OECD published 13 papers and an explanatory statement outlining consensus actions under the base erosion and profit shifting (BEPS) project. These papers include and consolidate the first seven reports presented to and welcomed by the G20 leaders at the Brisbane Summit in 2014.

On the basis of this mandate, the 15 actions of the project gave rise to 13 final reports published in 2015, which form the "BEPS package".[194]

BEPS package attempts to institutionalize political pressure on tax jurisdictions. Only some of the BEPS package's recommendations are politically binding.[195]

Compliance with minimum standards is ensured by peer review, which does not, however, give rise to a rating, but rather to written observations and recommendations. The peer review process is a staged approach, which is aimed at allowing for the early detection of inconsistencies with the minimum standard as well as to provide

[191] A. Christians, *Taxation in a Time of Crisis: Policy Leadership from the OECD to the G20*, in *Northwestern Journal of Law and Policy*, 2010, p. 19-40.

[192] O. Marian, *Blockchain Havens and the Need for Their Internationally Coordinated Regulation*, in *North Carolina Journal of Law and Technology*, 2019, p. 529-568.

[193] *See* Tax annex to the St. Petersburg g20 leaders' declaration, September 2013: «*International collective efforts must also address the tax base erosion resulting from international tax planning. Base erosion and profit shifting (BEPS) relates chiefly to instances where the interaction of different tax rules result in tax planning that may be used by multinational enterprises to artificially shift profits out of the countries where they are earned, resulting in very low taxes or even double non-taxation. These practices, if left unchecked, undermine the fairness and integrity of our tax systems. They fundamentally distort competition, because businesses that engage in cross-border BEPS strategies gain a competitive advantage compared with enterprises that operate mostly at the domestic level. Fair, transparent and efficient tax systems are not only key pillars for sound public finances, but they also provide a sustainable framework for dynamic economies*».

[194] *See* Y. Brauner, *What the BEPS?*, in *Florida Tax Review*, 2014, p. 55. On the relation between BEPS and EU law, *see* P. Baker & W. Schön, *The BEPS Action Plan in the Light of EU Law: Treaty Abuse*, in *British Tax Review*, 2016, p. 408-416; E. Traversa & A. Flamini, *The Impact of BEPS on the Fight Against Harmful Tax Practices: Risks… and Opportunities for the EU*, in *British Tax Review*, 2015, p. 396-407.

[195] The output under each of the BEPS actions are intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. They are broadly classified as "minimum standards", "best practices" or "recommendations" for governments to adopt.

jurisdictions with the opportunity to take action to address inconsistencies. Like the Global Forum on Transparency – the leading *international* body working on the implementation of global transparency and exchange of information standards created in 2009[196] – an "Inclusive Framework" was created in 2016, to ensure the implementation of the BEPS project.

The Inclusive Framework is open to all jurisdictions on an equal footing, and notably pilots peer reviews of compliance with the minimum standards, as well as monitoring the other actions in the package. By joining the Inclusive Framework, tax jurisdictions commit to adopting all the measures in the BEPS package, and to implementing them consistently. This political commitment is not limited to minimum standards.

Furthermore, as an additional element of pressure, certain jurisdictions of relevance can be identified by the Inclusive Framework via its review process and be subject to the same mechanisms as members. These are jurisdictions whose adherence to the minimum standards will be necessary to ensure that a level playing field is achieved. For the sake of efficiency and to avoid "free rider" behavior, some of the measures in the BEPS package have been implemented by a multilateral treaty ("multilateral instrument")[197] .

Three out of four actions in the BEPS package include minimum standards of direct relevance to the regulation of tax competition.

First and foremost, Action 5 of the BEPS project is a direct extension of the 1998 initiative on harmful tax competition, and includes two minimum standards of its own, requiring the dismantling of harmful preferential regimes and the automatic exchange of tax rulings. The first part of the agreement develops the surveillance framework while extending it to all jurisdictions in the Inclusive Framework and jurisdictions of "relevance".

[196] *See* L.E.C. Neve, *The Peer Review Process of the Global Forum on Transparency and Exchange of Information for Tax Purposes*, in *Erasmus Law Review*, 2017, p. 89-105.

[197] D. Kleist, *A Multilateral Instrument for Implementing Changes to Double Tax Treaties: Problems and Prospects*, in *Intertax*, 2016, p. 823-830; A. Bosman, *General Aspects of the Multilateral Instrument*, in *Intertax*, 2017, p. 642-659; M.L. Gomes, *The DNA of the Principal Purpose Test in the Multilateral Instrument*, in *Intertax*, 2019, p. 66-90; S. Dorigo, *L'impatto della convenzione multilaterale beps sul sistema dei trattati contro le doppie imposizioni: verso un diritto tributario internazionale dell'incertezza?*, in *Rivista Trimestrale di Diritto Tributario*, 2018.

However, the focus remains on "harmful" competition. As in 1998, even the absence of any taxation of profits is not in itself harmful. To cut to the chase, a regime is harmful if its benefits are granted even in the absence of substantial activity in the tax jurisdiction offering it.[198]

The OECD is therefore endeavoring to establish minimum substance criteria for each type of scheme, which in the particularly sensitive field of intellectual property, for example, translates into the nexus approach. The minimum standard was strengthened in November 2018, which illustrates that the Inclusive Framework naturally plays the role of "legislator" and not just executor of the BEPS package. To ensure a level playing field, the Inclusive Framework decided to subject jurisdictions that levy no or insignificant taxes on profits to the substantial activity test, whereas in the original framework of Action 5, this was only applicable to preferential regimes in jurisdictions that otherwise have a common law tax system.[199]

The jurisdictions concerned are required to identify companies whose particularly mobile activities are linked to their territory. In the absence of a common law tax regime, they are required to establish a specific system of sanctions, which may consist, for example, in deregistration, and to spontaneously transmit information on the entities concerned to the jurisdictions of their immediate parent company, and beneficial owner.

Action 5 serves two purposes. Indeed, it seeks to connect taxation power with where value creation occurs and develops tax transparency standards. In respect to the first function, the findings of Action 5 on tax incentives for Research and Development activities revealed as many as 16 schemes with no substantive relationship to the states that use them, highlighting their significant potential to promote damaging forms of tax

[198] OECD, *Countering harmful tax practices more effectively taking into account transparency and substance, Action 5 – 2015 Final Report,* 2016, p. 22.

[199] The report establishes minimum standards with regard to both determining whether preferential regimes take sufficient account of the need to reward only substantial activities and ensuring that there is transparency in relation to rulings. It also sets out minimum standards for domestic law provisions in respect of intellectual property regimes, such as patent box regimes. The September 2014 interim report on Action 5 (interim report) outlined the progress made on the delivery of the outputs asked of the FHTP. It focused on (i) elaborating on a methodology to define the substantial activity requirement in the context of intangibles regimes; and (ii) improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes. *See* also OECD, *Resumption of application of substantial of substantial activities factor to No or only Nominal Tax Jurisdictions*, 2018.

competition. Since this measure comes within the BEPS's so-called minimal requirements, the states have agreed to adjust the way these plans are implemented.

In terms of transparency, Action 5 has emphasized the use of interpellation in the context of granting preferential tax treatment, on the one hand requiring that the exercise of these powers take place in accordance with the conditions established by the BEPS project and, on the other hand, mandatorily establishing the spontaneous exchange of information to be used in this area[200].

Secondly, Action 6 obliges jurisdictions to include an anti-abuse clause in their tax treaties, in principle the main purpose clause, which should help to facilitate and intensify the fight against treaty shopping which, when it concerns a flow eroding the tax base in the source state, is the crudest means of transferring profits to tax-preferred jurisdictions. In this respect, the multilateral instrument is already making a decisive contribution to the spread of the main purpose clause. This is the hard core of the multilateral convention, and participating states cannot reject its application by entering a reservation.

Therefore, Action 6 established the minimum standards of the BEPS project, enshrining the obligation to combat abuse of international tax treaties through the inclusion of clauses limiting the benefits of the treaties within the treaties themselves.

This is achieved through the special provisions included in the multilateral instrument of the BEPS project and with corresponding anti-avoidance clauses within the new Article 29 in the OECD Model 2017.

As an alternative to the limitation-on-benefits clause these also provide for the possibility of applying the principal purpose test, which is in essence a kind of general anti-avoidance clause applied to the context of international conventions. The preference for the limitation-on-benefits clause is related to the proven effectiveness of this special anti-avoidance clause in convention practice, which succeeds in being applied almost automatically and thus counteracts the elusive phenomenon of treaty shopping (i.e., the undue application of the double taxation convention to the detriment of the exercise of taxing power by the state of the source of the income) even more quickly.[201]

[200] P. Pistone, *Manuale di Diritto Tributario* Internazionale, Torino, 2019, p. 35-56.

[201] E.C.C.M. Kemmeren, *Where is EU law in the OECD Beps discussion?*, in *EC Tax Review*, 2014, p. 190-193.

Thirdly, Action 13 attempts to make BEPS practices more visible, albeit for the time being only to tax administrations[202]. This should indirectly result in increased pressure on tax jurisdictions where a significant proportion of the tax base of the groups concerned would be concentrated, without any quid pro quo in terms of human and technical substance.

Action 13 is an OECD project minimum standard that requires multinational enterprises to implement more detailed transfer pricing documentation that can outline the methodologies used by these entities and also verify their impact on the group, based on the so-called master file, and on the individual enterprises that are part of it, which are also required to submit the so-called local file, beginning in 2017. This documentation, also known as the country-by-country reporting system, must highlight the essential aspects for a proper transfer pricing policy in accordance with the BEPS project's objectives, specifying the location of profits and sales, as well as the location of employees and business assets, as well as the taxes paid.

In brief, Action 13 required the creation of standards governing transfer pricing documents in order to improve transparency for tax administrations while taking compliance costs into account. Such guidelines include a requirement that MNE groups report information on their worldwide division of revenue, economic activity, and taxes paid across nations using a uniform template to all relevant governments. Action 13 work resulted in the adoption of a three-tiered standardized approach to transfer pricing paperwork, which promotes transparency while standardizing documentation and filing requirements, preventing the spread of different regimes.  A master file, a local file, and a country-by-country report compose the three-tiered standardized method.

The master file should give high-level information to tax administrations on the MNE group's global business activities and transfer pricing strategies. Such information should give a 'big picture' perspective of the taxpayer's global value chain and provide context for understanding and interpreting the data in both the local file and the CbC report. Each taxpayer's 'local file' should contain detailed transactional transfer pricing documentation on material relatedparty transactions, the amounts involved in those

[202] It seeks to «*develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business*». *See* BEPS Action plan on base erosion and profit shifting, p. 23.

transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions. A member of an MNE group's master file and local file should be lodged directly with that member's tax administration.

Moving on with Action 14, the growing awareness of international tax difficulties relating to the interpretation and execution of the BEPS project, as well as those related to associated domestic and traditional source measures, has necessitated the inclusion of this action inside the project. Its role is to supplement the tax transparency measures associated with the BEPS initiative by enhancing processes for resolving tax disputes in the international realm.

For this reason, this action is also included among the minimum standards of the BEPS project. However, given many countries' reluctance to introduce mandatory forms of arbitration, the multilateral implementing instrument of the BEPS project provided for the mandatory nature of the mutual agreement procedure, significantly reinforcing its mode of operation, while leaving the introduction of arbitration as optional.

The increased importance of MAPs in the context of international tax dispute resolution could be welcomed, especially if such procedures could be carried out with greater transparency and participation of the taxpayers involved, under conditions that are substantially similar to those that characterize domestic tax proceedings.

I order to join the Inclusive Framework – the supreme technical and political authority for handling the BEPS project recommendations and the continuation of related work. It now includes more than 140 states and territories – the Associates must agree to adopt the four BEPS items defined as “minimum standards”. These are Actions 5 and 6 on harmful tax practices and mandatory exchange of rulings; Action 13 on Country-by-Country Reporting to allow tax administrations to better assess risks in transfer pricing situations; and Action 14 on dispute resolution. With respect to Action 14, this may require a number of countries to make significant improvements in their mutual agreement procedures[203].

[203] H.J. Ault, *Tax Competition and Tax Cooperation: A Survey and Reassessment*, in J. Monsengo & J. Bjuvberg, *International Taxation in a Changing Landscape. Liber Amicorum in Honour of Bertil* Wiman, Alphen aan den Rijn, 2019, p. 7.

### 3.3. The OECD reaction against hybrid mismatch arrangements

In addition to the classical forms of financial instruments such as debt and equity, hybrid financial instruments have become very important in the last decades, especially in the context of international tax optimization. BEPS Action 2 called for the development of model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effects of hybrid instruments and entities[204].

Hybrid mismatch arrangements are used in aggressive tax planning to exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term tax deferral.

In short, BEPS Action 2 only targets mismatches that rely on a hybrid element to achieve: (*i*) deduction/no inclusion ("D/NI outcome"), i.e. payments that are deductible under the rules of the payer jurisdiction but are not included in the payee's ordinary income; (*ii*) double deduction ("DD outcome"), i.e. payments that give rise to two deductions in respect of the same payment; and (iii) indirect deduction/no inclusion ("D/NI"), i.e. a hybrid mismatch that arises between two jurisdictions can be shifted into another jurisdiction by means of a financial instrument..

Action 2 aims to mitigate the effects of hybrid mismatch arrangements by «*(a) Changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (b) Domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer; (c) Domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under CFC or similar rules); (d) Domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (e) Where necessary, guidance on co-ordination or tie-breaker*».[205]

[204] Action 2 states that tax arbitrage via hybrid mismatch *arrangements* «*result in a substantial erosion of the taxable bases of the countries concerned*» and «*have an overall negative impact on competition, efficiency, transparency and fairness*». *See* OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – Final Report, 2015, p. 11.

[205] BEPS Action 2 recommendations might not address all mismatches in a logical and systematic manner. In this regard, authors refer to trust-based mismatches as Action 2 does not fully account for the specific fiscal aspects of trusts or the largely transparent taxing paradigms that many nations use to tax trust income. *See* M. Brbazon, *BEPS Action 2: Trusts as Hybrid Entities*, in *British Tax Review*, 2018, p. 211-242.

Addressing BEPS also implies handling harmful tax regimes both at the OECD and the EU level[206] and, in the European Arena, BEPS Action 2 (and 4) have been substantially transposed by the European legislator in the Atad Directive[207]. One year later, Directive Atad 2, specifically to extend the substantive scope of anti-hybrid rules to mismatches involving third countries.

We will not delve into the specificities as it is not the core of this work, but we will provide the practical implementation of the BEPS action against hybrid mismatches and the Atad directives in the following paragraph when referring to the example of Italy.

### 3.3.1. Italian tax law on imported mismatches

The Italian tax rules on hybrid mismatches are contained in the Legislative Decree issued on 29 November 2018 n. 142 (also referred as the "Italian ATAD Decree"), that implements the EU ATAD in Italy, with the aim to «*neutralize hybrid mismatches in as comprehensive a manner as possible*»[208]. As clarified by the Preamble's Recital n. 28 of the EU ATAD 2 and reported by the Explanatory Notes to the EU ATAD Decree, the EU Member States should use the applicable explanations and examples in the OECD report on Neutralizing the Effects of Hybrid Mismatch Arrangements - Action 2[209] (the "OECD HMA Report") as a source of illustration or interpretation, to the extent that they are consistent with the provisions of the EU ATAD 2 and with EU law.

Among the four categories of "direct" hybrid mismatches, in line with EU ATAD[210], the article 6(1)(r) of the Italian ATAD Decree provides that a D/NI mismatch is triggered by a payment made by a hybrid entity (TUL in the case at hand) to its owner (TMI), that is offset against an amount that is not dual-inclusion income (at the level of TME).

With reference to imported mismatches art. 9(3) of EU ATAD has been implemented by art. 8(3) of Italian ATAD Decree, the latter containing the following

[206] *See* Commission Recommendation of 6 December 2012 regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters, 2012/771/EU

[207] *See* Article 9 of the Atad Directive.

[208] As provided by Preamble's Recitals n. 5 of the EU ATAD 2.

[209] Neutralizing the effects of hybrid mismatch arrangement, Action 2 - 2015 Final Report.

[210] As summarized by Recital n. 15 of EU ATAD 2.

provision: «*it is not allowed the deduction of a payment by an Italian taxpayer to the extent that it finances, directly or indirectly, deductible expenses that generate a hybrid mismatch through a transaction or series of transactions between associated enterprises or that are parties to a structured arrangement. Notwithstanding what reported in the previous period, the payment incurred, or which is believed to be incurred, by an Italian taxpayer is deductible if and to the extent that one of the States of residence or establishment of the subjects involved in the transaction or series of transactions has made an equivalent adjustment with the effect of neutralizing the hybrid mismatch at hand*».

As provided by OECD Hybrid Mismatch Arrangement Report, the rules on the imported mismatches «*involve an unavoidable degree of co-ordination and complexity, they only apply to the extent a multinational group generates an intra-group hybrid deduction and will not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report*»[211].

As to the ability to resolve an identified hybrid mismatch through the alternative inclusion of a controlled foreign company ("CFC") income, nor the EU ATAD nor the Italian ATAD Decree expressly provide for the possible "inclusion" of an income under a CFC regime (or other offshore investment regimes). Nonetheless, regarding the case of imported mismatches, the reference contained in the relevant law provision to the "equivalent adjustment" made by one of the States of residence of the subjects involved in the transaction and the explicit reference to the OECD HMA Report contained in the Recital n. 28 of the EU ATAD 2[212] should allow CFC regimes as a way of "inclusion" of an income, provided that specific conditions are met. A different outcome would lead to a possible case of double taxation, that would be, in general, not compliant with general EU principles[213].

Under such approach, the conditions for a CFC regime (or other offshore investment regimes) to qualify for the "inclusion" for anti-hybrid purposes are provided

[211] OECD HMA Report, para. 234 of Chapter 8 (Imported mismatch rule).

[212] Same reference in contained in the Explanatory Notes to the Italian ATAD Decree.

[213] Making reference to the consolidated approach of the European Court of Justice, a Directive that is enacted in order to avoid double non-taxation should also have adopted measures to prevent unintended double taxation stemming from the application of anti-hybrid rules. This is because the tax burden imposed on each taxpayer should be determined in accordance with the general ability-to-pay principle, irrespective of the origin of the corresponding item.

in the OECD HMA Report on Action 2, which states that (*i*) the payment is wholly and effectively included in the income of the controlling entity; (*ii*) the payment is subject to taxation at the full marginal rate; (*iii*) the payment is not subject to partial exemptions and/or exemptions were recognized; and (*iv*) the payment is not offset by other deductions or reliefs and not granted to reduce taxes due to the indirect credit against taxes incurred by the foreign subsidiary[214].

### 3.3.2. Italian tax authorities' interpretation of the tax law on imported hybrid mismatches

In Circular Letter n. 2/E issued on 26 January 2022 ("Circular n. 2/E/2022"), the Italian tax authority provided an interpretation of the anti-hybrid domestic rules (Italian ATAD Decree) implementing the EU ATAD 2.

At the outset, the Italian tax authority reported that the principles and examples contained in the OECD HMA Report assume a pivotal role as a source of interpretation of the provisions of the Italian ATAD Decree and shall be taken into consideration, to the extent that they are consistent with the provisions and principles of the Italian and EU principles[215].

With reference to imported hybrid mismatches, the Italian tax authority considered Recital n. 25 of EU ATAD 2 which clarifies that «*imported mismatches shift the effect of a hybrid mismatch between parties in third Countries into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralize hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure involving a hybrid mismatch. To counter such imported mismatches, it is necessary to include rules that disallow the deduction of a payment if the corresponding income from that payment is set off, directly or indirectly, against a deduction that arises under a hybrid mismatch giving rise to a double deduction or a deduction without inclusion between third Countries*».

In this respect, Italian tax authorities acknowledged that doubts may arise about the fact that imported mismatches can be triggered in transactions among EU companies

[214] OECD HMA Report, paras. 36-40 and 127, Example 6.4.

[215] Please refer to Circular n. 2/E/2022, Introduction.

but - in light of lack of expressed reference to EU or non-EU companies in the relevant articles of EU ATAD and of Italian ATAD Decree – imported mismatches from EU States should also be included, «*provided obviously that, in the such [EU] States the anti-hybrid rules have been implemented with a level of protection not equivalent to that provided by the Italian ATAD Decree*»[216].

This approach has been considered as an "export" of the rules provided by the Italian ATAD Decree to other States.

With reference to the regimes that provides for "inclusion" of a given income (such as CFC), the Italian tax authority reported that a foreign CFC regime can be deemed as an alternative way of "inclusion" of a given payment for the .anti-hybrid rules as long the conditions provided by the OECD HMA Report are met, i.e. basically the payment has been fully included under the laws of the jurisdiction applying the CFC regime and it is subject to tax at the full rate, consistently with certain conditions.

Based on the conditions provided by the OECD HMA Report, one could argue that the GILTI regime is not equivalent to a CFC regime for anti-hybrid purposes, since the foreign income is not subject to the full corporate tax rate in the US.

Nevertheless, as of today, the Italian tax authority have taken no formal position on whether the US GILTI regime can be considered equivalent to a CFC regime for anti-hybrid purposes. Furthermore, as of today, nor the EU Commission nor Italy have expressed any public complaints on the interpretation put forward by Irish tax authorities about the fact an amount included in the GILTI calculation for the purposes of the group's US taxable income should be regarded as "included" (under CFC charges) for the purposes of the anti-hybrid rules provided by the EU ATAD and implemented by Ireland.

### 3.3.3. The implementation of the EU Atad Directive

The EU ATAD has been adopted with the key objective to improve the resilience of the internal market as a whole against cross-border tax avoidance practices (including hybrid mismatches), that cannot be sufficiently achieved by the Member States acting individually.

[216] Unofficial English translation of the Circular Letter n. 2/E/2022.

Indeed, considering that «*national corporate tax systems are disparate and independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation* […] *such independent action by Member States] would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. The result would be lack of coordination*»[217].

In light of the above, although the EU does not have exclusive competence on direct taxation, it has adopted the EU ATAD 2 as the mentioned key objectives cannot be sufficiently achieved by the Member States and the action is implemented more successfully by the EU[218]. In this respect, when the Directive is transposed into the national law, the latter should be interpreted in the light of the objectives of the Directive[219]. Accordingly, the Directive should be interpreted and applied in as uniform manner as possible by the EU Member States to ensure the achievement of a common standard in countering hybrid mismatches with non-EU Countries.

In this regard, it should be noted that the need to adopt a coordinated and concerted approach to hybrid mismatches has been explained by the EU Commission in the context of the legal basis of EU ATAD 2, that provides for «*a comprehensive framework of rules against hybrid mismatch arrangements at the level of the EU would add value compared to what a multitude of national rules can attain. An EU initiative minimizes the risk of persisting loopholes or double taxation, which risk a patchwork of national rules addressing hybrid mismatches could entail*»[220].

Furthermore, also the OECD HMA Report (that, as mentioned, constitutes a relevant source of illustration and interpretation of the EU ATAD 2) highlights the need for the interpretation and application of the anti-hybrid provisions in a uniform manner in the involved States, as the OECD HMA Report «*sets out a common set of design principles*» and recognizes «*the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations*»[221].

[217] Recital n. 27 of EU ATAD 2.

[218] Art. 5, TFUE.

[219] Case C-14/83 (*Sabine von Colson v. Land Nordrhein-Westfalen*).

[220] COM(2016) 687 final.

[221] Executive Summary of the OECD HMA Report, p. 12.

The EU Directive shall be implemented by each Member State through domestic tax laws, while an implementation through tax authorities' administrative guidance (which by their nature are alterable at will by the authorities and are not given the appropriate publicity), cannot be regarded as constituting a proper fulfilment of the implementation[222].

Under the longstanding approach of the European Court of Justice that can be referred to the general principle of mutual trust between Member States, a Member State or its tax authorities may not unilaterally adopt corrective measures designed to obviate any alleged breach by another Member State of rules deriving from EU Directives (e.g., based on the unilateral belief that the other Member State, although it had implemented a Directive, does not ensure the compliance with the provisions of such Directive).

As a general principle, in an EU cross-border situation (such as the deduction of expenses under the hybrid mismatch rule) an obligation imposed to the taxpayer (by the law or through tax authorities' administrative guidelines) to produce specific certificates or information that are not required in a pure domestic situation, can be considered as a restrictive measure, which should be assessed against the "proportionality" principle, i.e., assessing if a specific obligation is the most suitable to attain the objectives pursued and does not exceed the limits of what is necessary.

Under the same rationale, the "proportionality" principle should be considered also in relation to the "effect" of the application of the tax rules implementing the relevant EU Directive.

Indeed, to the extent the transactions subject to the possible tax adjustment required by the Italian tax authority is caused by transactions of EU counterparts where the Italian taxpayer has not been involved, such tax adjustment can be considered as an "overkill", because it implies the tax burden associated to transactions that should have been already addressed by specific rules in other EU Countries[223].

[222] Case C-315/98 (*Commission vs Italy*); Case C-142/01 (*Commission vs Italy*), Case C-307/89 (*Commission vs France*).

[223] This thesis aims to provided a very brief overview of the topic since it is not its focal point. For a more through analysis about ATAD implementation in Italy, see P. Boria, *La clausula anti-abuso prevista dalla direttiva ATAD: l'esperienza italiana*, in *European Tax Studies*, 2019, p. 9-37.

## 3.4. The OECD Global Tax Deal: a milestone in international taxation

### 3.4.1. A deal to address the challenges arising from the digitalization of the economy

Although the idea of a “global minimum tax” was not included in the original BEPS agreement, political support has been increasing in recent years. BEPS negotiations had only led to an agreement on measures to curb “aggressive” international tax planning and tax avoidance. Due to the veto of the United States, the dispute over the potential realignment of the traditional distribution of taxing powers in response to the digitization of the economy was not truly resolved.

The concept of a worldwide effective minimum tax of low-taxed overseas profits was proposed in 2018 by France and Germany. The Franco-German engine reaffirmed the « *determination to establish a fair and effective taxation of large digital companies that will contribute to the modernization of our tax systems* » and expected the OECD to « *reach an agreement by 2020 on proposals aimed at tackling the challenges raised by the digitalization of the economy and tax avoidance* ».[224] A window of opportunity opened up after the implementation of the GILTI regime[225] in the US and the Inclusive Framework assessed this course of action shortly after.

Active discussions within the Inclusive Framework culminated in the publication of October 2020 Blueprint for Pillar One and Two[226], which set out the main policy

[224] Franco-German joint declaration on the taxation of digital companies and minimum taxation, https://www.consilium.europa.eu/media/37276/fr-de-joint-declaration-on-the-taxation-of-digital-companies-final.pdf.

[225] The Global Intangible Low Tax Income (“GILTI”) is a category of income that is earned abroad by U.S.-controlled foreign corporations (“CFCs”), and it is subject to a more unfavorable treatment under the U.S. tax code to discourage these corporations from moving their profits to foreign jurisdictions with lower tax rates. There will be a further explanation in Section III, paragraph I of this paper. *See* S.C. Morse, *GILTI: The Co-operative Potential of a Unilateral Minimum Tax,* in *British Tax Review*, 2019, p. 512-536.

[226] Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two, 8-9 October 2020.

features, notwithstanding that several technical details still needed to be sorted out. The Inclusive Framework agreed at the time to reach a successful result by mid-2021. In the months that followed, negotiations progressed, with the support of the US. This momentum was further enhanced by the support of the Finance Ministers and Central Bank Governors at their meeting in June 2021[227], and in July 2023 the OECD/G20 Inclusive Framework issued its Declaration on a Two-Pillar solution[228]. It outlines the main building blocks of the new international tax rules, while leaving some details and technical issues open for discussion with the goal of a revised declaration and detailed implementation plan by October 2021.

Finally, on October 8, 2021, 136 countries endorsed the declaration on a two-pillar solution. Almost all members of the OECD/G20 Inclusive Framework adopted the deal,[229] representing more than 90% of global GDP. In brief, the Declaration, which updates the political agreement reached in July by the members of the Inclusive Framework to achieve far-reaching reform of international tax rules, ensures that a minimum tax rate of 15% is applied to multinational enterprises from 2023 onwards. It will also reallocate more than $125,000,000,000 in profits from about 100 of the world's largest and most profitable multinational companies to countries around the world so that these companies pay their "fair share of taxes" regardless of the jurisdictions in which they operate and make profits. This two-pillar solution was adopted at the G20 Finance Ministers meeting in Washington, D.C. on October 13, 2021, and at the G20 Leaders' Summit in Rome in October 2021.

[227] G7 Finance Ministers & Central Bank Governors Communiqué (5 June 2021, London, United Kingdom): «*We strongly support the efforts underway through the G20/OECD Inclusive Framework to address the tax challenges arising from globalization and the digitalization of the economy and to adopt a global minimum tax. We commit to reaching an equitable solution on the allocation of taxing rights, with market countries awarded taxing rights on at least 20% of profit exceeding a 10% margin for the largest and most profitable multinational enterprises. We will provide for appropriate coordination between the application of the new international tax rules and the removal of all Digital Services Taxes, and other relevant similar measures, on all companies. We also commit to a global minimum tax of at least 15% on a country-by-country basis. We agree on the importance of progressing agreement in parallel on both Pillars and look forward to reaching an agreement at the July meeting of G20 Finance Ministers and Central Bank Governors*», https://home.treasury.gov/news/press-releases/jy0215

[228] Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, 1 July 2021.

[229] Kenya, Nigeria, Pakistan and Sri Lanka have not yet joined the agreement.

### 3.4.2. OECD Pillar One

Starting from the assumption that the notion of "permanent establishment" ("PE") and ultimately even digital taxes are rather unsuitable to meet the new challenges of the digital economy, Pillar One aims to adapt the international tax system to the new economic models by modifying the rules relating to the allocation of profits of the largest companies. In other words, it underlines the need for a redistribution of the effects of taxation on Multinational companies that would allow the least favored tax jurisdictions (those relating to markets where multinationals operate without a corporate presence) to get their "own fair share" of taxation. At present, the profits of Multinational companies, especially in the digital sector, are usually taxed in the source state in the absence of a physical presence of the company in the state of "consumption", where the most users benefit from their services.

The objective of Pillar One is therefore to recognize the jurisdictions where the business is an active participant to the economy of that jurisdiction, meaning that a jurisdiction can claim taxation rights over a portion of the profits of substantial, highly lucrative businesses when customers or suppliers of products and services are situated in that jurisdiction. It aims to ensure that a country can tax nonresident businesses which, while not rooted in that jurisdiction and lacking any physical connection to that state, earn a certain amount of revenue through transactions carried out by its residents (so-called "market jurisdiction").

The approach identified by the OECD classifies income from transnational activities into different portions, the so-called Amount "A" and "B".

Specifically, Amount A describes a new right to tax in jurisdictions where companies have a significant digital presence, which will be able to tax so-called "non-routine" residual profits there. Pillar One is going to apply to Multinational companies with worldwide sales exceeding € 20,000,000,000 and a profitability of more than 10% (the pre-tax profit ratio divided by sales), calculated using an averaging mechanism. This turnover threshold will be lowered to € 10,000,000,000 subject to successful implementation after seven years. The introduction of a special nexus is then envisaged, and this will allow the allocation of Amount A to a jurisdiction when the multinational enterprise makes at least € 1,000,000 in revenues in that jurisdiction, regardless of its presence there. For jurisdictions with GDP of less than € 40,000,000,000, the revenue threshold will be set at € 250,000. 25% of the residual profits of the largest and most profitable Multinational companies will be reallocated to the market jurisdictions (i.e., the jurisdictions where the users and consumers of the multinational enterprise are located). More specifically, the residual profit that will be redistributed to the various jurisdictions will be equal to 25 % of the portion exceeding the aforementioned 10% ("extra profit").

In essence, it will be necessary first to determine the profitability threshold, then the residual profit, and finally how it will be reallocated. It is crucial is to identify the starting accounting basis for quantifying the extra profit to be redistributed, which stems from the pre-tax profit resulting from the consolidated financial statements prepared according to International Financial Reporting Standards ("IFRS"). Other accounting systems, such as US GAAP, may be allowed where they do not result in significant misalignments. The modalities for reallocation need to be regulated since it is not clear how to set the boundaries of groups' discretion on where to draw resources for reallocation.[230]

It has also been highlighted that adoption of IFRS would often raise the reportable profit, given the fair-value concept under IFRS. The effective tax rate would be lower than the real effective tax rate when calculated in respect to the accounting profit.[231] Adopting accounting profit above taxable profit aims to eliminate structural variations in tax base computation between countries. However, accounting profit is typically larger than taxable profit for a number of reasons.

As for Amount B, Pillar One defines it, instead, as a fixed remuneration for certain basic distribution and marketing activities that take place physically in a given jurisdiction. It will cover all companies regardless of size and is intended to provide greater certainty in relation to the arm's length assessment of these marketing and

[230] Potential consequences on transfer pricing policies are clear, including with respect to the ever-increasing compliance obligations that revolve around such discipline.

[231] An example is provided by *Das and Rizzo: «If the tax paid is 8 and the accounting profit according to IFRS is 100, the effective tax rate is 8%. Under the same amount of tax payment, if the accounting profit is 80 the effective tax rate is 10%. Assuming that the global minimum tax rate is 10%, businesses that adopt IFRS would be in disadvantageous situations as the chances of falling under the scope of the GloBE tax would be higher for them because of inflated profit. Alternatively, the adoption of IFRS under the GloBE proposal would result in the payment of additional tax even in situations where businesses are already subject to adequate tax». See* D. Pitambar & A. Rizzo, *OECD/International - The OECD Global Minimum Tax Proposal under Pillar Two: Will It Achieve the Desired Policy Objective*?, in *Bulletin for International Taxation*, 2021.

distribution activities.[232] However, Amount B will be developed only after the implementation of Amount A.

Finally, Pillar One includes a mechanism to provide for mandatory and binding dispute avoidance and resolution to address any risk of double taxation. Certain exclusions are provided for several sectors (mining, shipping, regulated financial services, pension funds), either because their benefits are already linked to the place where they are earned or because different tax regimes apply to the activities because of their particular nature.[233] For its proper implementation and to prevent damaging trade disputes, Pillar One calls for the removal and freezing of digital service taxes (hereinafter, "DSTs") and other similar measures in relevant jurisdictions.[234]

### 3.4.3. OECD Pillar Two

Pillar Two introduces a global minimum tax and is only indirectly effective to undermine the logic of tax competition. It does not require all countries to raise their income tax rates above the minimum agreed rate. The rules in question put in place a system of shared taxation aimed at ensuring that Multinational companies are subject to a minimum level of taxation on income produced in each jurisdiction in which they operate. The chosen solution rests on guidelines that individual states are called upon to transpose into their own legal systems without, therefore, the provision of multilateral agreements for adoption.

It creates some rules ("GloBE rules") that allow countries to tax foreign income when that income is taxed at less than 15%, under the conditions that are briefly described below.

[232] Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, "Marketing and Distribution profits safe harbor": «*Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe harbor will cap the residual profits allocated to the market jurisdiction through Amount A. Further work on the design of the safe harbor will be undertaken, including to take into account the comprehensive scope*».

[233] These activities are very diverse, and it is still to be addressed how any segmentation of activities will be regulated if the group is very diversified and carries out activities that are only partially excluded.

[234] In a Joint Statement of October 21, 2021, the United States, Austria, France, Italy, Spain, and the United Kingdom, provided for a mechanism that recognizes a tax credit once the implementing rules of Pillar One come into effect. This credit can be offset against the portion of income tax calculated with reference to the "incremental" tax base ("Amount A") resulting from the implementation of Pillar One. *See* https://home.treasury.gov/news/press-releases/jy0419.

First, the “income inclusion rule” (“IIR”) allows a home country to tax the income of a parent company's foreign branches and subsidiaries in its jurisdiction if they do not pay the minimum effective tax rate in their host country. The home country is also granted the possibility to tax globally profits earned by a foreign branch subject to a rate lower than the global minimum rate. In order for the IIR to work, a parent entity must take into account its share of each constituent entity's income that is earned in a low-tax state or territory and tax that income up to the minimum rate (after deducting any covered taxes on that income). Only that portion of a foreign constituent entity's low tax income that is beneficially held – directly or indirectly – by the group member to whom the IIR is applied (the parent company) is subject to a top-up tax under the IIR. The IIR functions similarly to a CFC regulation in that it taxes a domestic taxpayer on its portion of any controlled subsidiary's overseas revenue.

However, when the parent jurisdiction has signed a bilateral tax treaty requiring the parent country to exempt the PE's income, the parent will be unable to apply the IIR to the income of an exempt PE. Therefore, a switch-over rule (“SOR”) is necessary to enable the state of the parent's domicile to tax the PE's income up to the minimal rate allowed under the income inclusion rule.

The “Undertaxed Payments Rule” (“UTPR”) is described as a denial of «*deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate*»[235]. It gives host countries the right to tax payments made by Multinational companies operating in their jurisdiction to foreign affiliates where such payments are not taxed at a minimum level. Based on the parent's direct or indirect ownership of low-tax constituent entities, the IIR stipulates a procedure for the collection of the top-up tax. The UTPR provides a method for making an adjustment in respect of any top-up tax in connection to the income of a low-tax constituent entity that is not within scope of the IIR, acting, in part, as a backstop to the IIR and addressing base erosion through deductible intra-group payments

These concerns appear to have been largely dropped by October 2020 with the approval of the “*Report on Pillar Two Blueprint*” by the inclusive framework[236].

[235] OECD, Public Consultation Document — Addressing the Tax Challenges of the Digitalisation of the Economy, 2019, para. 92.

[236] OECD, Tax Challenges Arising From Digitalisation — Report on Pillar Two Blueprint, 2020.

According to paragraph 21 of this study, only the subject to tax rule would necessitate revisions to current tax treaties, presumably because it would result in the taxation of income that is subject to taxes by another jurisdiction.

The UTPR (and the IIR), as described in the design, do not require these adjustments, and may be implemented through domestic law because it only limits the deductibility of payments without taxing revenue transferred to another jurisdiction.

Indeed, the UTPR does not violate profit attribution criteria in OECD model convention articles 9(1) and 7(2) since it primarily affects how a jurisdiction taxes its own inhabitants, similar to domestic laws on nondeductible costs.[237]: in particular it is provided that «*it is generally recognized, however, that once the profits have been allocated in accordance with the arm's length principle, how they are taxed is a matter determined by the domestic law of each country*».

As commented by scholars[238], the UTPR is described as not violating the nondiscrimination rules in articles 24(4) and 24(3) of the OECD model convention:

(i) On one hand, the application of the UTPR would not be triggered by the residence of the recipient of the payment, but by the jurisdiction's classification as low tax-based on the MNE group's local effective tax rate profile in the relevant period.

(ii) On the other hand, a deniability of deduction in accordance with the blueprint's pillar two rules would apply not only to payments directly made to low taxed group entities, but eventually to all net related-party expenditures of an entity, whether made to domestic or nonresident entities.

In this respect, it should be noted that the UTPR was portrayed in the plan as an undertaxed payments regulation — that is, a tax based primarily on deductible intragroup payments. On this, the blueprint, *inter alia,* clearly states that «t*he top-up tax imposed on each UTPR taxpayer is capped by reference to the gross amount of deductible intra-group payments that are taken into account for the purpose of the allocation keys*».[239]

[237] *See* paragraphs 689 et seq. of the blueprint.

[238] S. Douma, A. Kardachaki, G. Kofler, P. Bräumann, M. Tumpel, *The UTPR and International Law: Analysis From Three Angles*, in *Tax Notes International,* 2023, p. 859-860

[239] OECD, Tax challenges arising from digitalisation — Report on pillar two blueprint, 2020, para 687.

The “subject to tax rule” (“STR”) is based on the idea that a source jurisdiction that has ceded taxing rights under an income tax treaty should be able to apply a top-up tax to the agreed minimum rate in cases where, as a result of BEPS structures relating to intragroup payments, the income that is protected by the treaty is not taxed or is taxed at a lower rate than the minimum rate in the other contracting jurisdiction. The STR specifically targets cross-border arrangements involving intragroup payments that take use of particular treaty clauses in order to transfer profits from source countries to jurisdictions where such payments are exempt from taxes or subject to low rates of nominal taxation. Some payment types (referred to as “covered payments”) that carry a higher risk of base erosion will be subject to the STR. The work done so far has been taking into account interest, royalties, and a certain group of other payments that pose BEPS concerns due to their connections to mobile capital, risk, or assets.

On the whole, Pillar Two is intended to render the most harmful tax practices ineffective: jurisdictions that reduce their effective tax rate below 15% through tax incentives would transfer tax revenues of up to 15% to one or more jurisdictions that will collect the difference. Members of the OECD/G20 BEPS Inclusive Framework that agree to adopt the GloBE rules described in Pillar Two will be required to implement and administer the rules in a manner consistent with Pillar Two, following model legislation and commentary approved by the Inclusive Framework. The model legislation will be supplemented by commentaries that explain the purpose and operation of the rules and the need for a substitute rule in certain treaties.

#### 3.4.3.1. Safe harbors

As previously stated, the overall design of Pillar Two consists of two main interlocking domestic rules:

*(i)* an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of a subsidiary entity's low taxed income; and

*(ii)* an Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent a subsidiary entity's low tax income is not subject to tax under an IIR; and a treaty-based rule (STR) that permits source nations to apply restricted source taxes on some related party payments subject

to tax at a rate less than a specific threshold. Under the GloBE regulations, the STTR will be credited as a covered tax.

The OECD has issued additional guidelines in July 2023[240] on how to apply the Pillar Two standards. Importantly, this guidance includes details on two safe harbor rules, one of which applies when a sufficiently rigorous qualified domestic top-up tax (QDMTT) is in place, and the other of which is a temporary limitation on the application of the undertaxed payment rules to an ultimate parent entity when a corporate income tax rate of 20% is in place.

The first safe harbor concerns the application of the QDMTT guidelines. The guideline acknowledges that there may be disparities between the amounts charged under a QDMTT and the GloBE regulations, but this does not, in theory, create concerns owing to the credit mechanism used by a QDMTT (the GloBE rules will still cover any deficit).

However, the implementation of these rules will necessitate at least two different computations - one for the QDMTT rules and one for the GloBE rules. Clearly, the requirement to conduct different computations under parallel regulations will increase compliance expenses. The QDMTT safe harbor is designed to give a viable answer to this problem.

When a QDMTT qualifies as a QDMTT safe harbor, the regulations will prevent the GloBE rules from being applied in other countries by judging the top-up tax to be zero. To mitigate the danger that the amount payable under a QDMTT will be smaller than the amount payable under the GloBE regulations, a QDMTT must fulfill an extra set of conditions in order to qualify for the safe harbor. It must, in particular, satisfy the three criteria listed below:

- the QDMTT Accounting Standard, which requires a QDMTT to be computed based on the Ultimate Parent Entity's Financial Accounting Standard or a Local Financial Accounting Standard subject to certain conditions.
- the Consistency Standard, which requires the QDMTT computations to be the same as the computations required under the GloBE Rules except where the Commentary so specifies in Article 10.1 of the GloBE Rules or where the

[240] OECD, Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti- Base Erosion Model Rules (Pillar Two), July 2023

Inclusive Framework decides that an optional variation that departs from the GloBE Rules still meets the standard.

- the Administration Standard, which requires the QDMTT jurisdiction to meet the requirements of an ongoing monitoring process similar to the GloBE Rules.

Regarding the second safe harbor, the UTPR is intended to act as a backup to the IIR by encouraging states to adopt the GloBE regulations and Multinational companies to organize their group holdings in such a way that their operations fall within the jurisdiction of the IIR. MNE Groups subject to the possible application of the UTPR in the jurisdiction of the ultimate parent company have little capacity to restructure their ownership structure to put the UPE's revenues inside the scope of an IIR. The revised guideline states that the UTPR may be expected to apply more frequently in the early years of the GloBE regulations' operation as governments complete the process of implementing qualified regulations, including QDMTTs.

If the ultimate parent company jurisdiction imposes a corporate income tax at a rate of at least 20%, the UTPR Top-up Tax Amount determined for the UPE jurisdiction is assumed to be zero for each fiscal year. This transitory UTPR safe harbor is intended to give transitional relief in the ultimate parent company jurisdiction during the first two years after the GloBE regulations take effect, i.e., for fiscal years of no more than 12 months beginning on or before December 31, 2025 and ending before December 31, 2026.

Each jurisdiction's corporate income tax rate is the nominal statutory tax rate commonly applied on in-scope MNE Groups. The nominal 20% rate test assures that this safe harbor is only available to MNE Groups whose UPEs are based in a nation with a corporate income tax system and a sufficiently high corporate income tax rate.

The short transition period is intended to ensure that the safe harbor does not act as a disincentive for jurisdictions to adopt the GloBE Rules or as an inducement for MNE Groups to invert into a jurisdiction that has not yet adopted a QDMTT or to shift profits to UPE jurisdictions with lower effective tax rates.

### 3.4.4 Preliminary assessment of the OECD deal

As a preliminary remark on Pillar One, despite the optimism of the Declaration issued at the meeting of the leaders of the G20 at Bali on November 16, 2022,[241] many experts claim that «*it is highly unlikely that Pillar One can be finalized in 2023*» and that the latter «*is unlikely to succeed*»[242]. In this scenario, countries will likely look for alternatives, such as (*i*) DSTs, (*ii*) withholding taxes (hereinafter, "WHT"), particularly Article 12B of the UN Model Tax Convention,[243] and (*iii*) income-based rules (such as diverted profit taxes, anti-abuse rules, widening permanent establishment rules, or unilateral or multilateral fractional apportionment). However, (*i*) DSTs are not substantial on a worldwide scale (and maybe passed on to the consumer, akin to an indirect tax); (*ii*) WHT like 12B can only be implemented following bilateral or multilateral agreement in a tax treaty environment, and (*iii*) income-based laws may result in considerable double tax distortions given the actual framework. This would prove to be untenable and might push countries that would not be inclined to sign up to the deal to allow at least a credit for taxes levied in this manner.

As for Pillar Two, it is possible that it might be similarly weakened. The crucial deterrent for the overall OECD deal is knowing that other countries will tax their assigned earnings if they do not. In this scenario, the benefits of not taxing the profit – in terms of inward flows of investment and profit or favoring local Multinational companies — tend to vanish. With Pillar Two, research has shown that there might be enough critical mass

[241] G20 Bali Leaders' Declaration, paragraph 34: «*We are committed to the swift implementation of the OECD/G20 two-pillar international tax package. We welcome the progress on Pillar One. We also welcome progress on Pillar Two Global Anti-Base Erosion (GloBE) Model Rules, which pave the way for consistent implementation at a global level as a common approach, and we look forward to the completion of the GloBE Implementation Framework. We call on the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) to finalize Pillar One, including remaining issues and by signing the Multilateral Convention in the first half of 2023, and to complete the negotiations of the Subject to Tax Rule under Pillar Two that would allow the development of a Multilateral Instrument for its implementation*».

[242] *See* R. Avi-Yonah, *After Pillar One*, 247 in *Law & Economics Working papers*, 2023, p. 1- 11.

[243] In brief, pursuant to Article 12B, a WHT might be viable on gross payments for "automated digital services" imposed by a resident of one treaty country to a resident of the other treaty country. The recipient may elect to cease withholding and instead be taxed on its net income from "automated digital services" by establishing a PE in the payor country. Although Article 12B does not automatically take effect, it can be used as a model by nations to decide how to tax "automated digital services".

to encourage other nations to participate as long as a relatively small number of "major" countries opt to implement the agreement and nations choosing to withdraw from such a system cannot simply undermine it if the number is limited.[244] There are, however, some parts of the reform which might constitute a potential drawback and that will be briefly analyzed below.

### a) *Calculation of the Effective Tax Rate*

Pillar Two aims at achieving a global minimum level of corporate tax harmonization. The project's focal point is the "global minimum rate", a minimum level of taxation that has not yet been defined. This minimum level serves as the standard against which the effective tax rate of a country is assessed. It is worth noting that the GloBE income or loss and covered taxes are used to establish the effective tax rate of the jurisdictions in which the group operates. In particular, the effective tax rate for a jurisdiction is equal to the sum of the covered taxes of each entity in that jurisdiction divided by the aggregated GloBE income or loss of each entity there. The effective tax rate is thus determined on a jurisdictional basis. It is possible that no top-up tax is due even though an entity is subject to a low effective tax rate on a stand-alone basis because of the tax burden on other group entities in the same jurisdiction. More than 200 pages of technical information are contained in the October 2020 Blueprint on GloBE,[245] and the Inclusive Framework and the appropriate OECD Working Parties are presently debating further elements to integrate in the framework to prevent loopholes.

The strategic use of discrepancies between national company tax systems and the GLoBE base provision in the Pillar Two framework is where the possible effective tax rate linked to tax planning opportunity can be identified. Accordingly, the OECD might potentially open up a whole new realm of tax planning. The GLoBE base as it is currently designed lacks effective measures against intragroup transactions aimed at strategically inflating the effective tax rate in low-tax jurisdictions. There is an incentive to raise the effective tax rate without changing the amount of taxes owed in jurisdictions where the

[244] M. Devereux, *International Tax Competition and Coordination with A Global Minimum Tax,* in *National Tax* Journal, 2022, p. 145, 159.

[245] OECD *Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, 14 October 2020.

effective tax burden is near to or even below the minimal threshold.[246] The use of hybrid financial instruments for intra-group financing, where payments are regarded as interest under IFRS but as dividends for local taxation reasons, has been suggested as a potential flaw of the OECD agreement.[247]

Certain tax planning techniques are also inherent to the use of financial accounting as a starting point for the GloBE base and could depend on the use of accounting strategies to lower the GloBE base. Although this would also result in lower reported earnings, which would have negative effects on the Multinational companies' creditors and investors, the tax benefits may likely exceed these competing interests.[248]

Also, in order to administer and execute the regulations under the Two-Pillar proposal, tax agencies around the world will need extensive financial accounting knowledge and it is not that likely to happen in the glimpse of an eye.

### b) *Nature of the Income Inclusion Rule*

In brief, another topic which should be taken into account pertains to the nature of the IIR. It can be argued that that the IIR is a controlled foreign company rule[249] that, in fact, may supplement existing CFC rules. While the Blueprint clearly states that «*although similar in operation, the IIR and CFC rules can co-exist because they have different policy objectives*»,[250] some authors highlighted that «*instead of introducing new instruments that are not coordinated with the existing rules, it would make more sense*

[246] According to Prof. de Wilde, «*Boosting the effective tax rate can be done, of course, by increasing the covered taxes, the numerator in the effective tax rate fraction. But paying more tax, obviously, does not yield that much in terms of tax costs savings. Alternatively, one may perhaps be tempted to look at the GLOBE base, the denominator in the effective tax rate fraction, to see if it can be narrowed down. Then, the amount of tax due, the covered taxes, does not alter but the effective tax rate nevertheless may be steered upwards: 'effective tax rate inflation'. Such a narrowing down of GLOBE base could perhaps be organized by setting up hybrid interest flows within the group and turning the group entities in the low-tax jurisdictions into group debtors*». *See* M. De Wilde, *Is There a Leak in the OECD's Global Minimum Tax Proposals (GLOBE, Pillar Two)?, in Kluwer International Tax Blog,* 2021.

[247] *Id*.

[248] *See* M. Hanlon & M. Nessa, *The Use of Financial Accounting Information in the OECD BEPS 2.0 Project: A Discussion of the Rules and Concerns*, in *National Tax Journal*, 2023, p. 193-195.

[249] Many nations have expanded its international tax policy rules with measures intended to stop profit shifting in reaction to this widespread transfer of earnings to low-tax areas. The controlled foreign company rule is essentially a border-crossing corporate tax on multinational firms. The rules impose an immediate tax on selected parts of the income of low-tax foreign subsidiaries. *See* S. Clifford, *Taxing multinationals beyond borders: Financial and locational responses to CFC rules*, in *Journal of Public Economics*, 2019, p. 44-71.

[250] OECD *Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, 14 October 2020, 22.

*to refine the existing rules in light of the GloBE debate*».[251] Accordingly, since BEPS Action 3 addresses the majority of the GloBE IIR's components[252], the IIR might be seen as an improvement of the 2015 BEPS Action 3 CFC rules. It has been suggested that it would make more sense to incorporate GloBE rules into the existing CFC regimes although some authors are critical towards this approach.[253]

### c) *Formulaic carve-out*

A further issue is the carve out related to profits that represent a deemed routine return on "substantive activities".

To facilitate compliance, the regulations allow for the removal of small sums of revenue.[254] This implies that even if the effective tax rate is lower than 15%, there will not be a top-up tax assessed on the group's profits produced in the jurisdiction when revenues and earnings fall below a certain minimum level. Amounts of income that are at least 5% of the value of physical assets and 5% of payroll will also be exempt from the top-up tax for businesses ("substance carve-out"). However, the carve-out is subject to a transitional period. The substance carve-out starts out at 8% of the carrying value of tangible assets and 10% of payroll expenditures for the first 10 years under a transitional regulation. The rate of deterioration for tangible assets is 0.2% for the first five years and 0.4% for the remaining time. Payroll rates decrease yearly by 0.2% during the first five years and 0.8% for the remaining time.

[251] J. Hey, *Guest Editorial: The 2020 Pillar Two Blueprint: What Can the GloBE Income Inclusion Rule Do That CFC Legislation Can't Do?*, in *Intertax*, 2021, p. 7-13.

[252] The BEPS Action 3 recommendations outline approaches to attribute certain categories of income of foreign companies to the shareholder(s) in order to counter offshore structures that shift income from the shareholder jurisdiction.

[253] According to Prof. Englisch «*it has been argued that the "substance-based" carve-out assimilates the rationale for GloBE to the one underlying traditional CFC regimes, in line with the BEPS Action Item 3 Report. It is therefore suggested that GloBE should merge with existing CFC regimes, eliminating the high group revenue threshold and levying top-up tax at the regular rate applicable to the (ultimate) parent entity, while possibly maintaining the calculation of the effective tax rate based on IFRS and jurisdictional blending. However, while the finding of a certain convergence of the objectives pursued by GloBE and CFC regimes is convincing, the aforementioned conclusions are not fully so». See* J. Englisch, *International Effective Minimum Taxation – analysis of GloBE (Pillar Two)*, in F. Haase & G. Kofler, *OUP Handbook of International Tax Law*, Oxford, 2021, p. 969-990.

[254] The agreement does not apply to payments derived from overseas shipping since such income is subject to different tax regulations. Numerous countries have implemented special taxing regimes for this industry as a result of the unique characteristics of international shipping, including its capital-intensive nature, high degree of profitability, and lengthy economic life cycle.

There are two elements of value creation – eligible personnel and specific tangible fixed assets – that are considered as indicators of regionally significant operations that are less vulnerable to BEPS concerns and are consequently exempt from the GloBE minimum tax. Payroll and depreciation of eligible assets would be calculated using a fixed percentage, and earnings assigned to the relevant jurisdiction up to the resultant amount would not be subject to any top-up tax. In this respect, it is worth noting that while the tax rate on intangible income is combined with the tax rate on substantive income for determining the effective tax rate, in practice the carve-out might also protect low tax rates on that income.[255] In fact, the size of the formulaic carve-out is crucial when making the calculation of the global minimum tax. To calculate the measure of "excess profit", the carve-out is subtracted from the overall GLoBE revenue, adjusted financial accounting profit. Any top-up tax imposed, whether it takes the form of a qualified minimum domestic top-up tax,[256] IIR, or ITPR, has this as its base. Hence, a bigger carve-out lowers the top-up tax and, as a result, the final effective tax rate.[257]

In addition, considering that Pillar Two envisages a top-up tax to be levied primarily by way of an IIR in the ultimate parent jurisdiction, the carve-out might lead to a new type of tax competition that would essentially result in a corporate income tax rate of zero mixed with a DMTT[258] that would guarantee a tax rate of 15% on surplus profits. As expressed by Prof. Ana Paula Dourado, «*whereas the combination between the income inclusion rule and the undertaxed payment rule and the primacy of the former could foster source jurisdictions to increase their effective tax rate, the DMTT changes this. It will continue to promote tax competition and the reduction of corporate income tax rates in source jurisdictions, because the amount of the DMTT is more beneficial to the constituent entities and the MNE group (it is lower) than the application of the*

[255] N. Bammens & D. Bettens, *The Potential Impact of Pillar Two on Tax Incentives,* in *Intertax*, 2023, p. 155-169.

[256] In accordance with Pillar Two, jurisdictions are permitted to enact a qualified domestic minimum top-up tax ("DMTT"), which gives them the exclusive authority to levy the top-up tax on the domestic low-taxed component businesses.

[257] M. Devereux, J. Paraknewitz & M. Simmler, *Empirical evidence on the global minimum tax: what is a critical mass and how large is the substance-based income exclusion,* in *Fiscal Studies*, 2023, p. 11-18.

[258] The DMTT is to be charged and collected in the same jurisdiction where the low-level taxation took place and allows source states to apply general or specific tax rates that are lower than the minimum effective tax rate of 15%.

*minimum effective tax rate*»[259]. The DMTT would be in practice a means under Pillar Two to avoid the shifting of tax revenue to parent entities' jurisdictions.

Another setback involves developing countries: the goal of shielding developing nations from pressure to offer tax holidays is greatly diminished if substance-based carve-outs also apply to investments made there. In fact, developing nations require businesses where labor and physical assets are essential. This implies that, under the current model rules, the situation in certain emerging markets would not drastically change.

### d) *Excessive complexity*

The agreement under Pillar 2 is rather intricate and some research shows that a rise in tax revenue among high-income high-tax countries due to the global minimum tax is by no means assured.[260] The complexity of the deal might ultimately undercut the entire plan. For instance, the calculation of the effective tax rate in each jurisdiction in which the MNE operates is not always easy to make. The local tax base instead of a full GloBE base is normally much easier available even if not as effective. Besides, Multinational companies could find new methods to sabotage the deal by transferring profits in a jurisdiction which decides not to be bound by Pillar Two.

It is worth mentioning that some authors have conceived a less complex model that entails a simplification approach to determine if a full GloBE effective tax rate calculation is mandatory with a view to reducing tax compliance costs for taxpayers and tax administrations. For instance, Döllefeld, Englisch, Harst, Schanz and Siegel have conceived a dual simplification procedure to determine a country's GloBE risk profile. In short, they conceived a two-stage country-level exam's goal to determine if a country is typically low-risk, high-risk, or needs to undergo a further examination, the "MNE-level test". This is accomplished by analyzing each country's tax rates, tax bases, and

[259] A.P. Dourado, *Pillar Two Model Rules: Inequalities Raised by the GLOBE Rules, the Scope and Carve-Outs*, in *Intertax*, 2022, p. 282-285.

[260] OECD's proposal for a global minimum tax might leads to competition over other incentives than tax ones. Incentives such as subsidies, tax holidays, free trade zones, and land and infrastructure paid for by governments to attract firms will become attractive to some countries. *See E.* Janeba & G. Schjelderup, *The Global Minimum Tax Raises More Revenues than You Think, or Much Less,* CESifo Working Paper No. 10318, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4394843.

base variances between financial and tax accounting. The second test's goal is to determine whether the MNE profits from existing “red flag” rate or base deviations. To do this, the risk profile of each MNE is evaluated. A streamlined GloBE effective tax rate must be determined if the MNE benefits from “red flag” deviations or low tax rates.[261]

### e) *Dispute settlement*

Evaluations on the OECD deal are usually made on the assumption that the package will be fully implemented. Such assessments, which are formed by the general experience of tax practice, often do not stray from the international legal positivism that permeates most of the literature on cross-border taxation and grants non-binding international instruments a rather high degree of legal force. During the past ten years, the respect for international laws and organizations has become more and more influenced by political considerations. It goes without saying that the GloBE rules cannot function effectively without an appropriate tax dispute resolution process.

Litigation related to cross-border tax issues usually takes place in national courts and no specific international dispute resolution system will exist to handle GloBE issues. In general, the existing system of international tax dispute resolution places a significantly greater emphasis on cooperation and information exchange than on mandatory and binding dispute resolution.

It is worth noting that taxpayers have access to a more formal dispute resolution procedure through the MAP process, which is focused on cooperation toward mutual interests and agreement. In 2008, the OECD Model Convention added an arbitration choice to the MAP procedure. However, this is part of the MAP procedure and not separate from it; it is only applicable to state-state arbitration. Therefore, the existing arbitration provisions in tax treaties do not have the same “legal force” as those in investment treaties, and they continue to place more emphasis on state-state dispute resolution than investor-state litigation.

[261] D. Schanz, J. Englisch, C. Döllefeld, S. Harst, *Policy Note: Tax Administrative Guidance: A Proposal for Simplifying Pillar Two,* in *Intertax*, 2022, p. 231-246.

Access to MAP has improved, as has its efficacy, as a result of the members of the Inclusive Framework signing the Multilateral Instrument ("MLI")[262] and committing to the basic requirements outlined in Action 14 of the BEPS Action Plan.[263] While not all tax issues have been resolved by MAPs, many have.[264]

In particular, the MLI contains provisions that establishes a mandatory binding arbitration procedure.[265] As of 2021, 31 signatories have chosen to apply mandatory binding arbitration in their Covered Tax Agreements.[266]

Each country that signs the instrument has the option to list any reservations it may have, and many of these reservations are currently being made in relation to the arbitration clauses. For instance, Austria[267], Slovenia[268], Malta[269] and Japan[270] have made some reservations on the arbitration provisions.

[262] The MLI aims to incorporate tax treaty-related measures, which are a component of the BEPS project's measures, into the currently-in-effect tax treaties between the Parties to the MLI. The MLI gives the Parties the ability to execute the tax treaty-related BEPS prevention measures effectively and simultaneously with regard to a large number of their active tax treaties.

[263] The BEPS Action 14 Minimum Standard aims to facilitate better international tax dispute settlement. In order to promote efficiency and the timeliness of the resolution of double taxation issues, inclusive framework countries have agreed to have their compliance with the minimal standard evaluated and supervised by their peers.

[264] H. Pit, *Arbitration under the OECD Multilateral Instrument: Reservations, Options and Choices*, in *Bulletin for International Taxation*, 2017, p. 589.

[265] OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Art. 18 – Art. 26

[266] The 31 signatories are Andorra, Australia, Austria, Barbados, Belgium, Canada, Curaçao, Denmark, Fiji, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Mauritius, Netherlands, New Zealand, Papua New Guinea, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, United Kingdom.

[267] Austria reserved «*the right to exclude from the scope of Part VI (Arbitration) cases involving the application of its domestic general anti-avoidance rules contained in the Federal Fiscal Code* […]».

[268] Slovenia reserved the right to exclude from the scope of Part VI cases involving the application of domestic anti-avoidance provisions.

[269] Malta has made the following reservation: «*Where a reservation made by the other Contracting Jurisdiction to a Covered Tax Agreement pursuant to Article 28(2)(a) refers exclusively to its domestic law (including legislative provisions, case law, judicial doctrines and penalties), Malta reserves the right to exclude from the scope of Part VI those cases that would be excluded from the scope of Part VI if the other Contracting Jurisdiction's reservation were formulated with reference to any analogous provisions of Malta's domestic law* […]».

[270] Pursuant to Article 28(2)(a) of the MLI, Japan has formulated the following reservations with respect to the scope of cases that shall be eligible for arbitration under the provisions of Part VI: (i) Japan reserves the right to exclude from the scope of Part VI of the MLI with respect to a Covered Tax Agreement of Japan cases falling within the provisions of that Covered Tax Agreement which provide rules for determining whether a person other than an individual shall be treated as a resident of one of the Contracting Jurisdictions in cases in which that person would otherwise be treated as a resident of both Contracting Jurisdictions (as they may be modified by the MLI); (ii) Where a reservation made by the other Contracting Jurisdiction to a Covered Tax Agreement of Japan pursuant to Article 28(2)(a) of the MLI exclusively excludes, whether or not by referring to its domestic law, from the scope of Part VI of the MLI cases of taxation in that other Contracting Jurisdiction, Japan reserves the right to exclude from the scope of Part VI of the MLI with respect to that Covered Tax Agreement cases of taxation in Japan which are analogous to

As a result, for the majority of governments, the cooperative MAP procedure between parties to a tax treaty continues to be the preferred method of dispute resolution for taxpayers.

The Blueprint plans for Amount A essentially seeks a MAP-like process involving arbitration between the states concerned, if necessary, but no explicitly taxpayer-initiated arbitration against individual states. Because it enables an MNE to actively seek an agreed-upon allocation of its tax payments from states before filing tax reports, the Amount A method is known as an "early tax certainty process" and is based on the following features.

First, the first phase entails the creation by the MNE group of a standardized Amount A self-assessment return together with supporting paperwork that outlines the MNE group's expectations of what states may claim in terms of Amount A revenues and which states will pay for this to avoid double taxation. This would be accompanied by a first request for early tax certainty from the MNE group.

Second, in order to prevent double taxation, an extended MAP procedure establishes what is essentially a broad negotiation structure between states demanding payment of Amount A and those who will have to pay an adjustment to Amount A states.

Third, the taxpayer's country of residence will oversee the procedure and initiate the involvement of all required states, guaranteeing that MNE's interests are directly represented in the procedure. In the event that this fails, it is envisaged that a developed nation tax administration will step in to take the helm, such as the MNE's actual home state rather than a tax haven registration.

Fourth, the lead tax administration will oversee a negotiation process amongst the several states to try to reach a consensus on how to share Amount A advantages and expenses when the taxpayer's Amount A sharing plan is not immediately accepted by the states. In the event that no consensus is reached, a state-based review panel procedure will be initiated. This panel will be made up of the tax administrations of three to four developed and developing states. The home state tax administration is often anticipated to be the lead in the process, but the October 2020 language makes no guarantees as to which states will be engaged.

the cases referred to in that other Contracting Jurisdiction's reservation. *See* https://www.oecd.org/tax/treaties/beps-mli-arbitration-profile-japan.pdf.

A binding determination panel would be called if there is no progress. Whether or not the states took part in the review panel procedure, the conclusions of this panel would be legally enforceable on all states with regard to Amount A. The MNE that started the process, however, might still reject the outcome and go back to local courts or other procedures.[271]

Overall, the explained method seeks tax certainty through a negotiation procedure with a binding add-on for states exclusively but gives the MNE the upper hand in the process.[272] There is an interesting solution to dispute settlement advocated by Professors Danon, Gutmann, Maisto and Jimenez. They have emphasized that the lack of a suitable, binding tax dispute resolution process would make it impossible to apply the GloBE standards effectively. Optimal implementation of the deal would only occur through the absorption of the GloBE norms into domestic laws or through a specific multilateral instrument. According to their model, GloBE disputes, including those that arise in a multilateral setting, could be handled fairly on the basis of a framework that relies on (*i*) a strengthened interpretation of Article 25(3) of the OECD Model,[273] (*ii*) a newly drafted model domestic provision confirming this interpretation and extending it to non-treaty situations on the basis of the principle of reciprocity, and (*iii*) a formal administrative implementation of the information-exchange rules set forth in the  Convention on Mutual Administrative Assistance in Tax Matters, an international treaty designed to promote international co-operation between tax authorities.[274]

[271] Although the Blueprint does not explicitly state whether the outcome of the Determination Panel should be binding on the MNE initiating the process, its current recommendation is that it would not. One of the key distinctions between a genuine binding dispute resolution procedure and the broad-based negotiation approach outlined here may be seen in this component. According to para. 706: «*Where an MNE accepts the outcomes of the tax certainty process, these outcomes would be binding on the MNE and tax administrations in all jurisdictions affected by the calculation and allocation of Amount A, including jurisdictions that did not participate directly on the relevant panel. Where it does not accept the outcomes of this process, an MNE group may rely on domestic measures. Where an MNE does not elect to the early tax certainty process and disputes arise, the new approach also provides enhanced dispute resolution features. However, given the benefits of the early certainty process, the expectation is that most in-scope MNEs would make use of it*».

[272] H. Mann, *The expanding universe of international tax disputes: a principled analysis of the OECD international tax dispute settlement proposals*, in *Asia Pacific Law Review*, 2022, p. 268-274.

[273] *See* Article 25(3) of the OECD Model: «*The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention*».

[274] R. Danon, D. Gutmann & G, Maisto, A. Martin Jimenez, *The OECD/G20 Global Minimum Tax and Dispute Resolution: A Workable Solution Based on Article 25(3) of the OECD Model, the Principle of Reciprocity and the Globe Model Rules*, in *World Tax Journal*, 2022, p. 489-512..

Following the release on 20 December 2022 of a consultation document relating to tax certainty for the GloBE rules, they further proposed a framework which envisages a domestic resolution model rule applying on the basis of the principle of reciprocity and envisaging domestic rules neutralizing conflicts of interpretation and transposition. [275] In brief, the domestic implementing legislation should expressly provide that the commentaries to the GloBE Model Rules are to be taken into consideration for interpretation purposes and ensure that all jurisdictions consider the Commentary to the GloBE Model Rules as a primary means of interpretation under the same canons of interpretation. Furthermore, the professors claim that jurisdictions adopting the GloBE framework should include in their laws a provision that functions as a *lex specialis*[276] which ensures that a conflict between a jurisdiction's transposition of the GloBE Model Rules and the model rules is resolved. Finally, every jurisdiction using the GloBE framework should put in place a suitable structure for preventing disputes so that tax authorities can share information and sign contracts based on clear legal grounds.

f) *Tax incentives and potential new forms of tax competition*

Pillar Two tries to render tax incentives ineffective insofar as they lower the tax burden below the minimum rate of 15%. In this context, tax incentives below 15% do not further lower taxpayers' tax burdens and so do not boost a jurisdiction's attractiveness as an investment site. However, this does not mean that tax breaks of less than 15% will be eliminated entirely and preliminary research has shown

that a low global minimum tax might significantly alter tax incentives in tax havens and put other nations at serious danger[277].

[275] Conflicts of interpretation deal with situations when the applicable laws are equally stated but may be interpreted differently. Conflicts of transpositions deal instead with situations where the implementing laws, even unintentionally, deviate from the GloBE Model Rules. *See* R. Danon, D. Gutmann, G. Maisto, A. Martin Jimenez, *The Global Anti-Base Erosion (GloBE) Rules and Tax Certainty: A Proposed Architecture to Prevent and Resolve GloBE Disputes*, in *International Tax Studies*, 2023.

[276] The authors suggest a lex specialis or explicit "renvoi" rule designed to solve these conflicts, which could read as follows: «*Where a divergence between the text of the present legislation and the GloBE Model Rules as they stood at the time of adoption of this legislation results or will result in a failure to properly implement the GloBE Model Rules, these model rules shall prevail to the extent necessary to prevent or eliminate any dispute*».

[277] N. Johannesen, *The global minimum tax,* in *Journal of Public Economics*, 2022, p. 1-8.

The opportunity to combine low-tax and high-tax income within the same jurisdiction, and the de minimis exclusion – the fact that a multinational may qualify for an elective de minimis exception from the GloBE rules in the jurisdiction where its presence is limited – might represent a setback and the substance-based carve-out will largely minimize the impact of the GloBE regulations[278].

The GloBE guidelines, in their implementation, are centered on the surplus profits. Routine profits from substantive activities are unaffected by the GloBE regulations and can continue to benefit from certain tax incentives. Yet, the carve-out might also protect low tax rates on intangible income because the tax rate on such income is combined with the tax rate on substantive income when the effective tax rate is calculated. Furthermore, the carve-out might result in a new type of tax competition, culminating in a zero-rate corporate income tax mixed with a QDMTT insuring a 15% tax burden on surplus earnings.

By providing tax incentives meant to cut the taxpayer's tax obligations, governments may also profit from the shortcomings of the global tax system and multinationals eagerness for lower taxation. These incentives can come in the shape of special economic zones with a variety of direct and indirect tax breaks, decreased tax rates or greater tax deductions for specific taxpayers or industries and the multinationals operating in the digital economy are often the recipients of such tax advantages[279].

Certain incentives are distributed as tax credits rather than as a reduction in the company's tax base and could be considered "refundable tax credits" under Pillar Two regulations if the corporation is able to claim the portion of the credit that is ultimately left unpaid after four years as a direct reimbursement[280]. Also, A new class of tax credits known as marketable transferable tax credits was created by the Administrative Guidelines published in July 2023. These credits, which have the same impact on the effective tax rate as refundable tax credits and are lawfully transferable or marketable to

[278] *See* N. Bammens & D. Bettens, *The Potential Impact of Pillar Two on Tax Incentives*, in *Intertax*, 2023, p. 155-169.

[279] P. Mullins, Taxing Developing Asia's Digital Economy, Asian Development Bank Background Paper, 2022.

[280] These credits will be treated as GloBE income rather than a decrease of covered taxes and will have the same effect on the effective tax rate as refundable tax credits. The latter, in particular, are regarded as public expenditures rather than tax breaks. As a result, they will not lower the covered tax (the numerator of the effective tax rate); rather, they will be viewed as contributions to the GloBE income and will enter the effective tax rate's denominator.

third parties, will be seen as a component of GloBE income as opposed to a decrease in covered taxes.

While some tax incentives will be clearly targeted by Pillar Two like tax holidays, some other incentives like patent box regimes and business tax credits cannot be assessed *a priori*. In addition, there might be other forms of tax competition, like income tax incentives for expats as well as more effective tax procedure for residents[281].

All in all, Pillar Two certainly represents a change of paradigm, but its outcome could be mitigated and could severely affect tax policy of countries, even if indirectly. Also, it does not prevent governments from replacing existing tax-based incentives with economically similar nontax incentives. Nontax incentives such as investment grants are anticipated to replace at least some of the tax-based incentives rendered less effective by the new minimum tax and this «*will be motivated by an incentives competition similar to the tax competition that brought about the widespread toleration by governments of BEPS*»[282].

## 4. Implementation of the OECD global tax deal: the US and EU experiences

### 4.1. The US experience

The US Tax Cuts and Jobs Act ("TCJA") of 2017 was largely viewed as the reason for the adoption of Pillar Two. The Global Intangible Low-Taxed Income, or "GILTI", and the Base Erosion Anti-Avoidance Tax, or "BEAT", were both minimal taxes added in the TCJA and the IIR and the UTPR are viewed as deriving from these. Pillar Two is therefore considered as more in line with US tax policy than Pillar One, which has always been perceived as a way to tax the US digital giants more heavily[283].

[281] P. Arginelli & F. Reboli, *Pillar two and tax competition: which is the future of tax incentives*, in E. Favari & E. Cantoni, *Complexity and sustainability in* megaprojects, Cham, 2023, p. 197.

[282] M.C. Durst, *BEPS, Pillar 2, and the replacement of tax-based incentives with nontax incentives*, in *Tax Notes International*, 2023, p. 349-351.

[283] *See* L.V. Faulhaber, *Taxing Tech: The Future of Digital Taxation*, in *Virginia Tax Review*, 2019, p. 145-169 L.V. Faulhaber, *Lost in Translation: Excess Returns and the Search for Substantial Activities*, in *Florida Tax Review*, 2022, p. 545-606.

The fact that US businesses had amassed a huge amount of money in low-tax foreign jurisdictions was the key reason behind the TCJA. However, they were unable to return to the US without paying a steep 35% tax.[284] Considering similar reforms by Japan[285] and the UK[286], Multinational companies urged Congress to establish a participation exemption so they could bring the earnings home tax-free. Briefly, GILTI is foreign income earned by CFCs from intangible assets, such as copyrights, trademarks, and patents. CFCs are foreign corporations where more than 50% of the vote or value is owned by U.S. shareholders who in turn own 10% or more of the CFC.

CFC shareholders who own 10% or more of a CFC are liable for the tax on GILTI at a rate between 10.5% and 13.125%.[287] Also, the BEAT was created as a 10% minimum tax on incoming investment on a basis that effectively forbids deductions for interest, royalties, and other payments made to associated foreign parties. Cost of goods sold, however, are still exempt from this tax.[288]

Yet, none of these two taxes truly reflect the OECD global tax deal, which is not compatible with the two US tax policy provisions. As a matter of fact, Pillar Two is not totally compatible with GILTI and BEAT.[289] The GILTI rate is less than the 15% minimum rate needed by Pillar Two, and GILTI is applied globally rather than country by country as Pillar II mandates. BEAT differs significantly from the UTPR in that it is applicable regardless of the effective rate in the recipient nation. Also, BEAT might

[284] Before the introduction of the TCJA, if a CFC was located in the Cayman Island where there is a 0% corporate tax rate, dividends to the US parent company would carry a 35% US tax.

[285] Following the 2009 tax reform, by remitting dividends from overseas affiliates situated in nations with low dividend withholding tax rates, Japanese multinational corporations can avoid paying the tax charges associated with profit repatriation. *See* M. Hasegawa & M. Kakebayashi, *The Effect of Foreign Dividend Exemption on Profit Repatriation through Dividends, Royalties, and Interest: Evidence from Japan*, Discussion Paper No. E-20-004, https://www.econ.kyoto-u.ac.jp/dp/papers/e-20-004.pdf.

[286] Prior to 2009, the UK applied a global approach and taxed overseas repatriations from nations having lower corporate tax rates than the UK at the difference in tax rates between the host nation and the UK. Legislation enacted in 2009 exempted active overseas revenues from UK taxes: the reform decreased the dividend tax on foreign earnings in low-tax countries. See L. Liu, *Where Does Multinational Investment Go with Territorial Taxation? Evidence from the UK*, IMF Working Paper, 2018.

[287] U.S. Code 26 USC §951A Global Intangible Low-Taxed Income Included in Gross Income of United States Shareholders; PWC, Worldwide Tax Summaries, Quick Charts, Corporate Income Tax (CIT) Rates, https://taxsummaries.pwc.com/quick-charts/corporate-income-tax-cit-rates.

[288] The fundamental formula for determining such a minimal tax is as follows: first, the US corporation determines its regular US tax at the standard corporate tax rate (currently 21%), less certain credits. After bringing the deductible contributions back in, the tax is recalculated at a reduced BEAT rate (which is 5% in 2018; 10% in 2019 through 2025; and 12.5% in 2026). According to the calculation above, the BEAT minimal tax is the difference between the BEAT tax liability and the ordinary tax liability.

[289] *See* M. Herzfeld, *Can GILTI + BEAT = GLOBE?,* in *Intertax,* 2019, p. 510.

result in double taxation since it forbids the use of foreign tax credits, which is incompatible with Pillar Two.

Contrary to the previous Administration, the Biden one actively participated in the discussions that resulted in the decision to adopt both Pillars in October 2021.[290] However, the ratification process still requires the approval of the Congress.

Despite the modifications made in response to US pressure, such as expanding it to include all major multinational corporations rather than just the US digital giants, Pillar One is still quite contentious in the US. The primary issue with Pillar One in the US is that it plainly calls for a multilateral treaty to amend Articles 5, 7, and 9 of all current treaties, and that will be extremely challenging to enact because treaties require a two-thirds majority in the Senate. This would be challenging to implement, especially as the House of Representatives is now under the control of the Republicans that are against this reform.[291]

In contrast, Pillar Two appeared to be straightforward because it just required new legislation and the Democrats have held a majority in both chambers until the 2022 midterm elections. In fact, the Biden administration and Congressional Democrats proposed to align US tax law with Pillar Two in the 2021 budget and subsequent legislation (the “Build Back Better Act") by (*i*) raising the GILTI rate to 15%, (*ii*) applying GILTI on a country-by-country basis, and (*iii*) modifying BEAT to make it compatible with the UTPR by, among other things, providing an exception for payments subject to a sufficient level of tax.

Nonetheless, the Build Back Better Act fell short of being passed. Since there was no consensus on the expenditure side, the legislation that cleared the House was unable to go through the Senate. However, the Inflation Reduction Act of 2022 was approved by the Senate and the House of Representatives, and President Biden then signed it into law. Accordingly, the largest US corporations (with average annual income of above $1,000,000,000) are subject to the Corporate Alternative Minimum Tax (“CAMT”), a minimum tax of 15%, if their normal liability is less than 15%. Although technically

[290] HM Treasury, G7 Finance Ministers Agree Historic Global Tax Agreement, G7, June 5, 2021.

[291] On March 24, 2023, ten US Republicans on the House Ways and Means Committee urged House appropriators to cut US funding for the OECD. In spite of the Administration's claims that Congress will agree on the OECD accord, the letter underscores that it does not speak for Congress, especially in light of the Republican control of the U.S. House of Representatives.

speaking the CAMT is not an IIR under Pillar Two, the US might argue that it is a CFC regime since it covers the CFC profits of US businesses. The domestic component of the CAMT might be a qualified domestic minimum top-up tax. It remains to be seen whether other pertinent parties like the EU or OECD would adopt this line of reasoning. The US would not be in compliance with Pillar Two if no further tax legislation were to be passed since GILTI would not be regarded as a qualifying IIR under the Model Rules.

Some authors have asserted that the inability of the US to implement Pillar II (as envisioned in the gloomy scenario above) might result in the downfall of the entire project but the OECD tax deal is not necessarily at stake.[292]

First, while the lack of Pillar II adoption in the US may hold down the process, it does not prohibit other nations from implementing it. Just a few days after the OECD issued the Model Rules, the European Commission, for instance, presented its legislative proposal for an EU Directive to include the Model Rules.[293] The EU Directive attempts to apply the IIR and UTPR uniformly across the twenty-seven Member States by closely adhering to the Model Rules. In addition to the EU, a number of other nations also said that they will go forward with adopting Pillar II.[294]

Additionally, although Pillar Two's whole structure is intended to give the IIR precedence, it also anticipates that the UTPR would apply if a residence country did not apply the IIR for whatever reason in order to guarantee that the minimum tax level is met. Other nations would apply the UTPR to US corporations if the US did not reform GILTI such that it is not in compliance with the IIR. If that is the case, any US government would be under a lot of pressure to provide foreign tax credits for the UTPR taxes that would ensue. In order to comply with the IIR and lessen the administrative burden associated with adhering to Pillar Two, there will also be pressure to reform GILTI. When a worldwide minimum rate is mandated for all businesses, Republicans will find it more difficult to make the case that US corporations are at a competitive

[292] R. S. Avi-Yonah & M. Salaimi, *Minimum Taxation in the United States in the Context of GloBE,* in *Intertax,* 2022, p. 673-677..

[293] *See* Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final.

[294] One of these nations is the UK, which began a public consultation on the subject after the introduction of the Model Rules. See https://www.gov.uk/government/publications/introduction-of-the-new-multinational-top-up-tax.

disadvantage. In these conditions, one may assume that even the Republicans would eventually be willing to support changing US tax laws to comply with Pillar Two.

Very recently, the New York State Bar Association issued a report to the US Treasury on the subject of US foreign tax credit considerations.[295] It made several recommendations. Under existing US tax legislation, any QDMTT and IIR top-up taxes should qualify as creditable foreign income taxes. As a result, US laws should be updated to allow for this treatment and to make it clear how much of a foreign tax credit should be granted. However, the report underlines that under no circumstances could UTPR top-up taxes be considered creditable in the US. This is justified on the grounds that it is an anti-abuse tax as opposed to a tax on the entity subject to UTPR's income. What the Congress will decide is yet to be seen.

While deciding whether to impose the OECD reform, it seems reasonable that the US could theoretically allow foreign tax credits for unilateral income-based policies. However, the possibility that the cost will be passed on to US Multinational companies in the tech sector is increased in the short term by the US government's potential refusal to grant those credits in an effort to pull back such regulations and increase their economic cost.

Last but not least, in May 2023, House Republicans unveiled a draft bill that would establish a retaliatory tax and raise the US WHT for individuals and businesses who are citizens of UTPR nations. Although the new proposed tax is viewed as being aggressive, its reach is limited because it primarily applies to payments that are already subject to WHT and US real estate-related income, leaving out many operational trade flows and foreign income flows. WHT would first rise by 5%, but if UTPR is not repealed, it would rise to 50%. Given that the Senate is controlled by Democrats and there is a risk of a presidential veto, the likelihood of this becoming law during this Congress's current session is extremely low[296]. Besides, targets of this tax are UTPR-

[295] New York State Bar Association, Report on the OECD Global Anti-Base Erosion Model Rules (Pillar Two) of July 21, 2022.

[296] On July 31, 2023, Republican members of the United States House Committee on Ways and Means have sent a letter to Treasury Secretary Yellen defining Pillars One and Two as «*a matter that puts at risk jobs and U.S. tax revenues*» and claiming that the Biden Administration appears «*poised to put America last in its Pillar One negotiations*».

implementing nations, mostly US allies like the EU, UK or Japan and it is unlikely that the US will adopt this tax for geopolitical considerations.

Another interesting point would be understanding whether individual US states can adopt Pillar Two. This would go beyond the scope of this article, but it is worth mentioning that US states face constitutional limits on their ability to tax. States have to follow the Due Process Clause[297] or the Dormant Commerce Clause[298]. Also, a US state is unlikely to have the competence to intervene in lieu of Congress in this matter bearing consequences in the international arena.  Even if it has not yet been proposed, the adoption of Pillar Two by US states looks unlikely.

### 4.2. The EU experience

Following several months of uncertainty, the Council of the European Union unanimously adopted the European Commission's proposal to implement an EU-wide global minimum tax. Directive 2022/2523, aimed at ensuring a global minimum tax level for multinational corporate groups and large-scale domestic groups in the Union, was published in the European Official Journal on December 14, 2022. Member states must transpose Directive 2022/2523 by December 31, 2023.

Directive 2022/2523 aims to ensure, through a set of specific rules, that large multinational groups pay an effective tax of no less than 15% in each jurisdiction in which they operate, as agreed in the OECD through Pillar Two. If local taxation is below this threshold, the group is subject to a supplementary tax, in one of the jurisdictions where the group operates.  The European global minimum tax does not differ from the one structured by the OECD in Pillar Two. In fact, the recommendations of Pillar Two provide for the common approach: the States belonging to the Inclusive Framework, once they have given their consent to the project in its general guidelines, adopt them in a manner consistent with the common project.

[297] No state shall «*deprive any person of life, liberty, or property, without due process of law*». The Supreme Court has interpreted this to prohibit a state from taxing businesses unless there is a "minimum connection" between the business and the state in which it operates. See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[298] The Supreme Court has held that states may not adopt regulations or taxes that place an “undue burden” on interstate commerce, even if Congress has taken no action. *See* K*assell v. Consolidated Freightways*, 450 U.S. 662 (1981).

The EU proposed legislation is addressed to Multinational companies with a turnover of at least € 750,000,000 in at least two of the previous four fiscal years. If one or more of the four fiscal years have a duration of less or more than 12 months, the revenue threshold is adjusted proportionally. Directive 2022/2523 does not apply to certain types of entities, in particular: state entities, international organizations, non-profit organizations, pension funds, investment funds and real estate investment vehicles and, under certain conditions, most of the companies controlled almost exclusively by this type of entities which carry out activities connected to them.

The global minimum tax contains specific indications for calculating the effective tax rate, which is generally obtained through the ratio between the relevant taxes paid each year by the group in the specific jurisdiction and the qualifying income obtained in the same year in the same jurisdiction. The qualifying income is obtained starting from the net income or the accounting loss and applying a series of adjustments which are intended to bring the starting accounting item closer to a more purely fiscal value.[299] After calculating the amount of taxes paid by the company, a series of adjustments are applied in order to obtain the relevant value for the purposes of the calculation.[300]

The effective tax rate must be higher than 15%, otherwise the clauses of Directive 2022/2523 will be triggered. Member States will be able to choose to apply a qualified domestic additional tax in their national tax systems, over existing corporate income taxes, to ensure that they adequately tax companies in their jurisdiction. In this case, they must inform the Commission to provide certainty to the tax authorities of other Member States and jurisdictions of third countries, as well as to Multinational companies on the applicability of this qualified domestic top-up tax. The constituent entities of a multinational group of companies located in a Member State that has chosen to apply this system must pay the supplementary tax to the Member State itself.

If the effective rate is lower than 15% and the Member State does not apply the qualified domestic top-up tax, the system provides for two intertwined rules that intervene so that the minimum taxation is applied: the IIR and the UTPR. First, the IIR requires the entity that controls the MNE to pay its share of the supplementary tax for the low-tax constituent entities of the group. Second, if the parent entity is in a non-EU

[299] Articles 15-19 of Directive 2022/2523.

[300] Articles 20-25 of Directive 2022/2523.

country that does not apply the income inclusion rule, any of the jurisdictions in which the group operates can levy supplementary taxes. If the group operates in several Member States, the supplementary tax is distributed among the Member States proportionally on the basis of the number of employees and the value of the tangible assets, weighted equally.

Directive 2022/2523 also provides for a series of exemptions, based on the income of the individual constituent entities, and the exclusion of income based on substance. The latter is specifically aimed at safeguarding the right of individual States to implement measures that encourage activities of economic substance, understood as wage costs for employees and tangible assets.

One of the most disputed aspect of the new EU legislation reflecting the Two-Pillar solution is its compatibility with the freedom of establishment and CFC legislation.

As for the first issue, EU secondary law must always respect the principles of primary EU law (i.e., the founding treaties). Potential conflicts with European freedoms, in particular the European concept of freedom of establishment might arise while considering the adoption of a minimum tax. In contrast to the tax burden on domestic corporations, both the IIR and the UTPR result in a larger national tax burden at the level of the group entity that is required to pay the top-up charge.

The Court of Justice of the European Union ("CJEU") has already made decisions on the limitation of establishment freedom in relation to unilateral actions by member states that impose obstacles to the freedom of establishment.[301] Notwithstanding its stance, it is still extremely unlikely that the CJEU would hold the GLoBE rules to be a disproportionate restriction of the freedom of establishment given that the current rule does exclude routine profit from substantive economic activities and applies to all groups in scope of the GloBE Model Rules uniformly.

Nonetheless, it is also worth recalling that unilateral actions have only been deemed as acceptable as anti-abuse measures if they were expressly targeted at entirely artificial constructs made with the intention of evading the applicable Member State's tax laws. The GloBE measures will have a far wider scope, making it rather challenging to justify them as anti-abuse measures. Therefore, it has been proposed in the legal literature

[301] *See* M. Poulsen, *Freedom of Establishment and Balanced Allocation of Tax Jurisdiction*, in *Intertax*, 2012, p. 200-211.

that the implementation of a minimum tax within the EU can be protected if the substance-based carve-out is significantly broadened, turning it into an artificiality test that complies with the requirements specified by the CJEU[302].

More specifically the CJEU would seek to ensure the anti-abuse provisions enacted by the national legislators are bona fide used.[303] Indeed, the Court has specified that «*in order to determine whether an operation pursues an objective of fraud and abuse, the competent national authorities may not confine themselves to applying predetermined general criteria but must carry out an individual examination of the whole operation at issue. The imposition of a general tax measure automatically excluding certain categories of taxable person from the tax advantage, without the tax authorities being required to provide even prima facie evidence of fraud and abuse, would go further than is necessary for preventing fraud and abuse*»[304].

If the substance-based carve-out is broadened, the goals of Pillar Two would be utterly undermined by this as the goal is to generally reduce opportunities for base erosion and profit shifting, aside from artificiality, and to impose a minimal barrier to international tax competition.

As for the second point, namely the compatibility with CFC legislation, it has been argued that Pillar Two and the CFC regulations are, in general, not analogous to the Pillar Two framework[305]. It is important to recall the "principle of personality" in order to understand this line of thinking. In fact, a look-through approach should only be used in extreme circumstances, such as where there has been abuse, and the legal personality of an entity should always be respected[306].

According to renowned scholars, «*Taxing separate legal persons (i.e., group companies) on income obtained by other entities in the absence of an abusive arrangement generally cannot justify lifting the corporate veil which is what happens*

[302] *See* L. De Broe, *Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union*, in *Intertax,* 2022, p. 878-879.

[303] Judgment of the CJEU, 8 March 2017, Euro Park Service, C-14/16, Para 42.

[304] Judgment of the CJEU, 20 Dec. 2017, Joined Cases Deister Holding AG and Juhler Holding A/S, C-504/16 and C-613/16, para 60, quoting judgment of the CJEU, 7 Sept. 2017, Eqiom and Enka, C-6/16, para 32.

[305] . De Broe, *Some EU and Tax Treaty Law Considerations on the Draft EU Directive on Global Minimum Taxation for Multinationals in the Union*, in *Intertax,* 2022, p. 878-879.

[306] *See* Opinions of Advocate General Kokott, 14 November 2019, Case C-547/18, Dong Yang Electronics, paras 29-48 and 10 February 2022, Case C-596/20, DuoDecad kft, paras 52-63.

*under the Pillar 2 framework*»[307]. The OECD and the EU continue to defend the Pillar Two framework as a way to reduce base erosion and profit shifting but in practice, by setting a global minimum taxation of 15%, they are essentially putting a floor on tax competition.

Such intention was also evident in other legislative acts enacted within the framework of the EU. For instance, Action 3 report of the OECD and G20 BEPS Action Plan, published in 2015, already made recommendations for national legislators to allocate specific categories of foreign companies' income to the shareholders, in order to tackle offshore structures that withdraw income from the shareholders' jurisdiction. Whereas the Action Plan did not impose a requirement to enact such CFC legislation, this requirement was later imposed at the European level with the ATAD Directive.[308]

On the whole, a number of notable discrepancies between the two regimes can be observed. For example, the IIR will only apply to multinational corporations with yearly group incomes surpassing € 750,000,000 (subject to any more far-reaching national decisions). The CFC regulations, on the other hand, do not provide a minimum threshold. Furthermore, CFC laws are normally applied to each entity separately, but the IIR assesses the rate by jurisdiction. As a result, if the parent business using the IIR is not the group's ultimate parent company, the effective tax rate in a particular jurisdiction will not be set simply on the basis of the group companies that this parent company employs. The effective tax rate of a particular jurisdiction will therefore not be determined solely on the basis of the group entities that this parent company uses, but on the basis of all entities of the group established in that jurisdiction, if the parent company applying the IIR is not the ultimate parent company of the group.

While CFC regulations normally do not take into account the potential application of comparable rules by other states, the adoption of the IIR is also accompanied with a

[307] F. Debelva & L. Debroe, *Pillar 2: An Analysis of the IIR and UTPR from an International Customary Law, Tax Treaty Law and European Union Law Perspective*, in *Intertax,* 2022, p. 898-902.

[308] The ATAD gives Member States a choice between two methods for calculating the profit of the CFC that will be included in the tax base of the controlling company: (*i*) a categorical approach, in which certain passive income categories, such as interest, royalties, and dividends, are added to the result of the controlling company, unless the CFC performs a substantial economic activity supported by personnel, equipment, assets, and premises; or (*ii*) a transactional approach, based on which the CFC's undistributed gains resulting from a man-made structure set up for the primary aim of getting a tax benefit are viewed as taxable profit with the controlling business. A situation is specifically deemed artificial if the CFC would not own the assets or would not have taken the risks that produce all or a portion of its income if it were not controlled by a company where the key functions relevant to those assets and risks are performed, which play a crucial role in the CFC's income generation.

complicated set of coordination rules. The effective tax rate of a CFC is also computed in accordance with the tax laws of the state where the controlling entity is located, unlike the intricate computation guidelines created for the IIR. The under-taxed foreign entity is subject to domestic tax rates under CFC regulations, but the IIR merely levies a minimum charge.

In that regard, CFC regulations are much more intrusive. Despite these distinctions, it is undeniable that the two rules are somewhat similar and pursue the same objective, which begs the question of the new IIR's true additional value, especially considering the growing complexity involved in this new international scenario.

Even if there is no certainty, countries around the world – including EU Member States – will be able to tax local subsidiaries of U.S. groups on profits of U.S. parents, third country or U.S. subsidiary, to the extent nonlocal profits have not been taxed elsewhere at a rate of 15% or more. This might create a clash with the potential rationality of the UTPR and, as some authors have argued, it violates basic principles of private property law and could be deemed illegal confiscation[309]. In this regard, the IIR and UTPR might raise issues linked to a potential clash with fundamental freedoms as they would create a link between exercise of the latter and imposition of a top-up tax, with discriminatory treatment for those that exercise their fundamental freedoms[310]. There is a possibility that the Court of Justice might look more deeply into this.

## 4.3. The approach of the United Nations

Developing countries have cast doubts on the OECD two-pillar solutions as the effects could be modest in relation to their large revenue needs for development[311]. According to some authors[312], it has been proposed that profit allocation laws could be simplified by expanding formula apportionment and employing safe harbor rules could

[309] S. Soong, *Ship has sailed on Pillar Two, EU Committee warns U.S. Congress*, in *Tax Notes International*, 2023, p. 833.

[310] J.F. Pinto Nogueira & A Turina, *Pillar Two and EU Law*, in A. Perdelwitz & A. Turina, *Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative*, 2020, p. 283-314.

[311] During the 55th Asean Economic Ministers Meeting in Indonesia of August 19, 2023, Chair of Asean Investment Area Council Bahil Lahadaliahas called for pillar 2 rules review «*because they will only benefit developed countries and will adversely affect incentives offered by developing countries*».

[312] A.S. Castro, *Administrative Capability Analysis of OECD Proposals from the Perspective of Developing Countries*, in *EC Tax Review*, 2020, p. 218-232

better serve the interests of developing nations. The OECD two-pillar solution would not be able to provide a reliable allocation of tax revenue «*as the allocation discriminated against developing countries, did not correlate to the taxed real economic activity of multinational enterprises and was susceptible to manipulation*» by such companies[313].

The increasing complexity of the OECD with more rules and commentary[314] makes the situation even more challenging and can only further increase the unexpected consequences of the other components of the Two Pillars.[315]

In this context, the United Nations has stepped up in its cooperation efforts. It has prepared a model convention to modernize withholding taxes so that they may continue to be a strong and simple instrument for collecting and enforcing source taxation rights, which is especially crucial for low-income nations. Interest, royalties, and fees, particularly for services such as technical, managerial, or advisory services, are examples of potentially base-eroding cross-border payments. An asymmetric tax treatment of such services arises when the cost is deductible for the payer (service recipient) at the corporate income tax rate, while the fee income derived from the services may be untaxed or subject to a low rate of tax in the hands of the payee (service provider)[316].

Applying cross-border WHTs on the gross payment of service fees is an essential strategy to address this asymmetric tax treatment. Since it moves tax collection to the payer, this approach can protect the source country's taxation rights, particularly for low-income countries.

[313] A. Fedan, *Case study analysis of the OECD Pillar One and Pillar Two allocations to developing countries*, in *Bulletin of International Taxation*, 2021

[314] *See* OECD, Members of the OECD/G20 Inclusive Framework on BEPS joining the October 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 2022; OECD, Tax Challenges Arising from the Digitalisation of the Economy: Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, 2021; OECD, Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, 2022

[315] A. Fedan, *OECD/International - Case Study Analysis of the OECD Pillar One and Pillar Two Allocations to Developing Countries – What Has Changed Since the 2020 Blueprints?*, in *Bulletin of International Taxation*, 2023. Against this view, it has been claimed that «*Pillar One considers the multiplicity of developing country views regarding what kinds of digital interactions create tax distortions within their jurisdictions*» and the redistribution of «*some taxing rights from resident to source countries* […] *will provide more taxing rights to developing countries—a sign of incremental, yet worthy, progress toward equity*». *See* C.L. Smith, *Reflections from the brink of tax warfare: developing countries, digital services taxes, and an opportunity for more just global governance with the OECD's two-pillar solution*, in *Boston College Law Review*, 2022, p. 1797-1861.

[316] International Monetary Fund, *International Corporate Tax Reform*, IMF Working Paper, 2023.

The UN Treaty Model currently allows, subject to a rate cap, source taxation on fees for technical, managerial, or advisory services. This is contained in Article 12A of the 2017 UN Model convention[317]. It is subject to agreement by treaty contractors. Article 12A is wider than the STTR, which allows source nations to apply taxes only on designated payments. Furthermore, because the STTR is a top-up tax, it only applies after deducting the tax payable in the recipient and payer nations as protected under other tax treaty provisions. Additionally, current withholding tax rates under treaties take precedence. For example, if the existing withholding tax rates under an applicable tax treaty are higher, the STTR does not apply.

In brief, Article 12A allows a contracting state to tax fees for certain technical services rendered to a resident of another contracting state if the fees are paid by a resident of that state or a non-resident with a permanent establishment or fixed base in that state, and the fees are borne by the permanent establishment or fixed base. Furthermore, the technical services do not have to be offered in that state. In the absence of a permanent installation, taxation shall be levied on a gross basis at a rate to be agreed upon by the contracting nations. Fees for technical services are payments for management, technical, or consulting services.

In a similar vein, the 2021 UN Model Convention included Article 12B, which addresses income from automated digital services and envisages the taxation of income in both in the residence and in the source States with a limited source State taxation at a rate to be negotiated by the tax treaty signatories[318].

Article 12B of the UN Model Convention specifies that where the beneficiary of the income is the beneficial owner of such income, the taxpayer may choose net basis taxation under the tax rules of the source State. The qualified profits for such taxation shall be «thirty percent of the amount resulting from applying the profitability ratio of that beneficial owner’s automated digital services business segment to the gross annual revenue from automated digital services derived from the Contracting State where such

[317] Article 12A Commentary demonstrates the challenges that tax authorities and tax administrations when dealing with the new digital business models enabled by the digital economy: «*the Report did not recommend, for the time being, a withholding tax on digital transactions (which include digital cross border services); nor did it recommend a new nexus for taxation in the form of a significant economic presence test. However, it was recognized that countries were free to include such provisions in their tax treaties, among other additional safeguards against BEPS*».

[318] UN Model Convention, Article 12 B, paras 5 and 6.

income arises». UN Model Convention[319]. As a default rule, where the taxpayer does not maintain segmental accounts, the overall profitability ratio of the beneficial owner will be applied to determine qualified profits[320].

Article 12B allows gross basis taxation (for example, through a withholding tax) on cross-border payments for digital services[321] such as «*online advertising services; supply of user data; online search engines; online intermediation platform services; social media platforms; digital content services; online gaming; cloud computing services; and standardized online teaching services*»[322].

The introduction of Article 12B in the UN Model was reportedly done to protect developing nations' taxation rights in a more straightforward manner than Pillar One[323].

However, this Article has the drawback of being a ring-fenced approach with the scope restricted to ADS when compared to broader changes applied to more sectors of the economy and with a stronger element of destination-basing. According to relevant doctrine, «*Article 12B adds unnecessary complexity to the Model UN Tax Convention and presents several unjustified asymmetries between the conventional treatment*» of technical, managerial, and consultancy services on the one hand and automated digital services on the other[324].

The UN proposal is simpler to implement than Pillar One: designing a withholding tax system in which tax is collected by the payer of the relevant remuneration in the case of business-to-business transactions and by financial institutions, credit card entities, or other financial intermediaries entails a simplified and low-cost procedure for tax administrations.

[319] UN Model Convention, Article 12 B, paras 3.

[320] J. Sinnig, *The debate on digital taxes and its relevance for Luxembourg*, in *Cahiers de Fiscalité Luxembougeoise et Européenne*, 2022, p. 79-94

[321] Pursuant to UN Model, Article 12 B, para 5, income concerned remunerates «*any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider*».

[322] UN Model Convention, Article 12 B, paras 6.

[323] Article 12B is seen as surprising since Article 12A paragraph 2 of the 2017 UN Model Convention allows the market state taxation powers in respect of payments for technical services. It appeared to address the goal of long-term reform of the international tax system with a simple action. *See* A. Baez Moreno & Y. Brauner, *Taxing the Digital Economy Post-BEPS ... Seriously*, in *Columbia Journal of Transnational* Law, 2019, p. 123-188.

[324] A.B. Moreno, *Because not always B comes after A: Critical Reflections on the new Article 12B*, in *World Tax Journal*, 2021, p. 501-532

However, Article 12B could be used to bring unilateral measures directed at automated digital services – such as Digital Service taxes – within the scope of tax treaties, which can currently be designed to fall outside the scope of tax treaties, resulting in double taxation risks and other distortions. Given the asymmetry in digital trade, a treaty may not exist or never arise, or the requisite treaty amendment may be problematic.

The UN seeks to implement the new Art. 12B through bilateral agreements (it does not appear conceivable to include this provision in the present MLI because it is an OECD mechanism). Meanwhile, the OECD prefers to implement Pillar 1 through the creation of a new global instrument. The execution of a bilateral provision might result in disproportionate taxes and double taxation as compared to the multilateral application of OECD Pillar 1. Developing countries and smaller economies usually have more limited double tax treaties networks and the whole process would prove to be much more time consuming.

Additionally, since the nexus for the assignment of taxing power is the location of the payer of the relevant compensation rather than the location of the users, the number of jurisdictions that might get a portion of the tax revenues from digital activities could be significantly reduced.

Furthermore, the revised Art. 12B contains no revenue thresholds. In other words, the article applies to every taxpayer who conducts ADS, regardless of its global income or profitability. The OECD Pillar 1 plan, on the other hand, includes a worldwide revenue threshold and a de minimis foreign in-scope revenue test. The Pillar 1 plan includes a revenue threshold for each type of activity, ADS and CFB, in order to establish connection to the local jurisdiction. Furthermore, unlike the UN plan, the Amount A proposal proposes a one-stop shop sort of approach in which the taxpayer will only have to register with the Ultimate Parent Entity's tax administration[325].

Compared to the OECD solution, the UN proposal has been described as «*inefficient, simple on the face of it but complex when you get into the details, ineffective to collect taxes in several situations* […] *as well as non-flexible due to its narrow scope*».

[325] For a more detailed analysis, *see* B. Andrade, *Developing countries and the proposed Article 12B of the UN Model: some known unknows*, in *International Tax Studies*, 2021.

In brief, relevant doctrine views it as «*not really in the interest of developing countries*»[326].

[326] V, Chand & C. Vilaseca, *The UN Proposal on Automated Digital Services: Is It in the Interest of Developing Countries?*, in *Kluwer International Tax Blog*, 2021.

# CHAPTER 3

# *Harmful tax competition in the European Union*

## 1 Overview of tax competition in the European Union

Since the beginning of the last century, taxation has undergone profound changes linked to the development of state powers and the political and geopolitical transformations of economic regimes. While this observation has been theorized by "Wagner's law"[327], the reality and scale of the movement undeniably attest to a correlative increase in tax yield in all states and have necessitated a transformation of tax techniques and a reconsideration of the functions of taxation. This is especially true after the crises of the XXI century, included the coronavirus pandemic.

These questions of administrative and fiscal science challenge, in their own way, the legal principle of state sovereignty, since the latter, immersed in a globalized economy, are called upon to follow a common trajectory in their fiscal policies. Consequently, states are openly inspired by neighboring countries in order to define their orientations, even if they remain sovereignly free to define their own fiscal policies.

Applied on a European scale, these approximations do not deny the very principle of the need for tax harmonization in relation to economic integration, but in the absence of a common fiscal policy for the European Union and therefore harmful tax competition is echoed by the artificial dissociation between fiscal, monetary and budgetary tools[328].

[327] The Wagner law is the willingness of democratic societies, especially but non limited to the Western world, to increase their public expenditure in order to strengthen the resilience of the Welfare State. It has also been advocated by Toqueville. In particular, «*which the interventionist state is bound to capitalism or to democracy. The capitalist theory of the interventionist state was presented by Wagner, who stated that public spending growth is linked to the needs of industrialization and urbanization. For him, the point of departure is established by tax revenue, where economic growth creates revenue in order to finance needs. The democratic theory of public finance goes back to the pioneering work of Tocqueville who, as shown above, considers the cumulative effect of political, sociological, economic and cognitive facto*». *See* M. Leroy, *Toqueville Pioneer of Fiscal Sociology*, in *European Journal of Sociology*, 2010, p. 195-239.

[328] Mario Draghi called for a European common fiscal stance to address common challenges, import shocks (Covid-19 and Ukraine's war), and transnational challenges that will require large-scale investments for green and digital transformation and defense. He believes rationale for a Fiscal Union is different today than it was in the past. It is no longer about transfers from stronger to weaker countries, nor is it about responding to crises caused by unsustainable policies in specific countries. Instead, the need for an EU Fiscal Union arises because Europe faces a serious risk of failing to meet its climate objectives, failing to provide the safety its citizens need, and losing its

The European experience since the World War II easily confirms this, since the global economic system also exacerbates economic competition between States, which generates a centrifugal force resulting in divergent tax strategies that protect multiple national interests. The dynamism of the European system, based on free competition and freedom of movement as a means of establishing a common market, has now entered a phase of normative coagulation, there is the economic necessity of harmonizing tax legislation, without imposing a common political harmonization of national tax structures, if only as a substitute for abolishing customs duties and/or combating "harmful competition"[329].

### 1.1 Incompatibility between budgetary, monetary and fiscal tools.

The European Union's financial system is a major economic and political area that has undergone significant change since the early 1990s, in terms of both the financial regime and the financial techniques put in place[330].

In particular, Article 311 TFEU[331] is cryptic: «*The Union shall provide itself with the means necessary to attain its objectives and carry through its policies. Without prejudice to other revenue, the budget shall be financed wholly from own resources. The Council, acting in accordance with a special legislative procedure, shall unanimously and after consulting the European Parliament adopt a decision laying down the provisions relating to the system of own resources of the Union. In this context it may establish new categories of own resources or abolish an existing category. That decision shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements. The Council, acting by means of regulations in accordance with a special legislative procedure, shall lay down implementing measures for the Union's own resources system in so far as this is provided for in the decision adopted on the basis of the third paragraph. The Council shall act after obtaining the consent of the European Parliament*».

industrial edge to regions that put fewer restrictions on themselves. See Mario Draghi on the path to fiscal union in the euro zone in The Economist, 6 September 2023.

[329] J.F. Boudet, *Manuel de droit fiscal européen et comparé*, Bruxelles 2021, p. 59-66.

[330] See Art. 310 ss. TFEU about own resources, multiannual financial framework, annual European budget, discharge procedure and Court of Auditors.

[331] Ex Article 269 TEC

A tax system cannot be envisaged independently of the use of the resources collected, since any budget is certainly an accounting document, but also the reflection of the political orientations proposed by its leaders.

The Court of Justice of the European Union acknowledged that European Union States can create European taxes within the framework of enhanced cooperation, even if the principles of taxation under this tax had not yet been definitively established[332]. It would therefore be easy to imagine significant changes in tax matters in the near future, even if the final agreement would be a political decision for national governments, especially since the financial resources are more and more needed after the withdrawal of the United Kingdom from the European Union and in light of Next Generation EU.

This is the biggest stimulus package ever funded in Europe. The long-term EU budget, combined with the temporary instrument created to support the recovery, makes up the total amount of the stimulus package. At today's prices, the total package amounts to €2,018 trillion*. The EU is helping to build a new Europe after COVID-19. A Europe that is cleaner, more connected and more resilient. This money is being used to tackle the biggest challenges facing Europe and to support those who need it most. In the wake of Russia's aggression against Ukraine, billions of euros were made available from the EU budget to provide emergency aid and support, both in Ukraine and within the EU, and to help alleviate the humanitarian impact of the conflict[333].

What remains necessary is the agreement of national governments, whose budgets and internal situation are already largely constrained and defined by European standards, and even though both the European and national tax systems are still defined exclusively by the member states themselves[334].

These constraints are obviously linked to political debates at both national and European level, but they are also institutionalized by the introduction of the Stability and

[332] CJEU, C-209/13, United Kingdom of Great Britain and Northern Ireland v Council of the European Union*;* CJEU, C-565/18, Soci*été Générale SA vs Agenzia delle Entrate.*

[333] See P. Leino-Sandberg & M. Ruffert, *Next Generation EU and its constitutional ramifications: A critical assessment,* in *Common Market Law Review*, 2022, p. 433-472.

[334] See P. Martin, J. Pisani-Ferry, X. Ragot, *Reforming the European fiscal framework,* in Notes du conseil d'analyse *économique,* 2020, p. 1-12; D. Howarth 7 T. Schild, Nein to 'Transfer Union': the German brake on the construction of a European Union fiscal capacity, in *Journal of European Integration,* 2021, p. 209-226.

Growth Pact[335] and the ratification of the The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union[336].

Member States' budgets are now subject to control by the European authorities; in particular, they must submit a stability program based on which their performance in terms of debt management and public deficit will be assessed, and to which possible sanctions, penalties, and fines may be added. This orientation reflects an ordoliberal conception of political economy, originating in the writings of Walter Eucken and Wilhelm Röpke. In the wake of the Euro crisis, prominent German leaders such as the Finance Minister Wolfgang Schäuble, the President of the Bundesbank, and, in the wake of the economic and monetary union (EMU) reform process, the German Government adopted a stance that was in line with Ordoliberalism, advocating stricter regulations to reduce moral hazard, fiscal retrenchment, monetary policy retrenchment, and structural reforms[337].

Since July 1, 2012, the ESM has replaced the European Financial Stability Facility (EFSF), set up in response to the public debt crisis in the eurozone, within the

[335] Article 121 of the Treaty on the Functioning of the European Union sets out the main mechanisms for coordinating the economic policies of the Member States  through multilateral surveillance, with the Council as the main decision-making body and the European Council as an additional component. This feature of the surveillance system is designed to ensure that the coordination process is carried out by the Heads of State or Government, rather than leaving it to the lower political levels, such as the ministries. *See* L. Flynn, *Article 121 TFEU*, in M. Kellerbauer, M. Klamert, J. Tomkin, *The EU Treaties and the Charter of Fundamental Rights: a Commentary,* Oxford, 2019, p. 1276-1281.

[336] On 2 March 2012, the TSCG entered into force. The primary provision of the TSCG is the obligation to have a balanced budgetary rule in national legal orders. In the Fiscal Compact, the main rules are as follows: (i) The Member States have renewed their commitment to a balanced or in surplus budget position. The Member State has passed a national law or amendment of the national Constitution that limits the structural budgetary deficit to 0,5% of GDP. The structural budget deficit can be reduced to 1% of GDP only in exceptional circumstances or in deep recessions. The TSCG provides for a transitional period, the duration of which is not specified. For countries with a debt-to-GDP «*significantly below than 60% of GDP*», the structural budget deficit is limited to 0,5%; (ii) The European Court of Justice can now refer a Member State to the ECJ if it believes that another Member State has failed to pass a national "debt brake" into national law. If the ECJ finds that the other Member State has not complied with the provisions of the debt brake, it can impose a fine on the other Member State, which could be as high as 0.1%; (iii) The 1/20 rule allows for the opening of an excessive deficit procedure (as defined by the old Stability and Growth Pact) if a country with a higher than 60% debt to GDP ratio does not reduce its debt ratio quickly enough. The requirement is to reduce the debt ratio each year by one-third of the gap between the actual debt to GDP ratio and 60%. This rule applies over a period of three years, and countries are given a grace period of three years after their current deficit has been corrected below the target of 3%; (iv) The Treaty provides for the possibility of reverse qualified majority voting to be used in the excessive deficit procedure, which was not previously implemented in the European Union's previous legislation. *See* M. Evers, *Report EC Tax Review's Twentieth Anniversary Seminar 31 May 2012 Fiscal Autonomy in a Changing EU*, in *EC Tax Review*, 2012, p. 324.

[337] *See* F. Bruno, *Ordoliberal ideas on Europe: two paradigms of European economic integration*, in *History of European Ideas*, 2022, p. 737-756; J. Hien, The rise and fall of ordoliberalism, in *Socio-Economic Review*, 2023.

European Budgetary Pact. More specifically, the ESM is a common fund that may be funded by all Member States, so that the European Union can draw on colossal sums to support States experiencing difficulties in borrowing on the financial markets, and thus avoid a repeat of the Greek episode of 2007, which forced the European Central Bank to intervene. Under these conditions, this dissociation between fiscal, budgetary, and monetary matters seems hardly tenable in the long term, at the risk of inciting member states to adopt a form of sovereign stance on the fiscal tools still within their power, in order to comply with the budgetary constraints imposed on them by the European Union.

Though Member States have voluntarily agreed to significantly limit the conditions under which they exercise their sovereignty, their fiscal and budgetary powers are being framed with their help and consent, without any full attribution of powers to the European Union. The latter in charge of economic issues and harmonization of the European area with regard to legal principles. Also, with no autonomous revenue-generating powers and, more generally, no financial autonomy, it depends on the financial contributions of its member states, which also oversee its expenditure.

## 1.2 Tax havens in the European Union

Member states maintain an overtly national approach to taxation. As a result, the great heterogeneity of EU member states' tax systems means that European tax competition is in stark contrast to the EU's overall economy, since each member state maintains its attractiveness through its own uncooperative strategies in a globalized world. The whole framework is ultimately unbalanced by the diversity of European tax systems. This observation is all the more striking in that it is used by a certain number of Eurosceptics, who point to a certain paradox engendered by the will and degree of integration of national tax systems on a European scale.

In order to increase the tax attractiveness of the European Union, it would be advisable to move towards the standardization of European tax systems and, in the longer term, to build a European tax state without tax competition between EU member states, which is at the heart of the EU[338].

[338] M. Brulharbart & M. Jametic, *Vertical versus horizontal tax externalities: an empirical test*, in *Journal of Public Economics*, 2006, p. 2027.

Member States are developing their own tax havens within the European area. In this respect, it should first be noted that some Member States welcome with a certain degree of respect money produced in another Member State, either for storage or as a steppingstone to other tax havens outside Europe. With this in mind, on December 5, 2017, EU member states drew up their first list of non-cooperative countries (NCCTs) at European level[339]. This list aims to combat fraud and tax evasion and has specifically imposed a minimum level of tax transparency on states that refuse to comply, in accordance with the «*name and shame*» approach[340]. The idea is commendable and certainly deserving, but it remains highly «*confusing and ineffective*»[341]. Indeed, while this list currently includes more than a dozen states that lose access to European funds in general, and to the European Development Fund in particular, it still does not include any European Union member states that use privileged taxation as a lever for tax attractiveness. Those States include the Netherlands, Malta, Luxembourg, Ireland and Cyprus[342].

Although the notion of tax haven has entered common parlance, it seems difficult to define the precise and common contours of what it may cover. At European level, the concept has been established on the basis of the various practices deemed harmful and to be banned by States, as set out in the Code of Conduct for Business Taxation adopted by the Council on December 1, 1997. The criteria are as follows: (*i*) a level of effective taxation well below the general level of the country concerned; (*ii*) tax advantages reserved for non-residents; (*iii*) tax incentives for activities that are independent of the local economy and have no impact on the national tax base; (*iv*) rules for determining the profits of companies belonging to a multinational group that diverge from the standards set by the OECD in particular; (*v*) Lack of transparency of these measures.

While these criteria refer to a variety of situations, the common denominator is the desire to avoid taxation and the subsequent tax obligations. Thus, tax transparency is understood by the European Union first and foremost as the qualified tax jurisdiction's

[339] Resolution of the Council and the representatives of the governments of the Member States on a code of conduct for business taxation, adopted on 1 December 1997.

[340] A. Rusina, *Name and shame? Evidence from the European Union tax haven*, in *International Tax and Public Finance*, 2020, p. 1364-1424.

[341] European Parliament resolution of 21 January 2021 on reforming the EU list of tax havens (2020/2863).

[342] A. Cobham & J. Garcia-Bernard, *Time for the EU to close its own tax havens*, 4 April 2020.

compliance with international standards on information exchange; fair tax competition then suggests an absence of tax practices or the establishment of a harmful tax regime, or even the non-application of anti-BEPS tax measures.

Finally, economic activity is intended to reflect an absence of taxation favoring artificial tax structures. In fact, tax havens are used for tax avoidance purposes, as defined in terms of tax optimization, tax evasion and tax avoidance. Although no European state is on the list (Liechtenstein, San Marino and Andorra were until 2018, Switzerland until 2019), these same states cultivate tax competition between themselves, to such an extent that some people refer to certain European countries as tax havens because of the advantages and tax incentives they offer taxpayers. This boundary between attractiveness policies and tax-haven status is proving to be extremely fine and delicate, and only a case-by-case study of state tax practices could point to the existence of genuine European "tax havens"[343].

In particular, with specific regard to corporate taxation, the tax advantages or low tax burden of certain EU member states enables a number of countries to attract companies into their tax fold. Among these, Luxembourg is often considered one of Europe's most aggressive tax havens, with a corporate tax rate of 15% of operating profit for companies with taxable income up to € 175,000, and 17% above € 200,000. What's more, if the company is not established in the Grand Duchy and has an office or subsidiary in that country, it will only be taxed there on profits earned[344].

With their low corporate tax rates, Ireland, the Netherlands and Luxembourg appear to be privileged territories for Multinational companies. Digital transactions can give rise to profit transfers through either over- or under-invoicing mechanisms. Transfer pricing through over-invoicing mechanisms has notably inspired Facebook, Apple, Google and Nike, in the generally explained form of the "Double Irish" and the "Dutch sandwich", which we have already seen in this thesis. These mechanisms have created a profound outcry and are not generally used anymore[345].

[343] *See* G. Melis & A. Persiani, *The EU Blacklist: A Step Forward but Still Much to Do*, in *EC Tax Review*, 2019, p. 253-263.

[344] S. Franck, Le Luxembourg est-il un paradis fiscal?, in Publications Études & Analyses, 2009, p. 1-13.

[345] As highlighted in the 2018 tax filings, Google parent Alphabet Googl.O will no longer use an intellectual property licensing scheme, known as the "Double Irish, Dutch sandwich", which allowed it to delay paying U.S. taxes, 2018 tax filings show.

In the case of Facebook Inc. headquartered in California, the parent company holds the operating rights to the intangible assets and enters into a sales or licensing agreement with a Facebook company based in Ireland, but whose corporate functions are performed by a permanent establishment located in Bermuda. All profits earned outside the United States and attributable to these intangible assets are declared by this subsidiary. As a result, Facebook in Ireland controls another subsidiary established in Ireland (hence the term "Double Irish") which makes sales outside the United States, for example in France through a French subsidiary. Facebook France negotiates contracts in its own name, but on behalf of the foreign company that will earn profits. It is therefore bound "only" by a licensing agreement, and therefore owes "only" a royalty.

In order to reduce the profit made by Facebook France, it is advisable to increase its costs by overcharging the royalty it must pay. Facebook France will then pay little corporate tax, as its profit is cancelled out or at least significantly reduced by the payment of this royalty. So, by paying a large royalty, the profit made by the French subsidiary will be transferred from France to Ireland. The process may stop at this stage, but it is subsequently possible to locate the profit in the Netherlands – hence the term "Dutch sandwich" – via a shell company, in order to benefit from the favorable clauses of tax treaties signed by this country in general, and in particular the absence of withholding tax. In our example, the profits will be transferred in Bermuda to Facebook in Ireland, which holds all the operating rights to Facebook.

Amazon has also set up a similar arrangement with two Luxembourg-based companies, with the agreement of the Grand Duchy's government. The first, Amazon Europe, is the operational center with five hundred employees who manage all sales and collect all revenues generated in Europe; the second, Amazon Europe Holding Technologies, is a holding company with no premises or staff, acting as a liaison with the American headquarters. Its role is to collect royalties on behalf of Amazon Europe for the use of technologies developed by the head office, and to legally send these royalties across the Atlantic. However, there is some legal doubt as to the amount of the royalty invoiced to Amazon Europe, since this far exceeds its operating profits[346].

[346] W. Josh, *Amazon fights to overturn EU state aid ruling*, in *International Tax Review*, 2020.

In this case, a company decided to transfer its head office to a country with a high tax burden, in order to take on the tax status of a multinational company in that country. It holds the exploitation rights to its intangible assets and enters into brand licensing agreements with its European subsidiaries. However, given the tax burden in the parent company's home country, the group's strategy will be to avoid increasing profits, and therefore to charge subsidiaries a minimal royalty, well below market prices. These tax schemes show that tax treaties - whose original purpose was to avoid double taxation - can be used to circumvent national, regional and international tax rules by transferring profits to tax havens. It creates situations of double non-taxation, in which companies rush to pay taxes neither in the country where the profit is made, nor in the country where they have their head office. Without any moral compass, these companies decide to set up shop in Ireland, Luxembourg or the Netherlands, countries with low corporate tax rates that welcome them with deliberately attractive tax policies, but which are at odds with European fiscal cohesion. In this respect, the European Union can only note these shortcomings, ask for, discuss, and negotiate changes to these national tax strategies, without being able to impose its real authority[347].

## 2 Tax harmonization in the European Union

### 2.1 Harmonization attempts until the 1980s

As early as 1962, the European Commission tackled the issue of harmonizing direct tax bases with the publication by the Fiscal and Financial Committee of a report under the direction of Fritz Neumark. The assessment of the Fiscal and Financial Committee acknowledged the difficulty of finding a «*rational compromise between the necessity of eliminating or at least strongly reducing, in the interest of optimum functioning of the Common Market, the fiscal or financial disparities hindering the free play of competition between the Member States on the one hand, and the expediency of not interfering in the policy of the Member States anxious to maintain national peculiarities arising from natural conditions and/or historical evolution on the other hand*». Harmful tax competition was not mentioned in the report as such but experts

[347] P. Marchessou & B. Trescher , *Droit fiscal international et europeen*, Bruxelles, 2018, p. 264-268.

warned against fiscal and budget differences amongst Member States that could push companies to choose for their business a place which was different from the one naturally and technically more suitable[348].

However, the recommendations contained in the Neumark Report never found their way into concrete initiatives, and its content remained a dead letter[349].

Far from stopping with this failure, the effort to promote tax convergence continued with the introduction, in 1967, of a "Tax harmonization program". In the long-term, the Commission expected that tax revenue would be generated from three primary sources: a harmonized VAT and excise duties, a general corporate tax based on the same assessment and rates across the Community, and a unified personal income tax that would vary from one Member State to another for a long period of time. In order to achieve these objectives, the Commission believed that it was necessary to take more urgent action. The primary objective was to liberalize the movement of capital, with taxation being a major impediment to this[350]. Moreover, the Commission considered national tax rules to be a barrier to mergers and other types of associations between enterprises in different Member States. The Commission sought to ensure fiscal neutrality between purely national combinations and intracommunity combinations, both in terms of the initial tax cost of mergers and in terms of the treatment of related enterprises after the merger. Also, the Commission believed that those distortions of competitive conditions and of capital movements result not only from differences in incorporate tax systems, but also from differences in the ways in which taxable profits are calculated. Therefore, it proposed harmonizing rules governing depreciation allowance, stock valuation and the grant of investment incentives[351].

[348] Fiscal and Financial Committee (Neumark Report), pt. 12. See E. Traversa & A. Flamini, *Fighting harmful tax competition through EU State aid aid: will the hardening of soft law suffice?*, in *European State Aid Law Quarterly*, 2015, p. 323-331.

[349] C. Garbarino, *Harmonization and coordination of corporate taxes in the European Union, EC Tax Review*, 2016, p. 277.

[350] To achieve this, it was necessary to align national tax systems in order to create conditions for fiscal neutrality. However, in order to do this, four issues had to be addressed: a) withholding tax systems for dividends and interest; b) eliminating or reducing economic double taxation for dividends; c) tax arrangements for holding companies; and d) tax treatment for investments through financial intermediary.

[351] A. Easson, *Harmonization of direct taxation in the European Community: from Neumark to Ruding*, in *Canadian Tax Journal*, 1992, p. 600-637.

In the realm of harmonization on corporate taxation, the proposals put forward in this program were to achieve the desired objectives was the introduction of a global tax on company profits with the same structure and established according to very similar methods of assessment and rates in the six countries as well as the necessity to establish a common definition and method of calculation of company taxable profits in order to harmonize the tax base as far as possible[352].

The Harmonization Program was followed by a new report under the direction of Professor Van den Tempel who, without going so far as to advocate total harmonization of tax bases and rates within the Community, nevertheless advocated the establishment of a classic system of company taxation by the various member states[353].

It was superseded, five years later, by a new proposal for the harmonization of corporate tax and dividend withholding systems, which did not, however, take up its recommendations. This proposal envisaged a common system for the taxation of dividends within the Community, with harmonized partial imputation at tax rates ranging from 45% to 55%, a tax credit for dividend recipients, irrespective of their Member State of residence, and a harmonized 25% withholding tax on distributed dividends[354]. It was, however, widely criticized by the European Parliament, not least for the fact that it did not specify any rules for calculating the tax base[355].

It too remained a dead letter, before being followed by other proposals in 1984 focused on loss compensation, which was also withdrawn[356], and followed by a draft proposal in 1988 aimed at harmonizing the tax base of companies in the Community, but which was never presented «*due to the reluctance of most Member States*»[357].

[352] European Economic Community, Tax harmonization program, 1967, p.8.

[353] *See* A.J. Tempel, *Corporation Tax and Individual income Tax in the European Communities*, Brussels, 1970.

[354] European Economic Community, *Proposal for a Council Directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends COM (75) 392 final*, 1975.

[355] European Parliament, *Tax Coordination in the EU*, Working Paper, ECON 128, 2001.

[356] European Economic Community, *Proposal for a directive of the council on the harmonization of the laws of the member states relating to tax arrangements for the carry-over of losses of undertakings*, COM (1984) 404, 1974

[357] European Commission, Taxation, https://europa.eu/european-union/topics/ taxation_en

## 2.2 Coordination rather than harmonization: the "new approach" since the 1990s

This mountain of ambitious proposals to harmonize Europe's tax systems proved to be unsuccessful. As early as in 1980, the Commission published a document entitled "Possibilities of convergence of tax systems in the Community" in which it observed that fiscal sovereignty is «*one of the fundamental prerogatives*»[358]. Therefore, the approach was modified, replacing the ambitions of harmonization with the objective of greater coordination of Member States' tax systems.

Following a Commission communication on company taxation[359], three directives on this subject were finally adopted in 1990: the Parent-Subsidiary Directive eliminates withholding taxes on inter-corporate dividends from a subsidiary[360], the directive on mergers, designed to allow the deferral of capital gains taxation in the case of certain cross-border operations linked to the restructuring of groups of companies[361] and the convention on the elimination of double taxation[362].

In 1992, a committee of experts chaired by Onno Ruding published a report whose ambition was to propose various reforms to be carried out in the field of company taxation in order to guarantee the smooth operation of the internal market. The report focused on a number of priorities, including «*removing those discriminatory and distortionary features of countries' tax arrangements that impede cross-border business investment and shareholding*», «*setting a minimum level for statutory corporation tax rates and also common rules for a minimum tax base, so as to limit excessive tax competition between Member States intended to attract mobile investment or taxable profits of multinational firms, either of which tend to erode the tax base in the Community as a whole*», and «*encouraging maximum transparency of any tax incentives granted by Member States to promote investment with a preference for incentives, if any, of a non-*

[358] The convergence of tax systems in the Community. Information Memo P-23/80, March 1980

[359] European Economic Community, *Guidelines on Company Taxation. SEC (90) 601 final*, 1990

[360] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

[361] Directive 90/434/EECEN on a common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States

[362] Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/463/EEC).

*fiscal character*»[363]. Its various recommendations were, however, rejected by both the Council and the Commission[364].

In line with the new approach promoting of coordination rather than harmonization, the Commission instead proposed a new package of measures[365] which was finally reduced to three targeted measures contained in a new proposal[366]. The measures were (*i*) the introduction of a non-binding code of conduct in the field of corporate taxation; (*ii*) the elimination of distortions in the field of capital income taxation through the introduction of a minimum withholding tax on bank interest; and (*iii*) the introduction of certain specific measures aimed at abolishing withholding taxes on cross-border interest and royalty payments between companies.

The Code of Conduct on business taxation was the major proposal of this package, adopted by the Council in 1998. It was based on the idea that mutual pressure from member states to freeze and dismantle targeted harmful tax regimes was preferable to action through legislation. Member States thus committed to respect the principles of fair competition and not to introduce tax measures harmful to other States, in order to ensure that the effective taxation of companies within the Union was correlated with the location of economic activities.

In 1999, wishing to complete the work in progress on the tax package adopted in December 1997, the Council invited the Commission to carry out an exhaustive study on company taxation, which was finally published in 2001[367].

The study found that «*the Internal Market must* […] *not hinder the possibility of general tax competition while tackling all harmful or economically undesirable forms of tax competition*» *and that* «*there are potentially significant benefits to be derived from*

[363] Report of the Committee of Independent Experts on Company Taxation, 1992, p. 13.

[364] C. Garbarino, *Harmonization and coordination of corporate taxes in the European Union*, *EC Tax Review*, 2016, p. 277.

[365] Towards tax co-ordination in the European Union COM(97) 495 final, 1997

[366] A package to tackle harmful tax competition in the European Union, COM(97) 564 final, 1997.

[367] Communication from the commission to the council, the European parliament and the economic and social committee, Towards an Internal Market without tax obstacles A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM(2001) 582 final, 2001.

*providing, via a genuinely comprehensive solution, companies with a common consolidated tax base for the EU-wide activities*»[368].

## 2.3 New efforts in the 2000s: Common Consolidated Corporate Tax Base

The Common Consolidated Corporate Tax Base is a single set of rules to calculate companies' taxable profits in the EU. It was proposed in 2011 was based on a harmonization of the corporate tax base so that all profits and losses, calculated according to these common principles, would then be consolidated and allocated between the different Member States according to a pre-established apportionment formula based on three factors with the same weighting, namely labor, tangible fixed assets and sales[369].

However, in its first version, this system was optional, which was not conducive to its effectiveness in combating distortions of competition between Member States and aggressive tax planning[370]. The project eventually failed due to the lack of consensus required in direct taxation[371] matters but the project was relaunched in 2015 by the European Commission[372].

The Commission proposed a compulsory Consolidate Corporate Tax Base, since an optional measure «*would limit its effectiveness as a tool for preventing profit shifting, as multinational enterprises that minimize their taxable profits through aggressive tax planning would be unlikely to opt in to the CCCTB*»[373]. This communication was followed by a new proposal in October 2016 which, in line with the recommendations of the ECOFIN Council of the same year, was to be based on a two-stage approach

[368] Communication from the commission to the council, the European parliament and the economic and social committee, Towards an Internal Market without tax obstacles A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM(2001) 582 final, 2001, p. 5, 47.

[369] See E. Röder, *Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment*, in *World Tax Journal*, 2012, p. 125-150.

[370] The original aim of the proposal, which was primarily intended to lighten the administrative burden on companies and facilitate trade within the Union rather than tackling aggressive tax competition.

[371] On the more general competence of the European Union in the field of taxation, see P. Boria, *Diritto Tributario Europeo*, Milano, 2017, p. 41-50.

[372] A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action COM/2015/0302 final, 2015.

[373] A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action COM/2015/0302 final, 2015, p. 8.

consisting of first establishing a Common Corporate Tax Base before considering, in a second stage, a Common Consolidated Corporate Tax Base.

According to the Commission, the new corporate taxation system would make it compulsory for large multinational groups with the most aggressive tax planning to be taxed where they actually make their profits. Companies with global revenues over € 750,000,000 a year will be subject to the new system. It would encourage companies to fund their activities through equity rather than debt and foster innovation by providing tax incentives for Research and Development activities that are directly linked to real economic growth. The Common Consolidated Corporate Tax Base would not cover corporate tax rates, as these remain a matter of national sovereignty and would create a more transparent, more efficient and fairer system for calculating cross-border companies' tax bases, which would significantly reform corporate taxation across the EU.

The Commission believes that differences in the conditions of competition and capital movements are not only due to differences in incorporate tax systems, but also differences in the ways in which taxable profits are calculated. Therefore, it proposed harmonizing rules governing depreciation allowances and stock valuation, as well as the provision of investment incentives[374].

In June 2018, France and Germany issued the "Meseberg Declaration” in support of this initiative, proposing a number of significant changes to its content, including its application to all companies subject to corporate income tax, without any sales-related conditions, the withdrawal of certain incentives such as the super-deduction for research and development, and the cross-border compensation and recovery mechanism, which would be included in the discussions on consolidation[375].

[374] Vice-President Valdis Dombrovskis said: «*Tax policy should support the EU's goals of economic growth and social justice. Today's proposals aim to boost growth and investment, support enterprise and ensure fairness. The current corporate tax system treats debt financing of companies more favourably than equity financing. Reducing this debt-equity bias in the tax system is an important element of the Capital Markets Union Action Plan and underlines our commitment to deliver on this project*». Pierre Moscovici, Commissioner for Economic and Financial Affairs, Taxation and Customs said: «*With the rebooted CCCTB proposal, we're addressing the concerns of both businesses and citizens in one fell swoop. The many conversations I've had as Taxation Commissioner have made it crystal-clear to me that companies need simpler tax rules within the EU. At the same time, we need to drive forward our fight against tax avoidance, which is delivering real change. Finance Ministers should look at this ambitious and timely package with a fresh pair of eyes because it will create a robust tax system fit for the 21st century*». *See* Press release25 October 2016, Commission proposes major corporate tax reform for the EU, 25 October 2016.

[375] One of the objectives was to «*put in place actual tax convergence between France and Germany regarding corporate tax. Both countries have agreed on a common position on the Commission proposal for a directive establishing a Common Corporate Tax Base: we will promote it jointly in order to support and accelerate the*

In spite of this, a number of countries such as Cyprus[376], Ireland[377], Luxembourg[378] and the Netherlands[379] have expressed, if not negative opinions, at least certain reservations about the two proposed directives, mainly because of their fear of being on the losing side of the changes brought about by their tax effects. These reservations only serve to underline the limits inherent in the very principle of harmonization, which clashes with the deep-rooted attachment of States to their fiscal sovereignty, of which the determination of the tax base is an essential component. Many also suggest to carefully focus on the apportionment formula because it would prove to be decisive to its short-term and long-term consequences and «*due to the variety of dimensions involved, the implications are difficult to foresee and may be developed gradually*»[380].

Given the lack of political consensus to implement a CCCTB, the Commission

*European project to harmonize the corporate tax base in Europe*». *See* Meseberg Declaration - Renewing Europe's promises of security and prosperity, 19 June 2018.

[376] *See* Opinion submitted by the Standing Committee on Energy, Commerce, Industry and Tourism of the House of Representatives of the Republic of Cyprus with regard to the Commission's proposal for a Council Directive on a Common Corporate Tax Base [COM (2016) 685] and the proposal for a Council Directive on a Common Consolidated Corporate Tax Base [COM (2016)]: «*In its CCCTB proposals, the European Commission does not take into account the specific advantages and disadvantages of the economic situation of each member state or its current and future needs. […] Even though the European Commission's impact assessment presents an overall positive impact on the EU as a whole, it is inconclusive with regard to the extent to which each member state shall be affected. It is reasonably expected that both CCTB and CCCTB shall have a negative impact on small and open economies as is the case of Cyprus*».

[377] The Committee is also of the opinion that that the formula apportioning profits set out in the CCCTB is unlikely to remove the ability for tax planning any more than the existing transfer pricing rules. Joint Committee on Finance, Public Expenditure and Reform and Taoiseach issued a report highlighting that «*the proposals for a CCTB/CCCTB breach the principle of subsidiarity – that the EU shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States*». Reasoned opinion of Dáil Éireann on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2016)683 – C8-0471/2016 – 2016/0336(CNS).

[378] The Luxembourg Parliament on 22 December 2016 adopted a resolution indicating that Luxembourg did not support the re-launched Common Consolidated Corporate Tax Base proposal because it is regarded as incompatible with the subsidiarity and proportionality principle. Furthermore, the parliament took the view that the proposal is incompatible with the OECD Transfer Pricing Guidelines and the tax treaties signed by Luxembourg. The parliament was of the opinion that the launch of such far-reaching harmonization to combat tax evasion was unnecessary and would have a substantial impact on small economies.

[379] Some representatives of the Dutch Parliament feel that *See* Reasoned opinion by the House of Representatives of the Kingdom of the Netherlands on the proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2016)0683 – C8-0471/2016 – 2016/0336(CNS): «*for the Netherlands, the proposed CCCTB directive would be disadvantageous for the general level of prosperity. For most Member States it would mean a reduction in GDP. Based on the figures from 2011, the reduction in GDP for the Netherlands could be as much as 1.69%, which represents a deadweight loss of € 11 to 12 billion. The PVV representatives are concerned that the introduction of the proposed CCCTB directive would greatly reduce investment levels in the Netherlands*».

[380] See N. Munin, *Tax in troubled time: is it the time for a Common Corporate Tax Base in the EU*?, in *EC Tax Review*, 2011, p. 121-133.

has withdrawn its previous deadlocked plan and replaced it with "Business in Europe: Framework for Income Taxation" ("BEFIT"), which will be framed on the OECD's tax reform deal and for which, at the time of finalizing this thesis, there is not much information available. It envisages «*a single corporate tax rulebook for the EU, based on the key features of a common tax base and the allocation of profits between Member States based on a formula (formulary apportionment)*»[381].

On 12 September 2023, the EU executive branch published the new legislative proposal alongside a Directive on Transfer Pricing[382]. Pillar 2 regulations from the OECD would be repurposed to provide common procedures for calculating the business tax base. BEFIT would also feature a formulary apportionment, which appears to be based on profit reallocation under Pillar 1.

Both draft Directives will now enter the negotiating process with the goal of attaining unanimous agreement among Member States. The Commission recommends that Member States transcribe the BEFIT Directive into their national legislation by January 1, 2028, in order for the provisions to take effect on July 1, 2028. Instead, the Transfer Pricing Directive must be transposed by December 31, 2025, for the requirements to take effect on January 1, 2026[383].

In brief, literature seems to show that larger economies in the European Union with higher tax rates would experience a notable tax base increase, transferred from smaller countries with lower tax rates as multinational enterprises would have more limited opportunities to engage in artificial profit shifting activities. Numerous hurdles remain in the way of the planned revolution. In particular, the design of BEFIT should be protected from any arbitrary allocation of profits between states, limiting forms of tax evasion to the greatest extent feasible[384].

[381] European Commission, Communication on Business Taxation for the 21st Century, p. 11-12.

[382] European Commission, Proposal for a Council Directive on transfer pricing, SWD(2023) 308-309 final.

[383] For a more comprehensive, analysis, *see* J.A. Vicente, Rethinking corporate taxation in the European Union: how and where to tax Multinational Enterprises, REM Working Paper 0286, 2023.

[384] The redistributive power stemming from the Formulary Apportionment depends on the factors included in the formula and on the corresponding weights. A sensitive issue to take into consideration is whether intangibles should be included in the asset component of the formula. *See* A. Martins & D. Taborda, *BEFIT and Formulary Apportionment: Should Intangibles Be Included in the Formula?*, in *EC Tax Review*, 2022, p. 131-169.

The adoption of a common tax base and a consistent manner of allocating this tax base would undoubtedly result in further loss of taxation rights by Member States[385]. What is required at this stage is a true change of paradigm and recognition that the weakening Member States' fiscal sovereignty in the realm of taxation is a natural process in the establishment of a peculiar common market like the European Union. It does not only derive from EU’s positive or negative harmonization but also from the international major breakthroughs, namely the OECD two-pillar solution. The BEFIT may potentially pave the way for more broad harmonization efforts which are welcome to bring about some rationalization in direct taxation[386].

### 2.4 Limitations of the Consolidated Corporate Tax Base

While the ambition of harmonizing tax bases is laudable in many respects, since it makes it possible to overcome the various difficulties mentioned earlier in this study (distortions on the single market, erosion of tax bases, undermining of the fairness of tax structures), it must be admitted that it also has certain limits which are likely to hamper its implementation. These limits are of three kinds. First, despite its general nature, the reduction in statutory tax rates is likely to cancel out the beneficial effects of any harmonization of tax bases. Second, the lack of consensus between the various Member States on the desirability of harmonizing tax bases highlights the difficulties posed by the unanimity rule in tax matters, which is a precondition for any progress in this field within the Union. Third, it is worth noting that harmonizing tax bases would call into

[385] C.H.J.I. Panayi, *Corporate tax reform in the European Union: are the stars finally aligned?*, in *Yearbook of European Law*, 2023, p. 1-30.

[386] Relevant doctrine has highlighted some vulnerabilities of BEFIT, including (a) A possible breach of pre-accession double tax treaties regarding the profit attribution to Permanent Establishments; (b) The need for better cohesion between the Pillar Two Directive and the BEFIT proposal; (c) Uncertainty stemming from undefined key terms like “direct business interest' or 'arm's length principle”; (d) The switch-off of domestic CIT law but implicit reliance on it for key considerations such as tax residence; (e) The failures in the functioning of the baseline allocation formula if group members report losses; (f) Treatment of pre-BEFIT losses deemed 'final'; (g) The issues with the TP of intra-BEFIT transactions such as the possibilities for unchecked profit shifting in the low-risk zone and a number of unanswered questions in the high-risk zone; (h) The need for a comprehensive approach to TP for associated units that are not part of the BEFIT group; (i) The unlimited powers of the Member States to adjust their allocated share of the BEFIT base, calling into question the whole rationale of the proposed directive; (j) The misalignment between the stated goals of the procedural rules for creating a one-stop shop mechanism, while the actual rules creating one-MORE-stop shop; (k) Risks of audit/appeal duplications causing conflicting outcomes among Member States. *See* J.F. Pinto Nogueira, P. Pistone, I. lazarov, A. Turina, S. Messina, Proposal for a Council Directive on BEFIT: an initial assessment, IBFD, 2023.

question national tax frameworks, which are the product of so many economic and social developments and reflect the many particularities whose preservation would legitimately be defended by Member States[387].

As for the first point, countries might broaden their tax bases to compensate at least in part for the reduction in rates or propose targeted schemes or rulings that provide for significantly lower rates for certain types of income or business. While the resumption of work on the introduction of a Common Consolidated Corporate Tax Base within the European area is to be welcomed, it is also worth pointing out that, despite its ambitions, this reform does not provide for any harmonization of tax rates. This is an important limitation of this evolution, the foundations of which were already underlined by the Commission in 2001, which questioned the appropriateness of taking measures to consolidate the tax base without some harmonization of tax rates. This touches on a fundamental issue, since differences between tax bases can, to a certain extent, compensate for differences between tax rates, and harmonize tax bases without aligning rates would widen these differences. This was already one of the conclusions of the Ruding report and of earlier Commission proposals[388].

Some authors today question the propensity of the proposed directives to put an end to tax competition, on the grounds that aligning tax bases would not make it possible to combat opportunities to compete on the basis of tax rates Not only does the introduction of a common consolidated tax base maintain the possibility for States to adopt particularly low tax rates to attract investment and offer a competitive advantage to their resident companies, but it is also likely to encourage a race to the bottom in terms of tax rates, since this would be the last room for maneuver left to Member States[389].

As for the second point, according to Article 116 of the treaty on the Functioning of the European Union, «*Where the Commission finds that a difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the internal market and that the resultant distortion needs to be eliminated, it shall consult the Member States concerned. If such*

[387] N. Vergnet, *La baisse des taux et la non-harmonisation des assiettes: une situation paradoxale*, in *Revue européenne et internationale de droit fiscal*, 2021, p. 203-217.

[388] European Parliament, *Tax Coordination in the EU*, Working Paper, ECON 128, 2001,p. 65.

[389] N. Nieminen, *Destination-with-credit formula: a simple add-on that would make the CCCTB more resilient in the face of tax competition and tax planning*, in *Intertax*, 2019, p. 491.

*consultation does not result in an agreement eliminating the distortion in question, the European, Parliament and the Council, acting in accordance with the ordinary legislative procedure, shall issue the necessary directives. Any other appropriate measures provided for in the Treaties may be adopted*».

This provision makes it possible to use the ordinary legislative procedure to eliminate distortions of competition due to disparities between the rules of the Member States, when such distortions cannot be eliminated through concerted action. While this is a "nuclear option", its implementation is to be carefully assessed[390]. This solution therefore requires a strong political will on the part of the Commission, but also a lengthy analysis of the disparities between Member States' tax systems, in order to demonstrate the distortions of competition they may cause. The notions of "disparity" and "distortion" are open to interpretation, and it is not certain that, in the absence of general divergences in tax systems, distortions generated by specific tax regimes that do not affect all economic players can be covered[391].

Article 20 of the Treaty on European Union contains a provision whose implementation is encouraged by many authors in order to complete the harmonization of tax systems within the framework of a two-speed Europe[392]. This provision allows a group of at least nine Member States to put forward a joint initiative in the absence of unanimity in the Council. The conditions remain strict since the proposal must concern areas covered by the Treaty, promote the achievement of its objectives, remain within the framework of the Union's non-exclusive competences, and respect the competences, rights and obligations of the Member States which do not participate. It may not affect the internal market, nor economic, social and territorial cohesion. It may not distort competition between Member States and must be activated by at least nine Member States, on the basis of a proposal from the Commission, and constitute the solution of last resort (i.e., it must first be established that it is impossible to reach unanimous agreement).

[390] J. Englisch, *Article 116 TFEU – The Nuclear Option for Qualified Majority Tax Harmonization*, in *EC Tax Review*, 2020, p. 58-61.

[391] *See* Assemblée Nationale, Commission des affaires européennes: Rapport d'information sur l'espace fiscal européen – Jeudi, 9 juillet 2020.

[392] *See* P. Pistone & R. Szudoczky, *Coordination of tax laws and tax policies in the EU*, in M. Lang, P. Pistone, J. Schuch, C. Staringer, *Introduction to European Tax Law on Direct Taxation*, Vienna, 2022, p. 39-64.

Thus, since enhanced cooperation must not be such as to distort competition between Member States, the adoption of a common consolidated tax base by a reduced number of States raises the question of the competitive advantage that this would confer on them and even countries advocating for its establishment, like France, have excluded the use of Article 20[393].

## 3 State aid as the privileged tool to counter harmful tax competition

While it is commonplace to talk about the existence of tax competition between Member States, it is politically much more complicated to come up with effective, legally feasible and long-lasting solutions to monitor all forms of harmful tax competition and find a common, workable solution to preserve the internal market.

There are two main reasons. Firstly, Member States jealously defend their tax sovereignty, limiting the scope and pace of European integration[394]. Secondly, because the provisions of the Treaty dealing respectively with indirect and direct taxation still require unanimity, making it inherently difficult to achieve significant progress in this area[395]. In this regard, the Commission has proposed to replace the unanimity vote on harmonization of taxes by a qualified majority for a «*stronger and more competitive single market*»[396]. Furthermore, the Commission claims that unanimity has allegedly hampered progress on important tax initiatives needed to strengthen the Single Market and boost EU competitiveness. Inaction with regard to the definitive VAT regime, the Common Consolidated Corporate Tax Base, the financial transactions tax and the digital services tax has cost € 292,000,000,000 a year[397].

Although tax harmonization still resists integration mechanisms, the Union has achieved a number of notable successes: the introduction of a common VAT and excise-

[393] Résolution sur la proposition d'assiette commune consolidée pour l'impôt sur les sociétés (ACCIS) considérée comme définitive en application de l'article 151-7 du Règlement le 31 mars 2017, T.A. n° 935 , 31 March 2017.

[394] *See* P. Genschel & M. jachtenfuchs, *How the European Union constrains the state: multilevel governance of taxation*, in *European Journal of political Research*, 2010, p. 297.

[395] Treaty Articles 113 of the Treaty on the Functioning of the European Union and 115 of the Treaty on the Functioning of the European Union.

[396] European Commission, Communication to the European Parliament, the European Policy, COM(2019).

[397] A.P. Dourado, *The Commission proposal to replace unanimity with a qualified majority in the case of tax matters*, in *Intertax*, 2019, p. 341-344; R. de la Feria, *Pillar 2, Fiat, and the EU unanimity rule on tax matters*, in *EC Tax Review*, 2023, p. 2-8.

duty system, the elimination of the risk of double taxation, and the adoption of the "mergers", "parent-subsidiary", "interest-royalty", "savings" directives as well as the Directive on Administrative Cooperation requiring EU member states to share certain information related to tax matters with each other[398].

Yet, faced with these recurring difficulties and the blocking of certain States, the Commission has found legal expedients to limit, if not eradicate, this tax competition by using the other freedoms enshrined in the Treaty. Both the Commission and the Court make use of the free movement of goods, persons, services and, of course, capital[399], but also, and perhaps more surprisingly, of competition law and, in particular, state aid law.

This fight against the illegal disbursement of state aid is in line with the objectives pursued by the Commission in its quest for «*fair competition*» in the Union, since «*among the most significant impediments to free competition we find State aid, and expedient tool of distortion which comes in many forms and disguises*»[400].

Although useful in limiting this tax competition, State aid law is not intended to cover all anti-competitive tax practices. Indeed, only those that qualify as state aid (and in particular the condition of selectivity) fall within the scope of Articles 107 et seq. of the Treaty on the Functioning of the European Union. As for the other tax “advantages” granted by Members States but not falling under the definition of state aid, the options to pursue are limited. They are usually soft law instruments – like the Code of Conduct for Business Taxation – which is «*not an unqualified success* [and] *does not score well in terms of effectiveness*»[401].

This voluntary limitation of the scope of State aid is explained by legal reasons (the notion of State aid and the verification of the criteria set forth in Article 107(1) of

[398] Lawmakers in the European Parliament voted overwhelmingly in support of the eighth iteration of the Directive on Administrative Cooperation (DAC8), a cryptocurrency tax reporting rule, in a plenary session on Sept. 13, 2023.

[399] Since the pioneer judgement *Commission v France* judgment (Case C-270/83), through to *Schumacker* (Case C-279/93), *Marks & Spencer* (Case C-446/03) and *X-Holding* (Case C-337/08), the Court of Justice has taken up the question of the conformity of national tax legislation with the great freedoms enshrined in the Treaty, censuring discriminatory measures that constitute an obstacles to these freedoms.

[400] W. Schön, *Taxation and State Aid Law in the European Union*, in *Common Market Law Review*, 1999, p. 911

[401] H. Gribnau, *Improving the legitimacy of soft law in EU Tax Law*, in *Intertax*, 2007, p. 30-44. On the role of soft law in international tax law, *see* P. Boria, *Il Progetto di Global Minimum Tax e la moderna teoria delle fonti del diritto tributario internazionale*, in *Rivista di Dirittto Tributario Internazionale*, 2021, p. 55-79.

the Treaty on the Functioning of the European Union are part of a legal qualification operation that cannot leave room for subjective elements[402] or for reasons of expediency.

Moreover, European judges regularly highlight that the control of State aid must be neutral with regard to the tax system in force[403]. In fact, «*as Community law currently stands, direct taxation falls within the competence of the Member States*» and «*the application of the Community rules on State aid is without prejudice to the power of the Member States to decide on their economic policy and, therefore, on the tax system – and the common or 'normal' regime under it – which they consider the most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production and economic sectors*»[404].

The Commission's involvement in the field of direct taxation became apparent at the end of the 1990s. After the publication of its Notice on the application of the State aid rules to measures relating to direct business taxation[405], the Commission adopted a series of decisions finding that several Member States had adopted fiscal schemes benefiting solely certain companies, often multinationals[406].

These decisions served as basis for the investigations that the Commission has undertaken into Member States' tax ruling practices since 2013[407]. According to some

[402] General Court, MB System GmbH & Co. KG v European Commission, MB System GmbH & Co. KG v European Commission, Case T-209/11, para 35: «*with regard to the scope of judicial review under Article 107(1) TFEU, it is clear from the case law that the concept of State aid, as defined in that provision, is of a legal nature and must be interpreted on the basis of objective factors. For this reason, the Court of the European Union must, in principle and taking into account both the concrete elements of the dispute submitted to it and the technical or complex nature of the assessments made by the Commission, exercise full control over whether a measure falls within the scope of Article 107(1) TFEU*».

[403] Opinion of Advocate General Maduro, Enirisorse SpA v Sotacarbo SpA, Case C-237/04, para 45: «*The Court is seeking to guard against the scope of the Community rules being broadened to cover distortions of competition that are simply the result of differences in legislative policy between Member States. That caution stems from a concern not to encroach on powers reserved to the Member States. There is a danger that over extension of the State aid rules might result in all economic policy decisions of Member States being brought under the scrutiny of the Community authorities, without any distinction being made between direct interventions in the market and general measures to regulate economic activities*».

[404] Court of Justice of the European Union, European Commission (C-106/09 P) and Kingdom of Spain (C-107/09 P) v Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland., C-106/09, para 146.

[405] Commission notice on the application of the State aid rules to measures relating to direct business taxation (98/C 384/03).

[406] *See, ex multis*, Commission decision in Coordination centres in Vizcaya (2003/81/EC); Commission decisions in Control and coordination centers in Germany (2003/512/EC); Commission decisions in Coordination Centers in Luxembourg (2003/501/EC); Commission decisions in Coordination centers in Belgium (2003/755/EC); Commission decisions in Headquarters and logistics centers in France (Case 2004/76/EC); Commission decisions in US foreign sales corporations (Case 2004/77/EC).

[407] *See* European Commission, DG Competition Working Paper on State Aid and Tax Rulings, 2016.

authors[408], the latter form part of a Commission's wider strategy to fight tax avoidance and promote State aid law as an effective tool in the fight against tax competition in the European Union

### 3.1 Notion of State aid

Article 107(1) of the Treaty defines State aid as «*any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods* […], *in so far as it affects trade between Member States*». Hence, there are different elements which fall into the notion of State aid: (*i*) the existence of an undertaking, (*ii*) measure undertaken by a Member State, (*iii*) its financing through State resources, (*iv*) the granting of an advantage, (*v*) its effect on competition and trade between Member States and (*vi*) the selectivity of the measure[409].

#### 3.1.1 The existence of an undertaking

Regardless of their legal form or method of financing, the Court of Justice has consistently classified undertakings as organizations involved in economic activity[410].

The determination of whether a certain organization qualifies as an enterprise thus fully rests on the nature of its operations. This broad idea has three significant repercussions. First, the entity's legal standing under national law is not important. For instance, an organization that is recognized by national law as an association or a sports club may nonetheless need to be treated as an undertaking for the purposes of Article 107(1). The same holds true for a body that technically belongs to the public administration. Whether it engages in economic activity is the sole important criterion.

[408] A. Gunn & J. Luts, *Tax Rulings, APAs and State Aid: Legal Issues,* in *EC Tax Review*, 2015, p. 119.

[409] *See* Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01).

[410] *See* Court of Justice of the European Union, *Pavlov and Others*, Joined Cases C-180/98 to C-184/98, para 74; Court of Justice of the European Union, *Cassa di Risparmio di Firenze SpA and Others,* C-222/04, para 107.

Second, whether or not the company is designed to make a profit has no bearing on how the State Aid regulations are applied. On a market, non-profit organizations can also sell their products and services[411]. Nonprofit organizations continue to be exempt from State assistance regulation in the absence of this circumstance.

Third, an organization is always categorized as an enterprise in relation to a certain activity. An organization that engages in both economic and non-economic activity should only be considered an endeavor in relation to the former[412].

For the purposes of applying the State assistance regulations, many distinct legal entities may be regarded as constituting a single economic unit. The relevant endeavor is then regarded as that economic unit. The existence of a controlling stake and other functional, economic, and biological linkages are significant in this regard, according to the Court of Justice[413]. The Court of Justice has repeatedly ruled that any activity consisting of supplying products and services on a market is an economic activity, therefore defining the difference between economic and non-economic activities[414].

Depending on how such services are set up in the relevant Member State, the answer to the question of whether there is a market for a certain service may differ from one Member State to another[415]. Furthermore, the categorization of a particular activity may alter over time as a result of political decisions or economic changes. What is not currently an economic activity might, in the future, become one, and vice versa.

A governmental authority's choice to forbid third parties from performing a certain service (for instance, because it prefers to do the service internally) does not exclude the existence of an economic activity. Despite such market closure, there may still be economic activity if other operators are ready and prepared to offer the service in

[411] *See* Court of Justice of the European Union, *Van Landewyck*, Joined Cases 209/78 to 215/78 and 218/78, para 88; Court of Justice of the European Union, *FFSA and Others*, C-244/94, para 21; Court of Justice of the European Union, *MOTOE*, C-49/07, paras 27 and 28.

[412] *See* General Court, *Aéroports de Paris v Commission*, T-128/98, para 108.

[413] *See* Court of Justice of the European Union, *AceaElectrabel Produzione SpA v Commission*, C-480/09 P, paras 47-55; Court of Justice of the European Union, *Cassa di Risparmio di Firenze SpA and Others*, C-222/04, para 112.

[414] *See* Court of Justice of the European Union, *Commission v Italy*, 118/85, para 7; Court of Justice of the European Union, *Commission v Italy*, C-35/96, para 36; Court of Justice of the European Union, *Pavlov and Others*, Joined Cases C-180/98 to C-184/98, para 75.

[415] *See* Court of Justice of the European Union, *Poucet and Pistre*, Joined Cases C-159/91 and C-160/91, paras 16 to 20.

the market in question. More broadly, the economic essence of an activity is unaffected by the fact that a particular service is offered internally[416].

It is arduous to compile a complete list of activities that a priori would never be considered economic since the difference between economic and non-economic activity depends in part on political and economic developments in a Member State. It should be stressed, nonetheless, that merely because an entity owns shares—even a majority shareholding—in an enterprise that sells products or offers services on a market, such entity should not always be regarded as an enterprise for the purposes of Article 107(1) of the Treaty. However, if a shareholding solely results in the exercise of shareholder rights and, if appropriate, dividend payments, which are just byproducts of asset ownership, that company will not be regarded as an enterprise if it does not itself supply a market for products or services[417].

### 3.1.2 Measure undertaken by a Member State

Article 107(1) of the Treaty on the Functioning of the European Union makes a distinction between help given by the state and aid given using resources provided by the state. In accordance with the European Court of Justice's body of precedent, the notion of state aid includes «*not only aid granted directly by the State but also aid granted by public or private bodies designated or established by the State*»[418].

The state origin of the means utilized for the help and the imputability to the state of these means are two requirements for the existence of this criterion, according to ECJ case law. These prerequisites must all be met cumulatively. Hence, state resources are state resources are therefore «*all the financial means by which the public authorities may*

[416] *See* Opinion of Advocate General Geelhoed, Asociación *Nacional de Empresas Forestales (Asemfo)*, C-295/05, paras 110-116.

[417] *See* Court of Justice of the European Union, *Cassa di Risparmio di Firenze SpA and Others*, C-222/04, paras 107-118.

[418] *See* Court of Justice of the European Union, *Openbaar Ministerie (Public Prosecutor) of the Kingdom of the v Jacobus Philippus van Tiggele*, Case 82/77; Court of Justice of the European Union, *Norddeutsches Vieh- und Fleischkontor Herbert Will, Trawako, Transit-Warenhandels-Kontor GmbH & Co., and Gedelfi, Großeinkauf GmbH & Co., v Bundesanstalt für landwirtschaftliche Marktordnung*, Joined cases 213 to 215/81; Court of Justice of the European Union, *Norddeutsches Vieh- und Fleischkontor Herbert Will, Trawako, Transit-Warenhandels-Kontor GmbH & Co., and Gedelfi, Großeinkauf GmbH & Co., v Bundesanstalt für landwirtschaftliche Marktordnung*, Joined cases 213 to 215/81.

*actually support undertakings, irrespective of whether or not those means are permanent assets of the public sector»*[419].

As a result, the legal standing of the institution responsible for giving the funds is not relevant. However, the measure must be imputable to the state in order to qualify as a state measure. This is not exclusively due to the fact that the institution is state-owned. It is also insufficient that the State controls or has a dominant influence on the institution. Rather, governmental involvement or control over funding distribution must be concretely established and indicators provided by the Commission are necessary[420]. For example, the factors to be examined are, in particular, the undertaking's integration into public administration structures; the nature of its activities and their exercise in normal competition with private operators; the legal status of the undertaking (i.e. whether it is governed by public law or general company law); the intensity of the public authorities' supervision of the undertaking's management; and any other indicia showing involvement by the public authorities in the adoption of a measure, having regard also to its scope, content or conditions[421].

### 3.1.3 Financing through State resources

Only benefits supplied directly or indirectly through State resources can be considered State aid under Article 107(1) of the Treaty of Rome.

State resources encompass all public-sector resources[422], including intra-State entities (decentralized, federated, regional, or other)[423] and, in some cases, private-sector resources. It makes no difference whether or not a public-sector entity is autonomous[424].

[419] *See* Court of Justice of the European Union, *French Republic v Commission of the European Communities*, Case C-482/99.

[420] *See* Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01).

[421] *See* Court of Justice of the European Union, Fren*ch Republic v Commission of the European Communities*, Case C-482/99.

[422] *See* General Court, *Air France v Commission*, T-358/94, para 56.

[423] *See* Court of Justice of the European Union, *Germany v Commission*, 248/84, para 17; General Court, *Territorio Histórico de Álava and Others v Commission*, Joined Cases T-92/00 and 103/00, para 57.

[424] *See* Court of Justice of the European Union, Air France v Commission, T-358/94, para 58-62.

Funds granted by a Member State's central bank to specific credit institutions often indicate the transfer of State resources[425].

Because the State has the ability to direct the use of these resources, resources of public undertakings also comprise State resources under Article 107(1) of the Treaty[426]. Transfers within a public group may also constitute State help for the purposes of State aid law if, for example, resources are moved from the main firm to its subsidiary even though they comprise a single enterprise from an economic standpoint[427].

The fact that a public undertaking is a recipient of one assistance measure does not preclude it from granting aid to another beneficiary through a different aid measure[428].

The fact that a measure offering an advantage is not directly funded by the State, but rather through a public or private organization formed or designated by the State to administer the aid, does not necessarily imply that the measure is not funded with State funds[429]. A measure enacted by a public authority that favors specific enterprises or goods does not lose its gratuitous nature because it is completely or substantially funded by contributions imposed by the public authority and levied on the undertakings involved[430].

State resources can be transferred in a variety of ways, including direct grants, loans, guarantees, direct investment in company capital, and rewards in kind. A definite and concrete promise to make State resources available at a later date is also seen as a transfer of State resources. A positive transfer of monies is not required; forsaking State revenue suffices. Waiving money that would have otherwise been paid to the state is a transfer of state resources[431].

[425] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favor of banks in the context of the financial crisis.

[426] *See* Court of Justice of the European Union, *France v Commission*, C-482/99, para 38.; Court of Justice of the European Union, *Greece v Commission*, C-278/00, paras 53-54; Court of Justice of the European Union, *Italy and SIM 2 Multimedia SpA v Commission*, Joined Cases C-328/99 and C-399/00, paras 33 and 34.

[427] *See* Court of Justice of the European Union, *SFEI and Others*, C-39/94, para 62.

[428] *See* General Court, *Freistaat Sachsen and Land Sachsen-Anhalt and Others v Commission*, Joined Cases T-443/08 and T-455/08, para 143.

[429] *See* Court of Justice of the European Union, *Steinike & Weinlig*, 78/76, para 21.

[430] *See* Court of Justice of the European Union, *Steinike & Weinlig*, 78/76, para 22

[431] *See* Court of Justice of the European Union, *France v Ladbroke Racing Ltd and Commission*, C-83/98 P, paras 48-51.

A “shortfall” in tax and social security revenue, for example, due to Member State exemptions or reductions in taxes or social security contributions, or exemptions from the obligation to pay fines or other pecuniary penalties, satisfies the State resources requirement of Article 107(1) of the Treaty[432]. A guarantee or a contractual offer that creates a concrete risk of imposing an extra cost on the State in the future is adequate for the purposes of Article 107(1)[433].

Providing access to a public domain or natural resources, or providing special or exclusive rights, without proper compensation in accordance with market prices, can result in the loss of State income. In these cases, it must be determined whether the State, in addition to its role as manager of the public assets in question, acts as a regulator pursuing policy objectives by subjecting the selection process of the concerned undertakings to qualitative criteria[434].

When the State acts as a regulator, it can legitimately decide not to maximize revenues that could otherwise be achieved without falling under the scope of State aid rules, provided that all operators involved are treated in accordance with the principle of non-discrimination, and that there is an inherent link between achieving the regulatory purpose and foregoing revenue[435]. In any instance, a transfer of State resources exists if the public authorities do not charge the customary sum under their general system for access to the public domain or natural resources, or for giving specific special or exclusive rights in a given situation.

When a negative indirect effect on State income is an inherent component of a regulatory policy, it does not represent a transfer of State resources[436]. For example, a departure from employment law rules that alters the framework for contractual contacts between enterprises and employees does not represent a transfer of State resources, even if it reduces social security contributions or taxes owed to the State. Similarly, national

[432] *See* Court of Justice of the European Union, *Banco Exterior de España*, C-387/92, para 14; Court of Justice of the European Union, *Piaggio*, C-295/97, paras 40-43; Court of Justice of the European Union, *Ecotrade*, C-200/97, para 45.

[433] *See* Court of Justice of the European Union, *Ecotrade*, C-200/97, para 41; *See* Court of Justice of the European Union, *Bouygues and Bouygues Télécom v Commission and Others*, Joined Cases C-399/10 P and C-401/10 P, paras 137-139.

[434] *See* General Court, *Bouygues SA v Commission*, T-475/04, para 104.

[435] *See* General Court, *Bouygues SA v Commission*, T-475/04, paras 108-111; Court of Justice of the European Union, *Bouygues and Bouygues Télécom v Commission*, C-431/07 P, paras 94-98.

[436] *See* Court of Justice of the European Union, *PreussenElektra*, C-379/98, para 62.

legislation that establishes a minimum price for specific items does not imply the transfer of State resources[437].

### 3.1.4 The granting of an advantage

Any economic gain that an undertaking could not have gotten under normal market conditions, that is, in the absence of State interference, is the definition of advantage under Article 107(1) of the Treaty[438]. Only the effect of the measure on the activity is important, not the motive or goal of the government action[439].

An advantage exists if an undertaking's financial status improves as a consequence of State involvement on terms that differ from regular market circumstances. To determine this, compare the undertaking's financial condition after the action to its financial situation if the measure had not been adopted[440]. Because only the effect of the measure on the undertaking is important, it makes no difference whether the advantage is mandatory for the undertaking in the sense that it cannot avoid or refuse it[441]. The specific shape of the measure is also immaterial in determining whether it provides the venture with an economic advantage[442]. Not only is the provision of positive economic benefits relevant to the concept of State help, but alleviation from economic burdens like reduction of social security contributions can also be considered an advantage. The latter is a wide category that includes any reduction in charges that would ordinarily be included in an undertaking's budget[443]. This includes any circumstance in which economic operators are freed of the costs associated with their economic operations[444].

[437] *See* Court of Justice of the European Union, *Van Tiggele*, 82/77, paras 25-26.

[438] *See* Court of Justice of the European Union, *SFEI and Others*, C-39/94, para 60; *See* Court of Justice of the European Union, *Spain v Commission*, C-342/96, para 41.

[439] *See* Court of Justice of the European Union, *Italy v Commission*, 173/73, para 13.

[440] *See* Court of Justice of the European Union, *Italy v Commission*, 173/73, para 13.

[441] *See* Opinion of Advocate General Fennelly, *France v Commission*, C-251/97, para 26

[442] *See* Court of Justice of the European Union, *Altmark Trans*, C-280/00, para 84.

[443] *See* Court of Justice of the European Union, *Banco Exterior de España*, C-387/92, para 13; Court of Justice of the European Union, *Germany v Commission*, C-156/98, para 25; Court of Justice of the European Union, *Italy v Commission*, C-6/97, para 15; Court of Justice of the European Union, *Heiser*, C-172/03, para 36.

[444] *See* Court of Justice of the European Union, *GEMO SA*, C-126/01, paras 28-31.

For example, if a Member State pays a portion of the costs of a certain enterprise's staff, that undertaking is relieved of costs inherent in its economic activity. There is also a benefit when public authorities give a wage supplement to the employees of a certain enterprise, even if the company was not legally required to pay such a supplement[445]. It also includes circumstances in which certain operators are exempt from bearing expenses that other comparable operators would typically face under a specific legislative order, regardless of the noneconomic character of the activity to which the costs pertain.

Costs deriving from State regulatory duties might be seen to be intrinsic costs of the economic activity, therefore any reimbursement for these costs puts an advantage on the endeavor[446]. This indicates that the presence of an advantage is not ruled out by the fact that it does not go beyond reimbursement for a cost incurred as a result of the application of a regulatory duty. The same is true for reimbursement for expenditures that the undertaking would not have incurred if there had been no incentive from the State measure, because the undertaking would have organized its operations differently if there had been no incentive. An advantage is also not ruled out if a measure compensates for charges of a different sort that are unrelated to that measure[447].

In terms of reimbursement for expenditures paid in providing a service of wide economic interest, the Court stated in the *Altmark* decision that the awarding of an advantage can be avoided if four cumulative requirements are satisfied[448].

To begin, the beneficiary endeavor must have genuine public service commitments to fulfill, and those requirements must be clearly specified. Second, the parameters used to determine compensation must be specified in advance in an objective and transparent manner. Third, the remuneration cannot exceed what is required to compensate all or a portion of the costs spent in carrying out public service responsibilities, after deducting applicable revenues and a fair profit. Fourth, where the undertaking that is to discharge public service obligations is not chosen through a public procurement procedure to select a tenderer capable of providing these services at the

[445] *See* Court of Justice of the European Union, *France v Commission,* C-241/94, para 40; Court of Justice of the European Union, *Belgium v Commission,* C-5/01, paras 38-39; General Court, *Corsica Ferries France SAS v Commission*, T-565/08, paras 137-138.

[446] *See* Court of Justice of the European Union, *Belgium v Commission,* T-538/11, paras 74 to 78.

[447] *See* Court of Justice of the European Union, *France Télécom SA v Commission*, C-81/10 paras 43-50.

[448] *See* Court of Justice of the European Union*, Altmark Trans,* C-280/00, paras 78-95.

lowest possible cost to the community, the level of compensation required must be determined based on an analysis of the costs that a typical undertaking, well-run and adequately equipped to meet public service requirements, would have incurred in discharging those obligations. In its Communication on the application of European Union State assistance regulations to compensation provided for the performance of services of wide economic importance, the Commission clarified on its understanding of these circumstances.

In the case of a repayment of unjustly imposed taxes[449], a requirement for national authorities to compensate for harm they have caused to specific businesses[450] or the payment of compensation for an expropriation, the presence of an advantage is precluded. The existence of an advantage is not ruled out simply because competing undertakings in other Member States are in a better position Judgment of the Court of Justice of 2 July 1974, Italy v Commission, 173/73, ECLI:EU:C:1974:71, paragraph 17[451]. because the concept of advantage is based on an analysis of an undertaking's financial situation in its own legal and factual context with and without the particular measure.

### 3.1.5 Effect on competition and trade between Member States

Public assistance to enterprises is only considered State aid under Article 107(1) of the Treaty if it «*distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods*» and only if it affects trade between Member States. These are two different and necessary components of the concept of assistance. In reality, however, because they are intricately intertwined, these criteria are frequently evaluated together in the evaluation of State aid[452].

When a measure provided by the state is likely to boost the recipient's competitive position in comparison to other undertakings with whom it competes, it is regarded to

[449] *See* Court of Justice of the European Union, *Amministrazione delle finanze dello Stato*, 61/79, paras 29-32.

[450] *See* Court of Justice of the European Union, *Asteris AE and Others v Greece*, Joined Cases, 106 to 120/87, paras 23-24

[451] *See* General Court, *Confederación Espanola de Transporte de Mercancías v Commission*, T-55/99, par 85.

[452] *See* General Court, *Alzetta*, Joined Cases T-298/97, T-312/97, para 81.

distort or threaten to distort competition[453], Court of Justice of the European Union, *Philip Morris*, para 11. A distortion of competition within the sense of Article 107(1) of the Treaty is typically considered to occur when the State offers a financial advantage to an entity in a liberalized area where there is or may be competition[454].

The fact that the authorities delegate a public service to an in-house provider (even though they are permitted to delegate that function to other parties) does not rule out the possibility of a competitive distortion. However, if the following cumulative requirements are fulfilled, a possible distortion of competition is ruled out: (*i*) a service is subject to a legal monopoly; (*ii*) the legal monopoly excludes not only competition on the market, but also competition to become the exclusive provider of the service in question[455]; (*iii*) the service is not in competition with other services; and (*iv*) Cross-subsidization must be avoided if the service provider is involved in another geographic or product market that is open to competition. This necessitates the use of separate accounts, the allocation of expenses and revenues, and the prohibition on using public funds given for the service subject to the legal monopoly to benefit other enterprises.

Even if it does not assist the receiving company in expanding and gaining market share, public assistance has the potential to distort competition. It is sufficient that the help allows it to retain a stronger competitive position than it would have had otherwise. In this respect, it is usually sufficient for aid to be regarded distorting competition if it offers the recipient an advantage by relieving it of expenditures that it would otherwise have had to endure in the course of its day-to-day business activities[456]. The notion of State aid does not need a major or material distortion of competition or influence on commerce. The fact that the quantity of help is minimal or that the beneficiary enterprise is small does not rule out a distortion of competition or the prospect of such a distortion[457] provided that the probability of such a distortion is not just speculative[458].

[453] *See* General Court, *Alzetta*, Joined Cases T-298/97, T-312/97, para 80.

[454] *See* General Court, *Alzetta*, Joined Cases T-298/97, T-312/97, paras 141-147; Court of Justice of the European Union, *Altmark Trans*, C-280/00.

[455] *See* General Court, *Germany v Commission*, T-295/12, para 158

[456] *See* Court of Justice of the European Union, *Heiser*, C-172/03, para 55.

[457] *See* General Court, *Confederación Espanola de Transporte de Mercancías v Commission*, T-55/99, para 89; Court of Justice of the European Union, *Altmark Trans*, C-280/00, para 81.

[458] Court of Justice of the European Union, *Altmark Trans*, C-280/00, para 79.

### 3.1.6 Selectivity of the measure

A State measure must favor «*certain undertakings or the production of certain goods*» in order to be included under Article 107(1) of the Treaty. As a result, not all actions that benefit economic operators qualify as aid, but only those that provide a selective advantage to certain enterprises, groups of undertakings, or economic sectors. Measures of merely broad applicability that do not favor specific businesses or the production of specific items do not fall within the meaning of Article 107(1) of the Treaty. However, case law has established that even interventions that appear to apply to all enterprises may be selective and interpreted as measures aimed to favor specific enterprises[459].

Neither a large number of eligible undertakings – which can include all undertakings in a given sector – nor the diversity and size of the sectors to which they belong provide grounds for concluding that a state measure constitutes a general measure of economic policy, if not all economic sectors can benefit from it[460].

The fact that the aid is not aimed at one or more specific recipients defined in advance but is subject to a set of objective criteria under which it may be granted to an indefinite number of beneficiaries who are not initially individually identified, is insufficient to call the measure's selective nature into question[461]. The measure in question in that case was a partial exemption from excise duty on the diesel used for the heating of greenhouses. The General Court indicated that the fact that the exemption could benefit all undertakings choosing greenhouse production was not sufficient to establish the general character of the measure.

To define the concept of selectivity under State assistance legislation, it is necessary to distinguish between material and geographical selectivity. Furthermore, it is useful to give further advise on particular difficulties related to tax (or similar) policies. The material selectivity of a measure indicates that it applies exclusively to particular

[459] *See* Court of Justice of the European Union, *DMTransport*, C-256/97, para 27; General Court, *Territorio Histórico de Álava — Diputación Foral de Álava et aL. v Commission*, Joined Cases T-127/99, T-129/99 and T-148/99, para 149.

[460] *See* Court of Justice of the European Union, *Belgium v Commission*, C-75/97, para 32; Court of Justice of the European Union, *Adria-Wien Pipeline, C-143/99*, para 48.

[461] *C*, *Confederación Espanola de Transporte de Mercancías v Commission*, T-55/99, para 40; Court of Justice of the European Union, *Italy v Commission*, T-379/09, para 47.

undertakings or sectors of the economy in a certain Member State. Material selectivity can be established either *de jure* or *de facto*.

*De jure* selectivity arises directly from the legal criteria for granting a measure that is formally reserved for only certain undertakings (for example: those of a certain size, active in certain sectors, or having a certain legal form)[462]; companies incorporated or newly listed on a regulated market during a specific period[463]; companies belonging to a group with certain characteristics or entrusted with certain functions within a group[464]; ailing companies[465]; or export undertakings or undertakings performing export-related activities[466].

*De facto* selectivity can be proven when, despite the fact that the legal criteria for applying the measure are articulated in universal and objective terms, the measure's structure is such that its effects considerably favor a certain group of undertakings[467].

*De facto* selectivity may come from restrictions implemented by Member States that prohibit particular businesses from benefiting from the legislation. Applying a tax measure such as a tax credit solely to investments surpassing a specific threshold may imply that the measure is de facto reserved for large financial operations[468]. A measure that provides specific benefits for a limited time may also be de facto selective[469].

[462] *See* Court of Justice of the European Union, *Paint Graphos and others*, Joined Cases C-78/08 to C-80/08, para 52.

[463] *See* General Court, *Italy v Commission*, T-211/05, para 120; Court of Justice of the European Union, *Italy v Commission*, C-458/09 P, paras 59-60.

[464] *See* Court of Justice of the European Union, *Belgium and Forum 187 v Commission*, Joined Cases C-182/03 and C-217/03, para 122.

[465] *See* General Court, Heitkamp *Bauholding v Commission*, T-287/11, para 129.

[466] *See* Court of Justice of the European Union, *Commission v France*, Joined Cases 6 and 11/69, para 3; Court of Justice of the European Union, *Greece v Commission*, 57/86, para 8; Court of Justice of the European Union, *Spain v Commission*, C-501/00, para 92.

[467] *See* Court of Justice of the European Union, *Commission and Spain v Government of Gibraltar and United Kingdom*, Joined Cases C-106/09 P and C-107/09 P.

[468] *See* General Court, *Ramondin SA and Ramondín Cápsulas SA v Commission*, Joined Cases T-92/00 and T-103/00, para 39.

[469] *See* General Court, *Italy and Brandt Italia v Commission*, Joined Cases T-239/04 and T-323/04, para 66; General Court, *Italy v Commission*, T-211/05, para 120; Court of Justice of the European Union, *Italy v Commission*, C-458/09 P, paras 59-60.

## 3.2 The "selectivity of the tax measure" criterion

As we have seen in the previous paragraph tax measure falls within the scope of Article 107 TFEU only if it is "selective" that is if it is likely to «*favour certain undertakings or the production of certain goods*». *A contrario*, therefore, if the measure in question is indiscriminately applicable to all sectors and all economic operators, it is not a prohibited State aid, but a general measure which States must endeavor to harmonize.

Determining the "selective" nature of the offending tax measure is therefore decisive in determining how State aid law will apprehend this tax competition. However, this exercise ranges from simple hypotheses, easily identifiable and therefore easily censured by the Commission, to much more complex schemes which automatically open up a more discretionary field of assessment to the Commission.

With regard to the first category, the French Borotra plan to grant aid only to companies active in the leather, footwear and textile sectors[470], the Italian tax credit scheme instituted solely for the road haulage sector[471], a system of tax exemptions reserved solely for public service companies with a majority public shareholding sector[472], an Italian law instituting specific tax treatment for bodies specializing in the holding of shares in companies with low or medium capitalization[473], a tax system applying only to companies producing intangible goods[474], excise duty exemptions granted by several member countries on mineral oils used by companies active in the production of alumina[475].

In all these cases, the sector or companies benefiting from the tax advantage are "isolated" within the scheme itself, so that the Commission can classify them as aid and, more often than not, censure them by applying articles 107 et seq. of the TFEU. In other cases, the Commission uses two criteria to determine the selectivity of the measures in question.

[470] *See* Court of Justice of the European Union, French Republic v Commission,*C-251/97.*

[471] *See* Court of Justice of the European Union, *Italy v Commission,C-6/97.*

[472] *See* Court of Justice of the European Union, *Iride et Iride Energia c/ Commission, C-25/07.*

[473] *See* Court of Justice of the European Union, *Ass. Italiana del risparmio gestito c/ Commission, C-445/05.*

[474] *See* Court of Justice of the European Union, *Adria-Wien Pipeline, C-143/99, C-143/99.*

[475] *See* Court of Justice of the European Union, *Ireland v. Commission, C-143/99.*

Firstly, if the State author of the tax provision in question retains a discretionary power of assessment in its implementation, it constitutes State aid because «*where the body granting financial assistance enjoys a degree of latitude which enables it to choose the beneficiaries or the conditions under which the financial assistance is provided, that assistance cannot be considered to be general in nature*»[476].

Consequently, as soon as the authority granting an advantage is free to choose the beneficiary or the amount, or to modulate or refuse to grant the measure in a discretionary manner (i.e., outside the scope of pre-established rules and objective and known criteria), the legislation in question is selective and constitutes State aid within the meaning of the Treaty. For example, a Dutch tax mechanism allowing special provisions to be set aside for foreign establishments subject to an individual authorization regime[477], or the agreement reached by the Bulgarian authorities with the sole company MOL to allow it to continue to benefit from a reduced mining royalty rate[478].

Secondly, the Commission considers that State aid is involved when the measure in question derogates from the application of general tax law. Thus, when a tax measure is reserved for certain operators[479] or operations[480].

In other words, to be qualified as selective, tax measures «*effectively open to all firms on an equal access basis, and they may not de facto be reduced in scope through, for example, the discretionary power of the State to grant them or through other factors that restrict their practical effect. However, this condition does not restrict the power of Member States to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production*» and «*provides in favor of certain undertakings in the Member State an exception to the application of the tax system*»[481]. The Commission's qualification task therefore requires it to determine the "reference framework"[482] and then to examine

[476] *See* Court of Justice of the European Union, *DM Transport, C-256/97.*

[477] *See* Court of Justice of the European Union, *Koninklijke Friesland Foods c/ Commission, T-348/03.*

[478] *See* General Court, *MOL Magyar Olaj c/ Commission*, T-499/10.

[479] *See* Court of Justice of the European Union, *France et France Telecom c/ Commission,* T-427/04 and T-17/05; Court of Justice of the European Union, *France et France Telecom c/ Commission*, C-81/10 P*;* Court of Justice of the European Union, *Ministerio de Defensa, Navantia c/ Concello de Ferrol,* C-522/13.

[480] *See* Court of Justice of the European Union, *Paint* Graphos, C-*78/08 to C-80/08.*

[481] Commission notice on the application of the State aid rules to measures relating to direct business taxation(98/C 384/03), paras 13-16.

[482] *See* Court of Justice of the European Union, *P Oy,* C-*6/12.*

whether the tax measures in question are part of this general system or derogate from it. In the first alternative, the measure does not constitute state aid, and is not subject to Commission scrutiny[483].

In the second, the measure is selective and falls within the scope of Article 107(1) of the Treaty on the Functioning of the European Union. Subsequently, the Commission will be in a position to censure the measure. Although the Court of Justice has somewhat relaxed the rules by allowing States to reduce the reference framework of the tax system within regional rather than national geographical limits[484], it must be noted that the Commission most often concludes that aid schemes exist.

In light of the above, it is difficult not to see aid law as a tool  in the fight against tax competition between Member States through specific legislation or simple *ad hoc* measures or, alternatively, the «*powerful weapon at the hands of the Commission*»[485].

### 3.2.1 Excessive widening of the concept of selectivity?

One of relevant relevant development in the category of selectivity is undoubtedly *Commission v. Hansestadt Lübeck*[486], in which the Court of Justice confirms the annulment by the Court of First Instance of the Commission's decision to carry out a formal investigation procedure against the regulation on airport charges applicable to Lübeck airport, given that it failed to demonstrate the selective nature of the measure. More specifically, to determine whether the fees charged by a public authority for the supply of goods or services are selective, the General Court stated that all firms that use or intend to use such goods and services must be considered, and it must be determined whether some of them may benefit from an advantage. The G General Court C further noted that, because German aviation legislation authorized each airport manager to decide the costs payable to airlines utilizing its facilities, the 2006 schedule applied solely

[483] *See* Court of Justice of the European Union, Ministero dell’Economia e delle Finanze and Agenzia delle Entrate v Paint Graphos Soc. coop. arl (C-78/08) Adige Carni Soc. coop. arl, in liquidation v Agenzia delle Entrate and Ministero dell’Economia e delle Finanze (C-79/08) and Ministero delle Finanze v Michele Franchetto (C-80/08).

[484] *See* Court of Justice of the European Union, Portuguese Republic v Commission of the European Communities, Case C-88/03.

[485] D. Kyriazis, *Fiscal state aid law and harmful tax competition in the European Union*, in *Yearbook of European Law,* 2022, p. 313.

[486] *See* Court of Justice of the European Union, European Commission v Hansestadt Lübeck, C-524/14 P.

to flights departing from Lübeck Airport and not to flights departing from other airports. As a result, only the airlines utilizing Lübeck Airport were in a comparable position.

After the appeal of the Commission, the Court of Justice stated that all firms that use or intend to use such goods and services must be considered to determine whether the fees charged by a public authority for the supply of goods or services are selective. It must be determined whether some of them may benefit from an advantage. The Court further noted that, because German aviation legislation authorized each airport manager to decide the costs payable to airlines utilizing its facilities, the 2006 schedule applied solely to flights departing from Lübeck Airport and not to flights departing from other airports. As a result, only the airlines utilizing Lübeck Airport were in a comparable position[487].

*Commission v. Hansestadt Lübeck* has been an important judgement but one of the pivotal ones is undoubtedly *World Duty* Free[488]. Here, the tax relief under investigation had been introduced by the Spanish state in 2004 through an amendment to the *Ley del Impuesto sobre Sociedades* and made the subject of an investigation by the Commission, which had identified its selective character in the asymmetrical structure of the benefit, granted to the taxpayer who had acquired shareholdings of foreign companies and not to those who had carried out similar transactions with respect to Spanish companies.

The General Court had annulled the Commission's decision, holding that, with respect to such measures, structured as incentives to carry out specific transactions, genuinely open to all taxpaying companies, it was necessary to identify the characteristic features of the exclusive companies benefiting from the advantage[489].

On appeal, the European Court of Justice, following the opinion of AG Wathelet, overruled this interpretation, stating: «*since it is a national measure that confers a tax advantage of general application, the requirement of selectivity is satisfied when the Commission arrives at demonstrating that the measure in question derogates from the*

[487] *See* H.A. Petzold, *Airport selection – New tools or loopholes opened?*, in *European State Aid Law Quarterly*, 2017, p. 285-287.

[488] *See* Court of Justice of the European Union, European Commission v World Duty Free Group SA and Others, C-20/15.

[489] *See* General Court, World Duty Free Group, SA, formerly Autogrill España, SA v European Commission, T-209/10.

*"normal" tax regime applicable in the Member State concerned. Therefore, the measure would introduce, through its concrete effects, differential treatment between operators, where operators benefiting from the tax advantage and those excluded from it are in terms of the objective pursued by the tax system of that Member State in a similar factual and legal situation*»[490].

This interpretation seems to contradict Article 107(1) TFEU and the established case law, which identified the "selectivity" of the measure in the State's desire to favor certain operators or economic sectors clearly identifiable ex ante. Moreover, as pointed out since the first comments to the judgment, the concrete use of the advantage for operators belonging to all economic sectors, would seem, at first sight, to demonstrate the highest degree of "generality".

In the perspective of the Court of Justice, it is irrelevant whether the tax relief is granted to operators who are identifiable *ex ante*, on the basis of their distinctive features, or only *ex post*, in that they have carried out the transaction. Instead, the contrast between the Spanish state's regulatory choice and the reference tax model, which, requires that the tax burden be graduated solely on the basis of the companies' ability to pay, is striking.

Alongside the systematic profile, the ruling under review assumes relevance for its application consequences, which the Court shows it is not ignoring. Faced with the risk that the mere derogation from a "tax law of general application" may be equated with state aid, the Court stresses, in concluding its legal analysis, that the relevant determination «*that examination must be carried out rigorously and while sufficient reasons must be stated to permit full judicial review, in particular of the question whether the situation of operators benefiting from the measure is comparable with that of operators excluded from it and, where appropriate, of the justification for discrimination relied on by the Member State concerned, the fact remains that the General Court erred in law by not undertaking such a review, and by ruling, in the judgments under appeal, that the examination method applied by the Commission in the contested decisions, in failing to define a particular category of undertakings which were exclusively favored by the tax measure at issue, was based on a misinterpretation of the condition relating to*

[490] *See* Court of Justice of the European Union, European Commission v World Duty Free Group SA and Others, C-20/15, paras 66-94.

*selectivity as laid down by Article 107(1) TFEU*»[491]. Yet, according to some commentators, the Court interpreted selectivity in an overly extensive manner, which may contribute to the devaluation of the selectivity criterion[492].

The CJEU deduces the presence of selectivity from the fact that undertakings will be preferred over others in analogous situations, maintaining only the measure's impact. However, it is maintained that it was not a measure that was reserved for certain enterprises, but rather a measure that offered an advantage to those undertakings that decided to participate in a specific activity, an option that was accessible to all, without discrimination. An unconditional tax break related to a non-selected activity does not appear to be selective. This decision is seen by some commentators as fueling confusion and calling into question a number of tax measures that did not appear to be State aid until now. More importantly, it raises serious concerns that the Commission could control virtually all direct taxation measures, a competence fundamentally retained by the Member States[493].

It has been argued that it is a misconception to believe that the Member States are alone in charge of the EU's state aid policy-making process. Due to the broad and expansive interpretation of the Court of Justice, the European Commission has been able to operate quite independently and against the wishes of the Member States[494].

### 3.2.2 What limits to tax selectivity?

The analysis of "selectivity" should address the rulings on two taxes introduced by Hungary and Poland, which were initially qualified as state aid by the Commission and later deemed non-selective by the Court of Justice[495].

[491] *See* Court of Justice of the European Union, European Commission v World Duty Free Group SA and Others, C-20/15, para 94.

[492] *See* P. Nicolaides, *Excessive widening of the concept of selectivity*, in *European State Aid Law Quarterly*, 2017, p. 62-72; S. Piotrowski, *Selectivity in corporate tax matters after World Duty Free: a tale of two consistencies revisites*, in *Intertax*, 2018, p. 156-166.

[493] J. Derenne, *Commission v World Duty Free a.o.: Selectivity in (fiscal) state aid, quo vadis curia*, in *Journal of European Competition Law & Practice*, 2017, p. 311-313.

[494] C. Peters, *Tax policy convergence and EU fiscal state aid control: in search of rationality,* in *EC Tax Review*, 2019, p. 14.

[495] Court of Justice of the European Union, Hungary v Commission, T-20/17, para. 80–83; Poland v Commission, T-836/16 and T-624/17, para. 65.

The two regulations introduce turnover taxes on taxpayers whose ability to contribute to public burdens is greater than general tax obligations. The first peculiarity is the circumscribed sectoral scope: the Hungarian tax covered retail trade, telecommunications, and energy while the Polish tax only the retail sector. Second, both taxes considered taxable turnover over the entire group and not solely with respect to companies located in the domestic territory, which evidently affected multinational groups to a greater extent. Finally, the two regulations had a highly progressive structure, so that the first bracket – in which enterprises with smaller turnover fell – had a rate of 0 %, resulting in exemption from the tax, while in subsequent brackets the rate rose sharply to 20 %.

After affirming the three-element selectivity test in paint *Graphos*[496], the Commission considered that the combined effect of these criteria showed industrial policy purposes unrelated to taxation and, in particular, a desire to tax multinational companies more heavily than smaller companies in strategic economic sectors[497].

In contrast, first the General Court and then the Court of Justice held that such regulations did not contravene Article 107(1) TFEU, as the Member States are free to establish the system of taxation which they consider most appropriate and cannot be charged with having introduced a tax having certain characteristics, unless it «*signed in a manifestly discriminatory manner, with the aim of circumventing the requirements of EU law on State aid*»[498].

Given the undoubted need not to inhibit the ability of states to tax multinationals, especially in light of the institutional *impasse* in the EU institutions, the ruling risks

[496] The selective nature of tax measures must be assessed on the basis of a three-step test: (*i*) identify the reference system; (*ii*) assess if the measure deviates from the reference system; (*iii*) justify by the nature and the design of the reference system. *See* Court of Justice of the European Union, *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. Paint Graphos Soc. coop. arl*, C-78/08.

[497] Commission decision (EU) 2018/160 on the State aid (2016/C) implemented by Poland for the tax on the retail sector, para 36: «*The progressive character of the tax has the effect that not only the amount of tax but also the average percentage of the tax levied on a retailer's turnover from retail sales increases when its turnover increases and reaches the next upper bracket. As a result, retailers with low turnover are either not subject to the retail tax or subject to the tax at substantially lower average effective rates than retailers with high turnover, thereby reducing the charges that undertakings with low turnover have to bear as compared to undertakings with high turnover. Since the amount of turnover achieved by an undertaking correlates to a certain extent with the size of that undertaking, the progressive rate structure under the Act can be said to confer an economic advantage on smaller retailers to the detriment of larger retailers in the form of a reduction of their tax burden and a reduction in the average effective tax rate to which those undertakings are subject*».

[498] Court of Justice of the European Union, European Commission v Hungary, Case C-596/19 P, para 50.

depowering the effectiveness of the institution. The assertion, in absolute terms, that the concrete modulation of the rate falls within national competence except in cases of "manifest abuse", in fact, could lead states to abuse their tax competence, discriminating, but doing so, precisely, in a non-manifest manner. In other words, the introduction of a materiality threshold under Article 107(1) TFEU seems to be an ambiguous parameter[499].

In this framework, the Court held that *Gibraltar* can be relied on to find that a given measure is selective only when «*the tax system had been configured according to manifestly discriminatory parameters intended to circumvent EU law on State aid*»[500]. If other tax systems are internally consistent in terms of their legislative wording but in reality, are intended to favor particular activities ("de facto selectivity"), the question is whether they might be viewed as discriminatory. The answer appears to be no given the Court's current understanding of Gibraltar. However, this strategy is problematic since it restricts the Commission's ability to challenge discriminatory tax policies. Another effect of the ruling is that the Commission would going forward have a very high burden of proof and so this opened the door for Member States to arbitrarily shape their progressive tax systems to differentiate the economic situation of certain market players, and hence distort competition[501].

## 4 The role of the Court of Justice and the European Commission in the fight against harmful tax competition

### 4.1 The initial deafening silence of the Court of Justice

Although tax competition is politically at the heart of several important cases brought before the Court, the latter has remained silent on this point. The silence of the

[499] The rules applicable to tax rulings in tax ruling cases could be argued to be an inherent component of the reference system. As a result, any differentiation made with regard to integrated companies would be inherent to the application of the normal reference system. A similar argument was made by Belgium but rejected by the Commission in *Belgian Excess Profit. See* N. Bayón Fernández, *The Selective Advantage Criterion in Tax Rulings: The Path Towards a More Coherent and Thorough Analysis of Selectivity,* in *Journal of European Competition Law & Practice*, 2021, p. 200-216.

[500] *See* Court of Justice of the European Union, *Commission and Spain v Government of Gibraltar and United Kingdom*, Joined Cases C-106/09 P and C-107/09 P, para 43.

[501] M. Bernatt & Ł. Grzejdziak, *Selectivity of State aid and progressive turnover taxes – Leaving the door (too) wide open: Commission v. Poland,* in *Common Market Law Review*, 2022, p. 187-202.

Court of Justice stems first of all from the non-binding legal nature of the 1997 Code of conduct for business taxation. In its own words, this "Code of Conduct" is no more than a political commitment and is devoid of any binding character. As a result, neither individuals nor institutions can rely on them before the courts responsible for ensuring the correct application of EU law[502].

This does not mean, however, that EU law is ineffective in combating harmful tax competition. As the "Code of Conduct" emphasizes, parallel recourse to European state aid law makes it possible, under the authority of the European Commission, which acts under the control of the European courts, to make up for the apparent shortcomings of the Code of conduct, and to lead Member States to dismantle aggressive tax planning schemes[503]. Assuming that Member States do not spontaneously apply its principles, the legal nature of the "Code of Conduct" is not based on the case law of the Court, but on the way in which the Commission implements State aid law. Yet, the Court of Justice can control the legal implementation of State aid law by the Commission.

Questions relating to tax competition are sometimes referred to the Court of Justice. In a case which did not concern the application of State aid law, but the tax scope of the freedoms of movement, it could have ruled on a question relating to tax competition. In the Elisa case, the French government attempted to justify a restrictive tax measure on the grounds that it was designed to counteract the "damage" caused by Luxembourg's holding company legislation. Its main arguments were that this Luxembourg legislation was incompatible with the "Code of conduct" and European State aid law[504].

[502] W.W. Bratton, J.A. McCahery, *Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation*, in *Common Market Law Review*, 2001, p. 677-718.

[503] Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy - Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation - Taxation of saving, point J: «*The Council notes that some of the tax measures covered by this code may fall within the scope of the provisions on State aid in Articles 92 to 94 of the Treaty. Without prejudice to Community law and the objectives of the Treaty, the Council notes that the Commission undertakes to publish guidelines on the application of the State aid rules to measures relating to direct business taxation by mid- 1998, after submitting the draft guidelines to experts from the Member States at a multilateral meeting, and commits itself to the strict application of the aid rules concerned, taking into account, inter alia, the negative effects of aid that are brought to light in the application of this code. The Council also notes that the Commission intends to examine or re-examine existing tax arrangements and proposed new legislation by Member States case by case, thus ensuring that the rules and objectives of the Treaty are applied consistently and equally to all*».

[504] Court of Justice of the European Union, Européenne et Luxembourgeoise d'investissements SA (ELISA) v Directeur général des impôts and Ministère public, C-451/05, para 113.

As Advocate General Mazàk stated in his opinion in this case, «*The French Government appears to justify this assumption in particular by invoking generally the harmfulness of 1929 holdings*». In this respect, it should be noted that the harmfulness of this legal regime has been indeed recognized by the OECD as well as by the Economic Affairs and Finance Council (Ecofin Council) in the course of the adoption of a code of conduct for business taxation. Luxembourg's legal regime applicable to 1929 holdings was cited in the report of the "Code of Conduct" group, responsible for evaluating national measures which may come within the scope of the code, as being a harmful measure. That tax regime therefore is required to be progressively abolished[505].

However, this analysis did not convince the Court, which in this case responded neither to the argument concerning the incompatibility of the Luxembourg legislation on 1929 holding companies with State aid law, nor to the argument concerning the harmful nature of the legislation as recognized by the Code of Conduct Group. This means, on the one hand, that it implicitly considered this plea to be inoperative, but also, on the other hand, that it intended to give precedence to the objective of combating tax obstacles over the objective of dismantling harmful tax measures and State aid.

This silence is open to criticism. When claimants put forward a plea before a court, it is desirable for the court to respond explicitly to that plea. In the Elisa judgment, however, the Court did not respond to France's plea concerning the legality of a defensive countermeasure. It is true that countermeasures adopted unilaterally and without prior authorization are reprehensible, as they are hardly compatible with a community based on the rule of law. And it is equally true that it was the Commission's exclusive responsibility to use legal means to ensure that other States did not suffer from the harmful tax competition introduced in this case by Luxembourg. However, the Court recognized that freedoms of movement should take precedence over other objectives to which they are not necessarily superior, including the fight against harmful tax competition and the dismantling of State aid in the form of taxation. Beyond this last consideration, the Elisa judgment has been criticized for not explicitly addressing the issue of the fight against harmful tax competition[506].

[505] Court of Justice of the European Union, Européenne et Luxembourgeoise d'investissements SA (ELISA) v Directeur général des impôts and Ministère public, C-451/05, para 114.

[506] R. Arras, S. Keyhani, A.Rainer, *ECJ rules French restrictions on exemptions from annual real estate tax violate EC Treaty (EC Tax Scene),* in *EC Tax Review*, 2007, p. 736.

## 4.2 The refusal of the Court of Justice

The Court of Justice has issued judgments favoring competition between member states' tax systems in its case law. In the important Cadbury Schweppes decision of September 12, 2006, the Court ruled that while «*a Member State cannot attempt, under cover of the rights created by the Treaty, improperly to circumvent their national legislation* [and] *must not improperly or fraudulently take advantage of provisions of Community law*»[507], «*the fact that a Community national, whether a natural or a legal person, sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty*»[508].

In other words, Member States' tax regulations may never restrict the free movement of persons, services or capital, unless they are justified by an overriding reason in the general interest, subject to compliance with the principle of proportionality. On the other hand, such regulations can in no way prevent taxpayers from seeking out the most attractive tax system and putting national tax systems in competition with one another. This gives rise to the risk of tax law shopping, the most visible but not exclusive manifestation of which is the transfer of companies or their headquarters within the European Union.

In this regard, the Court of Justice embraced a restrictive approach to exit taxes imposed by Member States[509] and it seems like the Anti Tax Avoidance Directive Directive – which  aims to create a minimum level of protection against corporate tax avoidance throughout the EU, while ensuring a fairer and more stable environment for businesses through five legally-binding anti-abuse measures[510] – leaves «*no doubt as to*

[507] Court of Justice of the European Union, Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, C-196/04, para 35. The Court referred to its previous case law in *Knoors* (1979), *Bouchoucha* (1990) and *Centros* (1999).

[508] Court of Justice of the European Union, Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, C-196/04, para 36. The Court referred to its previous case law in *Barbier* (2003).

[509] *See, ex multis,* Court of Justice of the European Union, European Commission v Portuguese Republic, C-171/08; Court of Justice of the European Union, National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam, C-371/10; Court of Justice of the European Union, European Commission v Kingdom of Spain, C-64/11; Court of Justice of the European Union, European Commission v Denmark, C-261/11; Court of Justice of the European Union, DMC Beteiligungsgesellschaft mbH v Finanzamt Hamburg-Mitte, C-164/12.

[510] These are the (*i*) Controlled foreign companies rule, (*ii*) the switchover rule, (*iii*) rules on exit taxation, (*iv*) rules on interest limitation and (*v*) general anti-abuse rule. For a more detailed analysis, *see* F.A. Garcia Prats, The EU Atad interest limitation rule, BEPS and CCTB: The EU Atad rule and BEPS Action 4, in G. Bizioli, M. Grandinetti,

*the mandatory normative integration by all EU Member States of a harmonized exit taxation on corporate taxpayers and on its implementing rules*»[511].

According to established case law, the only abuse that Member States can combat when taxpayers intend to take advantage of tax competition between Member States is that which consists in creating purely artificial arrangements whose aim is to evade tax (for instance, structures devoid of any economic substance and purely artificial).

And it is not possible for them to create a tax obstacle in order to counter tax competition of other Member States, as the United Kingdom claimed in the Cadbury Schweppes case to justify the controlled foreign company regime in force at the time. Although the Dublin International Financial Services Centers regime enjoyed by one of Cadbury Schweppes' subsidiaries was considered harmful by the Code of Conduct Group and State aid by the European Commission, the Court held that such circumstances could not justify a tax obstacle. Since the Court of Justice was rather inactive in the fight against harmful tax competition, it was up to the Commission on an exclusive basis to make recourse to legal means in order to ensure that other States were not subjected to the harmful or aggressive tax competition.

In 1998, the Commission reevaluated two aid programs related to Ireland's preferential tax laws that it had previously authorized. The Commission came to the conclusion that the two schemes could no longer be regarded as complying with state assistance regulations based on its revised course. The Commission cited the Council's adoption of a resolution establishing a code of conduct for business taxation as evidence supporting the necessity for concerted steps at the European level to combat harmful tax competition in support of its findings. The decisions marked the beginning of a new approach to fiscal aids by the Commission, based on the conclusion that some

L. Parada, G. Vanz, A. Vicini Ronchetti, *Corporate taxation, group debt funding and base* erosion, Alphen aan den Rijn, 2020, A.P. Dourado, *The interest limitation rule in the anti-tax avoidance directive (ATAD) and the net taxation principle*, in *EC Tax Review*, 2017, p. 112-121; P. Arginelli, *Critical overview of the Atad implementation: the implementation of the Atad in Italy*, in *Intertax*, 2022, p. 531-542; I.J.M. Valderrama, C*ritical Review of the Atad implementation: Foreward: The implementation of the Atad in the EU: the same but not the same*, in *Intertax*, 2022, p. 915-916; P.K. Schmidt, D. Kleist, J. Lindgren, *Implementation of the Atad rules on controlled foreign companies: a Nordic Member State perspective*, in *European Taxation*, 2021, p. 425-439; A. Linn & T. Braunn, *The Atad and its effect on German law*, in *International Tax Review*, 2016, p. 62-64; B. Kuźniacki, *The C.J.E.U. Case Law relevant to the General Anti-Avoidance Rule (G.A.A.R.) under the Anti-Tax-Avoidance Directive (A.T.A.D.)*, in *University of Bologna Law Review*, 2019, p. 261-282.

[511] G. Letizia, *The recent restrictive ECJ approach to exit tax and the Atad implementation*, in *EC Tax Review*, 2020, p. 33-37.

preferential tax regimes for multinational corporations are market-specific because they effectively limit the types of cross-border activities that multinational corporations can engage in, including financing and the provision of other mobile corporate services, without their market-specificity being justified by the nature of the system[512].

### 4.3 Towards a more limited refusal of the Court of Justice?

On several occasions, the Court has refused to allow taxpayers to rely on a most-favored-nation tax clause for the application of international tax treaties. An example is *Inspecteur Van De Belastingdienst Rijnmond/Kantoor Rotterdam* in which the Court refused to uphold the claim of a German taxpayer subject to wealth tax in the Netherlands, who was asking to be treated as a Belgian resident. The interplay of international tax treaties between the Netherlands and Belgium, on the one hand, and Germany, on the other, meant that, in the same factual situation, a German resident received less favorable tax treatment than a Belgian resident. The latter was entitled to an allowance which the German resident did not enjoy. In order to obtain the same tax treatment as a Belgian resident, Mr. D. argued that the situations of a German resident and a Belgian resident were perfectly comparable, and that these two taxpayers should not be apprehended on the basis of their nationality but on the sole fact that they were both non-residents of the Netherlands.

Here, unlike in *National Grid Indus BV*, the Court of Justice refused to accept this argument, referring to the European Union's lack of competence in matters of international tax treaties, to the fact that the purpose of such treaties is not to confer rights on nationals of Member States, but merely to prevent double taxation, and to the relative effect of international tax treaties, which allocate fiscal competence between two Member States. The Court acknowledged that «*legislation such as that at issue in the main proceedings is appropriate for ensuring the preservation of the allocation of powers of taxation between the Member States concerned*» and was of the opinion that the argument put forward by *National Grid Indus* that the tax at issue in the main proceedings cannot be justified because it is charged on an unrealized capital gain, not a

[512] P. Rossi-Maccanico, *Commentary of State aid review of multinational tax regimes,* in *European State aid Law Quarterly,* 2007, p. 25-42.

realized capital gain, was to be rejected[513]. It concluded that «*freedom of establishment cannot therefore be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules*»[514].

This refusal to recognize a most-favored-nation tax clause was subsequently confirmed by Test claimants in Class IV of the ACT Group Litigation[515]. The Court ruled that despite not granting a tax credit to non-residents, a member state could grant companies receiving dividends from a company resident in that state who is also a resident a tax credit equal to a portion of the corporation tax paid on the distributed profits by the company making the distribution under the terms of Articles 43 EC on freedom of establishment and 56 EC on free movement of capital. Furthermore, those clauses did not prevent a scenario in which a member state did not extend the right to a tax credit stipulated in a double taxation convention to businesses located in a third member state with which it had signed a double taxation convention that did not stipulate such a right for businesses located in that third state[516].

The Court reiterated his reasoning in *European Smallcap Fund* concerning the Netherlands fiscal investment funds regime. It held that «*where a benefit granted by a bilateral tax convention cannot be classified as a benefit that is separable from that convention, but contributes to its overall balance (the fact that the reciprocal rights and obligations arising under that convention apply only to persons resident in one of the two contracting Member States being an inherent consequence of bilateral conventions), Community law does not preclude the benefit in question from not being conferred on the resident of a third Member State, in so far as that resident is not in a situation comparable to that of residents covered by the convention in question*»[517].

[513] Court of Justice of the European Union, *Inspecteur Van De Belastingdienst Rijnmond/Kantoor Rotterdam*, C-371/10, para 49.

[514] *See* C. HJI Panayi, *National Grid Indus BV v. Inspecteur Van De Belastingdienst Rijnmond/Kantoor Rotterdam : Exit Taxes in the European Union Revisited,* in *British Tax Review,* 2012, p. 41-49.

[515] Court of Justice of the European Union, Test claimants in Class IV of the ACT Group Litigation, C-374/04.

[516] See P. Plansky, *Limitation on Benefits: From the US Model 2006 to the ACT Group Litigation*, in *Intertax,* 2007, p. 484.

[517] Court of Justice of the European Union, Staatssecretaris van Financiën v Orange European Smallcap Fund NV, C-194/06, para 51.

In other words, taxpayers cannot put international tax treaties in competition with each other and choose – among the various clauses of the different treaties – those which are favorable to them even though they are not applicable to them. Ultimately, the Court of Justice accepts law shopping but rejects treaty shopping.

From the perspective of a competitive tax system, taxpayers are free to move around, to choose their tax jurisdiction and, consequently, the applicable tax treaties, without this necessarily constituting an abuse. On the other hand, they cannot invoke a most-favored-nation tax clause by relying on an international tax treaty that does not apply to them. It would therefore appear that, while the Court's case law seems to favor tax competition, it can also limit it.

Moving forward to a more active approach of the Court, the case law through which the Court of Justice indirectly regulates tax competition concerns the fiscal scope of State aid law, and currently stems from the *Gibraltar* judgment of 2011[518].

In this case, the Court of Justice was asked whether it was possible for the European Commission to review under State aid law a system whereby companies established in Gibraltar were taxed solely by means of a tax on the number of employees working in Gibraltar, a tax on the occupation of business premises located in Gibraltar and a registration tax. Insofar as this system inherently favored offshore companies with no real physical presence in Gibraltar, the Court of Justice ruled that it constituted an advantage meeting the "selectivity" criterion, despite the fact that virtually all companies established in Gibraltar are offshore companies.

To this end, and in order to consider that a general measure may be selective, the Court modified the legal reasoning it usually employs to examine the selectivity of a tax advantage. Rather than asking whether the latter derogated from the normal system of taxation without being justified, where appropriate, by the general scheme of this tax system (objective analysis), the Court exceptionally referred to the aims of the disputed scheme (subjective analysis), which were to grant a favorable tax regime to offshore companies[519].

[518] Court of Justice of the European Union, European Commission (C-106/09 P) and Kingdom of Spain (C-107/09 P) v Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland., C-106/09.

[519] Court of Justice of the European Union, European Commission (C-106/09) and Kingdom of Spain (C-107/09 P) v Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland, paras 106 and 107: «*it should be observed that the fact that offshore companies are not taxed is not a random consequence of the regime at issue, but the inevitable consequence of the fact that the bases of assessment are specifically designed so that offshore*

Although, contrary to the contextual presentation made in the Opinion of Advocate General Jääskinen, the Court never used the terms "tax competition" and "tax haven" to refer to the legitimate concerns of Spain and Portugal in the face of the risks of relocation of their companies to Gibraltar and unfair competition between the latter and non-relocated companies, these political elements are certainly not unrelated to the development of the Court's legal reasoning[520].

The main takeaway from *Gibraltar* is that a Member State may choose to completely abolish its corporate income tax and replace it with a tax on salaries and commercial real estate. What it cannot do, as the Court of Justice noted, is enact a general corporate income tax that seeks to apply to all businesses operating within its borders while inadvertently excluding a significant portion of the economy (the off-shore industry) by using a tax base that is insufficient for that purpose[521].

The European Commission correctly underlines the unusual nature of the case and the Court's reasoning in its latest "notice"[522], despite some commentators' perceptions that this judgement signals a paradigm shift toward a purely discriminating test[523]. A deeper look reveals that the Court did not completely abandon the ideas of advantage and benchmark; rather, the judges adopted a "substance over form" attitude about how the benchmark should be determined[524].

*companies, which by their nature have no employees and do not occupy business premises, have no tax base under the bases of assessment adopted in the proposed tax reform. Thus, the fact that offshore companies, which constitute a group of companies with regard to the bases of assessment adopted in the proposed tax reform, avoid taxation precisely on account of the specific features characteristic of that group gives reason to conclude that those companies enjoy selective advantages*».

[520] In his opinion, the Advocate General recognized that «*the main issue in this case is therefore material selectivity and clarification of the concept of State aid in relation to the phenomenon of harmful tax competition*» and underlined «*the fact that Gibraltar is considered to be a 'tax haven' by the Organization for Economic Co-operation and Development (OECD) and an 'offshore financial centre' by the International Monetary Fund (IMF)*». See Opinion of Advocate General Jääskinen, European Commission (C-106/09) and Kingdom of Spain (C-107/09 P) v Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland.

[521] R. Luja, EU state aid, tax competition and its limits, in Tax Notes International, 2014, p. 1-14.

[522] European Commission, Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, 2016/C and 262/01, 2016, para. 129 and 130.

[523] M. Lang, *Das Gibraltar-Urteil des EuGH: Neue beihilferechtliche Vorgaben für das Steuerrecht*?, in *Österreichische Steuerzeitung*, 2011, p. 593; M. Lang, *State aid and taxation: recent trends in the case law of the ECJ*, in European *State Aid Law Quarterly*, 2012, p. 411–421; R, Lyal, *Transfer pricing rules and state aid,* in *Fordham International Law Journal, 2015, p. 1017–1043.*

[524] H. López López, *General Thought on Selectivity and Consequences of a Broad Concept of State Aid in Tax Matters*, in European *State Aid Law Quarterly,* 2010, p. 807-819; E. Dubout & A. Maitrot de la Motte, *Normalité, sélectivité et légitimité des régimes fiscaux dans l'Union européenne: les paradis fiscaux au purgatoire des aides d'État?*, in *Revue de droit fiscal*, 2012, p.49-54.

This should not be dependent on the legislator's "regulatory technique," to use the Court's terminology. In the Gibraltar case, it was evident that the business expenditure tax was still a corporate income tax that had been mislabeled as an expenditure tax since it was arbitrarily set at 15% of the company earnings. And under this system, offshore corporations benefited greatly compared to the norm of a corporate income tax. The lesson to be learned from Gibraltar is obvious: the definition of the benchmark is unaffected by petty legal wording and labeling details. However, the ideas of "advantage" and "normal tax treatment" have not been forgotten, and they later surfaced in a number of other judgements[525].

## 4.4 The intervention of the European Commission

Given that regulation of tax competition is only conceivable on a European scale and it involves recourse to State aid law, it certainly requires legal support from the Court of Justice, as demonstrated by *Gibraltar*. Politically, however, the European Commission is actively engaged. Only the Commission can assess the appropriateness of dismantling national tax arrangements that are incompatible with the proper functioning of the internal market. It has an active role and has invited Member States to «*adopt as soon as possible the Commission proposals for Directives on administrative cooperation, mutual assistance in the recovery of taxes and savings taxation and continue to give appropriate priority to the elimination of harmful business tax regimes*»[526].

In the realm of harmful tax competition, the suitability of the arm length principle – which will be analyzed in the following paragraph – is part of a larger debate on the role of state aid as a general competition tool used by the European Commission[527].

[525] Court of Justice of the European Union, NP Paribas and Banca Nazionale del Lavoro SpA (BNL) v European Commission, C-452/10 P; para 66–68; Opinion of the Advocate General Szupnar, Kernkraftwerke Lippe-Ems GmbH v Hauptzollamt Osnabrück, C-5/14, para 68. *See* W. Schön, *Tax Legislation and the Notion of Fiscal Aid: A Review of 5 Years of European Jurisprudence*, in I. Richelle, W. Schön, E. Traversa, *State Aid Law and Business Taxation*, Heildelberg, 2016, p. 3-26.

[526] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Promoting Good Governance in Tax Matters, COM(2009) 201 final.

[527] *See* e.g., G. Allevato, Ju*dicial Review of the State Aid Decisions on Advance Tax Rulings: A Last Resort to Safeguard the Rule of Law*, in *European Taxation*, 2022, p. 1-39; D. A. Kyriazis, *From Soft Law to Soft Law Through Hard Law: The Commission's Approach to the State Aid Assessment of Tax Rulings*, in *European State Aid Law Quarterly*, 2016, p. 428-439; G. Perotto, *How to Cope With Harmful Tax Competition in the EU Legal Order: Going Beyond the Elusive Quest for a Definition and the Misplaced Reliance on State Aid Law*, in *European journal of legal*

In a society where multinational corporations exploit national tax systems to reduce their tax burden, the Commission's actions are desirable. They have arguably made significant strides in the fight against unfavorable tax competition and brought this issue to the public's attention. However, it is widely accepted in the literary and political communities that the Commission's legal defenses will not hold up in court and that they have taken significant short cuts to achieve their ultimate goal of limiting harmful tax competition to protect the internal market's functionality. It is crucial that the Commission's approach to evaluating budgetary measures for State aid be clear and transparent, and the Commission should take additional measures to provide legal clarity

Although desired to lessen vulnerability to detrimental tax competition inside the internal market and fit to address imbalances in international tax competition, tax harmonization is improbable as a result of the Member States' reluctance to give up sovereignty. Fiscal aid has exceeded its original purpose at a major sacrifice in terms of State sovereignty[528]. It must be kept within the bounds of its teleological boundaries to avoid this boundary being blurred as its reach is expanded[529].

## 4.5 Tax rulings and the interpretation of the arm's length principle

Tax rulings are assurance letters from tax authorities providing a specific firm with legal clarity on how its corporation tax would be computed or on the use of special tax provisions, tax rulings as such are not problematic. However, if tax judgements are utilized to give a particular firm or group of enterprises preferential treatment, they may constitute state assistance within the definition of EU regulations.

The existence of state help would be ruled out if tax authorities insisted on paying a subsidiary or branch on market terms, reflecting normal circumstances of competition, while approving the computation of the tax- able base submitted by a corporation. However, if the calculation is not based on compensation on market terms, it might

*studies*, 2021, p. 309-340: C. Peters, *Tax Policy Convergence and EU Fiscal State Aid Control: In Search of Rationality*, in *EC Tax Review*, 2019, p. 6-17.

[528] R. Miceli, *The State Aid framework in European Fiscal Integration*, New York, 2017, p. 57-107.

[529] E. Forrester, *Is the state aid regime a suitable instrument to be used in the fight against harmful tax competition?*, in *EC Tax Review*, 2018, p. 19-35.

indicate that the company would be treated more favorably than other taxpayers would typically be under the tax laws of the Member States. This could qualify as state aid[530].

In this paragraph, we will now delve into the potential discretionary use of "advance tax rulings", which are statements provided by the tax authorities, or an independent council, regarding the tax treatment of a taxpayer with respect to his future transactions and on which he is – to a certain extent – entitled to rely. In recent years, the European Commission has initiated formal review procedures and issued incompatibility rulings against tax rescripts issued by Ireland, Luxembourg, and the Netherlands to well-known multinationals: *Amazon*[531], *Fiat*[532], *Starbucks*[533], *Apple*[534] and *Mcdonald's*[535]. All of these proceedings concern the advance validation of their transfer pricing criteria, including the respect of the so-called arm's length principle, and led the Commission to decide whether these companies had benefited from unauthorized state aid which they were required to repay.

Our analysis cannot omit recent developments regarding the action of the European Commission with regards to one of the most contentious issues: how the Commission has defined the arm's length, which is different from the OECD notion[536]. An equal playing field in terms of taxation should be maintained between multinational groupings of taxpayers and independent businesses according to the arm's length concept. There are still variances in how the arm's length concept is applied even though all EU Member States included it into their domestic transfer pricing regulations. For the EU internal market, these discrepancies present two difficulties. The arm's length principle only being applied in a cross-border setting might result in an unjustifiable

[530] *See* F. Cachia, *Analysing the European Commission's Final Decisions on Apple, Starbucks, Amazon and Fiat Finance & Trade*, in *EC Tax Review*, 2017, p. 23-35; R. De la Feria, *Prohibition of abuse of (Community) law: The creation of a new general principle of EC law through tax*, in *Common Market law Review, 2008*, p. 395 – 441.

[531] Commission Decision (EU) 2018/859 of 4 October 2017 on State aid SA.38944 (2014/C) (ex 2014/NN) implemented by Luxembourg to Amazon.

[532] Commission Decision (EU) 2016/2326 of 21 October 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat.

[533] Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks.

[534] Commission Decision (EU) 2017/1283 of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple.

[535] Commission Decision (EU) of 19.9.2018 on tax rulings SA.38945 (2015/C) (ex 2015/NN) (ex 2014/CP) granted by Luxembourg in favor of McDonald's Europe.

[536] *See* K. Vogel, *Klaus Vogel on Double Taxation Conventions, in* E. Reiner & A. Rust, Alphen aan den Rijn, 2015, p. 530-535.

limitation of basic freedoms, hindering the free and competitive allocation of resources inside the EU internal market and favoring local transactions.

The most contentious issue, which has an impact on the legal certainty concept, relates specifically to how the Commission has defined the arm's length norm.

In reality, one must inquire as to the legal justifications for the Commission's adoption of the autonomous arm's length concept.

In Article 107 of the Treaty on the Functioning of the European Union, the arm's length principle is not stated. Instead, Article 9 of the OECD Model Tax Convention sets the standard of the arm's length concept that is accepted globally[537].

. However, the Commission has asserted that the arm's length concept is not drawn from Article 9 of the OECD Model Tax Convention and instead relates to a general principle of equitable treatment in taxes coming within the applicability of Article 107 (1) of the Treaty on the Functioning of the European Union.

When the Commission published its rulings in *Fiat* and *Starbucks*, it made the first explicit argument that the arm's length norm was a fundamental component of Article 107 of the Treaty on the Functioning of the European Union. Additionally, it was the first time the Commission had used Article 107 of the Treaty on the Functioning of the European Union in relation to specific tax judgements on transfer pricing. In subsequent decisions, like its investigation of *Apple*, and, more recently, in the Commission's 2016 Notice on the Notion of State Aid, the Commission expressed a similar viewpoint.

How national tax authorities are intended to implement the arm's length concept in the Commission's version, when they were unaware of this principle prior to the said

[537] Article 9 of the OECD Model Tax Convention: «*(1) Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.* (2) *Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall, if necessary, consult each other*».

rulings, is being questioned given the absence of an express legal foundation at the European level.

In reality, the argument that the Commission based its analysis on an ill-defined, legally unsound interpretation of the arm's length principle is becoming more and more prevalent. In fact, it appears that the Commission's version violates the legal certainty principle because the Commission changed its course from the past, which caused serious harm to the taxpayer and overstepped the bounds of the powers granted to it by the Treaties.

Instead, the Commission conceived a new definition which is different from the OECD Forum on Harmful Tax Practices agreements, hampering the principle of legal certainty[538]. Yet, this interpretation contends that the Commission's application of the arm's length principle is a necessary component of Article 107 of the Treaty on the Functioning of the European Union, which grants the Commission the authority to enforce its own transfer pricing scheme throughout the Union. It believes an equal playing field in terms of taxation should be maintained between multinational groupings of taxpayers and independent businesses according to the arm's length concept[539].

The arm's length concept as it is conceived by the Commission has essentially been imposed as the yardstick for determining whether there is an economic benefit in any internal market transfer pricing situation. It is possible that some Member States have not adopted this principle into their national laws or that there are differences in how it is interpreted and applied from one Member State to another because transfer pricing tax rules are not the subject of harmonization measures at the EU level. No Member State is legally required to incorporate the arm's length concept into its national law and to apply it in a manner that is compatible with OECD Guidelines since it does neither have the nature of treaty law nor of customary law.

[538] L. Gormsen, *EU state aid law and transfer pricing: a critical introduction to a new saga*, in *Journal of European Competition Law & Practice*, 2016, p. 369-382.

[539] However, there are still variances in how the arm's length concept is applied even though all EU Member States included it into their domestic transfer pricing regulations. For the EU internal market, these discrepancies present two difficulties. The arm's length principle only being applied in a cross-border setting might result in an unjustifiable limitation of basic freedoms, hindering the free and competitive allocation of resources inside the EU internal market and favoring local transactions. See P.J. Wattel, *Stateless income, state aid and the (which?) arm's length principle*, in *Intertax*, 2016, p. 791-801.

The main issue is whether the Commission can actually insist that Member States compute their taxable profits in accordance with the arm's length principle. It is controversial whether State assistance legislation has the authority to demand that the arm's length principle be applied to taxpayers. The Commission will be able to use its new strategy regardless of whether a Member State has included the arm's length concept in its national legal system by elevating it to be a general equal treatment principle inherent in Article 107 of the Treaty on the Functioning of the European Union.

As a result, the Member State's direct taxation policy incorporates the arm's length concept of the Commission. Any departure from it would be considered a derogation and result in State assistance. Therefore, regardless of whether they have incorporated this concept into their legal systems or not, the arm's length principle of the Commission is applicable to all Member States of the European Union. Finding an economic benefit is necessary to prove the assumption of selectivity, but the Commission believes that doing so will also reveal the beneficiary's advantage if there is a deviation from the reference system. Therefore, by identifying a departure from the reference framework, the Commission seems to show an economic benefit.

All in all, EU Member States could provide advantages of unlawful State aid by using the arm's length principle as a tool for tax competition through transfer pricing decisions that result in lower tax obligations. The subsidiarity and proportionality criteria may call for harmonization of the arm's length principle in light of these challenges to the EU internal market. However, attempts at harmonization would be less successful than expected due to the underlying character of the arm's length concept as an open and flexible legal notion.

The requirement for unanimity in EU law addressing direct taxation implies that the European Commission may attempt to sway Member States' tax policies without passing legislation in order to combat unfair tax competition among Member States and aggressive tax planning by taxpayers[540].

The internal market faces two issues as a result of differences in how Member States use the arm's length principle. First, when Member States only apply the arm's length principle in a cross-border context, they may unnecessarily restrict fundamental

[540] A.P. Dourado, *The Fiat case and the hidden consequences*, in Intertax, 2023, p. 2-4.

freedoms, which impedes the free and competitive allocation of resources within the EU internal market by favoring domestic transactions. The arm's length principle can be utilized as a tool for tax competition if Member States enter into advantageous transfer pricing decisions with taxpayers, providing a State aid benefit in the form of lower tax obligations. This is the second problem. It appears that the arm's length concept should be standardized at the EU level in order to defend the internal market.

Any future harmonization attempt must, however, take into account the Member States' direct taxation autonomy. Nonetheless, harmonizing the implementation of the arm's length principle at the EU level appears to be unfeasible due to the open standard of the arm's length principle's imperfection in addressing tax competition by Member States and active tax planning by taxpayers. Due to the inherent arbitrariness in the use of transfer pricing methodologies, harmonizing the definition of the arm's length principle, in particular, does not always address transfer pricing incompatibilities. Hence, alternative actions to eliminate tax competition and aggressive tax planning should take precedence in order to protect the integrity of the EU internal market[541].

## 4.6 Recent interpretation of the Court of Justice on the application of Article 107 of the Treaty on the Functioning of the European Union

On November 8, 2022, more than a year after issuing its decision in *Belgian Excess Profits*[542], the Court of Justice issued its final judgement in *Fiat*[543]. The Court of Justice reversed the General Court's decision[544] and invalidated the Commission

[541] R. Doeleman, In Principle, (Im)possible: harmonizing an EU Arm’s Length Principle, in EC Tax Review, 2023, p. 93-102

[542] The Court of Justice of the European Union rendered its decision on whether or not the Belgian excess profit rulings might be considered a state aid program on September 16, 2021. The General Court's ruling from 14 February 2019, which rejected the "scheme" criterion and, as a result, invalidated the European Commission's state aid decision from 11 January 2016, is now vacated by the Court of Justice. The case has now been sent to the General Court for a second evaluation of the case's merits, specifically whether these decisions gave their recipients an unjustifiable selective (tax) advantage. *See* Court of Justice of the European Union, European Commission v Kingdom of Belgium and Magnetrol International, C-337/19. See also B. Michel *ECJ Determines 'Only in Belgium' Excess Profit Ruling Practice Constitutes Aid Scheme, but Did It Provide Illegal Aid?*, in *European Taxation*, 2022.

[543] Court of Justice of the European Union, Fiat Chrysler Finance Europe v Commission Case C-885/19 P (Joined Cases C-885/19 P, C-898/19 P.

[544] General Court, Grand Duchy of Luxembourg and Fiat Chrysler Finance Europe v European Commission, T-755/15.

Decision[545], touching on several of the key elements of the State aid analysis of tax ruling provisions.

The commission had essentially two legal defenses left for its independent, arm's-length standard by the time of the Fiat appeal[546]. The commission first argued that since Luxembourg sought to tax both stand-alone and group companies on their profits and Luxembourg taxed stand-alone companies on their market profits, the commission was justified in using the arm's-length standard to calculate the income of group companies because arm's length is also a market-based standard[547]. According to this logic, it was irrelevant whether Luxembourg explicitly integrated the arm's-length requirement into its domestic legislation. Luxembourg was created with the intention of taxing earnings at sui generis arms-length. The only pertinent issue was whether Luxembourg intended to impose a profit tax on group corporations. If so, despite anything to the contrary in local law, such gains have to be calculated under the EU's arm's-length principle. It did not matter, in particular, because Luxembourg had its own laws controlling arm's length.

The commission offered a second justification for sui generis arm's length. The arm's-length criterion should be used in state assistance cases, it was contended, in light of precedent from *Forum 187*[548]. Even while the Court of Justice had authorized the commission's use of the arm's-length requirement in Forum 187, it was also true that Belgium had adopted the norm into its domestic legislation. Therefore, it was clear that the case did not support the claim that the commission could apply the arm's-length requirement even in situations where the accused member state had not adopted it into domestic law or had included a different version[549].

The Court of Justice has instead drafted a judgment that sends the Commission a very clear message: the Commission's analysis of national tax rules under Article 107 TFEU must only be based on national law, as doing otherwise would infringe upon

[545] Commission Decision (EU) 2016/2326 of 21 October 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat.

[546] R. Mason, *Ding-Dong! The EU Arm's-Length Standard Is Dead*, in *Tax Notes*, 2022.

[547] Court of Justice of the European Union, Fiat Chrysler Finance Europe v Commission Case C-885/19 P (Joined Cases C-885/19 P, C-898/19 P, para 219-311.

[548] Court of Justice of the European Union Kingdom of Belgium (C-182/03) and Forum 187 ASBL (C-217/03) v Commission of the European Communities, Joined cases C-182/03 and C-217/03.

[549] See R. Mason, *Special Report* on EU *State Aid*: *Part 6—Arm's Length on Appea*l, in *Tax Notes*, 2018, p. 771–796.

Member States' autonomy in areas involving direct taxation that have not yet been harmonized.

The Corporate Income Tax system was cited by the Commission as the pertinent reference framework in its Decision in *Fiat*, but this was done without taking into account the possibility that a more limited reference framework—consisting of the administrative tax ruling practice of the national tax authorities—could also serve as a reference framework. Regardless of the reference framework the Commission employed, the General Court determined that the tax judgment had been appropriately categorized as selective in the Decision[550].

The Court of Justice overturned the General Court’s judgement and invalidated the Commission's decision, but it did not see fit to rule on whether the Commission ought to have chosen a broad or restricted definition of the pertinent reference system. Without taking into account how the arm's length principle had actually been incorporated into national tax law, the Commission had improperly interfered with Member States' tax autonomy by relying on an uncodified definition of the objective of the corporate income tax system that was based on an "ideal" version of the arm's length principle that was not based on national tax law[551].

The Court recognized that the OECD notion of arm’s length cannot be taken into account as «*it is only the national provisions that are relevant for the purposes of analyzing whether particular transactions must be examined in the light of the arm’s length principle and, if so, whether or not transfer prices, which form the basis of a taxpayer’s taxable income and its allocation among the States concerned, deviate from an arm’s length outcome. Parameters and rules external to the national tax system at issue cannot therefore be taken into account in the examination of the existence of a selective tax advantage within the meaning of Article 107(1) TFEU and for the purposes*

[550] General Court, Grand Duchy of Luxembourg and Fiat Chrysler Finance Europe v European Commission, T-755/15, para 362: «*In those circumstances, it must be held that the arguments by which the parties seek to challenge the reference framework identified by the Commission are ineffective and the Court must reject, as unfounded, the arguments seeking to challenge the Commission’s analysis with regard to the second step of its reasoning, that is the examination of a derogation from the reference framework*».

[551] Court of Justice of the European Union, Fiat Chrysler Finance Europe v Commission, Case C-885/19 P (Joined Cases C-885/19 P, C-898/19 P, para 91, 94 and 95.

*of establishing the tax burden that should normally be borne by an undertaking, unless that national tax system makes explicit reference to them*»[552].

This finding is an expression of the general legal principle known as the legality of taxation, which states that any obligation to pay a tax and all the necessary components defining its substantive features must be provided for by law, with the taxable person having to be able to predict, calculate, and determine the point at which it becomes payable[553].

To prove that a measure has given the questioned undertaking a different treatment from undertakings that are in a comparable factual and legal situation in light of the defined national reference system, the Commission must conduct a comparability analysis. This analysis must show that the measure in question has granted the questioned undertaking a different treatment from undertakings that are in a similar factual and legal situation. The CJ has restricted the Commission's authority in transfer pricing cases by requiring it to use national tax laws and forbidding it from using the EU standard of the arm's length principle which has not even been thoroughly defined[554].

The Fiat decision makes clear that the Commission cannot use the State aid analysis allowed by Article 107(1) of the Treaty on the Functioning of the European Union as a blank check to limit the ability of Member States to levy taxes in non-harmonized areas, such as direct taxation. The Commission can only define the reference system by reference to the national law of the Member State in question, which includes, first of all, the national arm's length principle and, secondly, the Commission shall prove

[552] Court of Justice of the European Union, Fiat Chrysler Finance Europe v Commission, Case C-885/19 P (Joined Cases C-885/19 P, C-898/19 P, para 96.

[553] Court of Justice of the European Union, Fiat Chrysler Finance Europe v Commission, Case C-885/19 P (Joined Cases, C-855/19 P, C-898/19 P, para 96. *See* also Court of Justice of the European Union, Związek Gmin Zagłębia Miedziowego w Polkowicach v Szef Krajowej Administracji Skarbowej, C-566/17.

[554] Court of Justice of the European Union, Fiat Chrysler Finance Europe v Commission, Case C-885/19 P (Joined Cases C-885/19 P, C-898/19 P, para 122: «*In particular, after having observed that a Member State has chosen to apply the arm's length principle in order to establish the transfer prices of integrated companies, the Commission must, in accordance with the case-law cited in paragraph 70 of the present judgment, be able to establish that the parameters laid down by national law are manifestly inconsistent with the objective of non-discriminatory taxation of all resident companies, whether integrated or not, pursued by the national tax system, by systematically leading to an undervaluation of the transfer prices applicable to integrated companies or to certain of them, such as finance companies, as compared to market prices for comparable transactions carried out by non-integrated companies*».

that there has been systematic discrimination between integrated companies vis-à-vis comparable transactions between standalone companies[555].

Following the judgment in *Fiat*, according to several commentators[556], it is unlikely that the Commission will win its appeal in the Apple case[557] as any appeal will be limited to points of law and this judgment focuses on factual assessments in its critique of the Commission's applied legal standard.

The current trend in State aid investigations signals heightened Commission scrutiny in its investigation and factual analysis of State aid cases. Though the Commission can apply the arm's length principle to determine the existence of a selective advantage in the absence of national legislation to the contrary, it must do so with the evidence necessary to demonstrate the advantage[558]. Whether the Commission can pursue a new line of inquiry is a different question from whether the Commission should. The recent judgments in *Apple* and *Fiat* the Court's flippancy in dismissing the Commission's subsidiary argument may have been intended to signal a change in course or as a part of a larger trend of rulings that limit the Commission's authority to challenge domestic tax regulations on the basis of State aid[559].

[555] N. Bayón Fernández & R. García Antón, *Op-Ed: "Final Judgment in Fiat: The Answers (not) Provided by the Court of Justice in its Second Chapter of the Tax Rulings Saga"*, in *EU Law Live*, 2 December 2022.

[556] *See* J. Davis, *Ireland and Apple v. Commission: The General Court annuls European Commission judgment on unlawful state aid, signaling era of scrupulous fact investigation in EU state aid cases*, in *Tulane Journal of International and Comparative Law*, 2022, p. 417-431; R. Mason, *Tax competition and state aid*, in *Yearbook of European Law*, 2023.

[557] The General Court of the European Union had already invalidated the Commission's judgment in Apple *where the latter requested the Court to make Apple pay a record € 13,000,000,000 to Ireland as uncollected taxes* on the grounds that the Commission had not proven its case.

[558] General Court, Ireland and Others v European Commission, Cases T-778/16 and T-892/16, para 243: «*In its primary line of reasoning the Commission considered, in essence, that the profits of ASI and AOE relating to the Apple Group's IP (which, according to the Commission's line of argument, represented a very significant part of the total profit of those two companies) had to be allocated to the Irish branches in so far as ASI and AOE had no employees capable of managing that IP outside those branches, without, however, establishing that the Irish branches had performed those management functions*».

[559] S. Daly, Fiat v Commission: A Misconception at the Heart of the Tax Ruling Cases, in *Modern Law Review*, 2023.

# CHAPTER 4

# *Leverage anti-money laundering measures in the fight against harmful tax competition*

## 1 Relation between harmful tax competition and anti-money laundering

The worldwide economic slowdown caused by the COVID-19 epidemic and the war in Ukraine – which is causing lackluster growth around the world[560] –, puts a burden on state budgets. In 2020, the IMF has observed the largest one-year debt surge since World War II, with global debt rising to $226,000,000,000,000 as the world was hit by the pandemic and a consequent deep recession[561]. The shaky economic recovery has been hampered by persistent supply-demand mismatches, higher-than-expected global inflation, rising energy and food costs and geopolitical fragmentation affecting global trade and money flows. As a result, many governments are striving to increase income in order to maintain economic stability while maintaining the same level of public services.

Increased government spending and lower *tax* revenues have driven an *increase* in budget deficits and government debt and countries are considering whether to increase their tax burden[562] or even create new taxes[563], a tax hike could be controversial and negatively affect the economy, especially during recessions, and have devastating social effects[564].

[560] This is especially true in developed countries, which «*are expected to see an especially pronounced growth slowdown* [and] *growth* [potentially] *falling below 1 percent*». See IMF World Economic Outlook, April 2023.

[561] *See* IMF Global Debt Database.

[562] For instance, the District of Columbia made its income tax more progressive by raising revenue from the highest earners and the United Kingdom was one of the first Nations to Increase Taxes to Cover Covid-19 Costs through an increase of payroll taxes.

[563] For instance, lawmakers in Massachusetts have introduced bill H. 74 that would impose a 5 % tax on the gross receipts collected by streaming companies to fund local media channels. In addition, the Italian government has recently signaled its intention to introduce a one-time windfall tax on banks, which made European bank shares tumble.

[564] According to the OECD, «*even a progressive tax can increase poverty risk for certain vulnerable groups*». See OECD Policy Responses to Coronavirus (COVID-19), Tax and fiscal policies after the COVID-19 crisis, 14 October 2021.

In this framework, various commentators underline the pervasive magnitude of aggressive tax planning strategies implemented by multinationals and the different channels used for profit shifting[565] – especially to offshore financial centers but also amongst OECD countries – leak away substantial revenue stemming from corporate income tax[566].

Recent research shows that making better use of current Anti-Money Laundering provisions is one of the instruments accessible to policymakers to increase tax compliance. Using AML safeguards might improve tax compliance and help combat tax evasion[567]. *This should not substitute international and regional action to tackle aggressive tax planning scheme to curtail harmful tax competition but should supplement these efforts*[568].

The OECD has understood how anti-money laundering[569] can be leveraged to fight tax crimes. In this regard the OECD's Committee on Fiscal Affairs has established a dialogue with the Financial Action Task Force and continues to examine ways of improving co-operation between tax and anti-money laundering authorities. Joint workshops with tax and anti-money laundering officials have been held allowing experts to share experiences on some of the practices that are common to both tax evasion and money laundering. However, the anti-money laundering framework can also be used harmful tax competition since they share tax avoidance and evasion as a common denominator and can complement each other.

On the one hand, research has shown that «*tax havens have an incentive to maintain low regulatory standards in order to attract black money activities*» and «*stricter regulations increasing the probability to detect money laundering could impede*

[565] *See* P. Egger, W. Eggert, H. Winner, *Saving taxes through foreign plant ownership*, in *Journal of International Economics*, 2010, p. 99-108.

[566] E.J. Bartelsman & R.M.W. Beetsmg, *Why pay more? Corporate tax avoidance through transfer pricing in OECD countries*, in *Journal of Public Economics*, 2003, p. 2225-2252.

[567] E. Mathias & A. Wardzynski, *Leveraging Anti-money Laundering Measures to Improve Tax Compliance and Help Mobilize Domestic Revenues*, IMF Working Papers, 2023.

[568] *C*onclusions of G7 Finance Ministers, London, May 1998, para 16: «*we encourage international action to enhance the capacity of anti- money laundering systems to deal effectively with tax related crimes. Action here would both strengthen anti-money laundering systems and would also be an essential component of a coherent programme to increase the effectiveness of tax information exchange arrangements*».

[569] It can be described as a process of disguising the illegal origin of criminal proceeds. *See* Vienna Convention, Article 3; Palermo Convention, Article 6; FATF Recommendations (2012–2023), Recommendation 3 and its Interpretive Note. See also FATF Recommendation 36.

*the business model of tax havens, at least of those tax havens, which specialize in tax evasion of private household capital income*»[570]. Hence, there is a clear link between money laundering and tax evasion[571].

The traditional definition of money laundering is the conversion of the profits of a crime ("predicate crime") into money that seems to be legitimate. Money laundering is commonly associated with drug trafficking, however criminal laws in a number of nations have a far broader definition of predicate offences for money laundering purposes[572]. Nowadays, it is more and more recurrent that «*tax haven and money laundering services coincide within the same country*»[573].

On the other, harmful tax competition has caused significant declines in statutory corporate income tax rates and is closely related to tax evasion, avoidance and fraud. The frontier between what is considered legal and illegal is often blurred in practice, especially manipulating intragroup export and import prices, creating excessive intragroup interest deductions ("thin capitalization") and setting a strategic location of intangibles[574]. Aggressive tax planning incentivized by a "race to the bottom" public revenue losses lead to a significant loss of public revenue from corporate tax avoidance[575]. Relevant literature recognizes «*the interdependence of tax avoidance and tax Competition*» and advocate for harmful tax competition to «*be reframed with a typology of tax competition and by considering tax avoidance and tax competition together*»[576].

[570] See P. Schwartz, *Money launderers and tax havens: two sides of the same coin?,* in *International Review of Law and Economics*, 2011, p. 37-47.

[571] A. Storm, *Establishing The Link Between Money Laundering And Tax Evasion,* in *International Business & Economics Research Journal*, 2013, p. 1437-1450.

[572] G. Spreutels & C. Grijseels, *Money launderers and tax havens: Two sides of the same coin?,* in *EC Tax Review*, 2001, p. 3-12.

[573] P. Schwarz, *Money launderers and tax havens: Two sides of the same coin?,* in *International Review of Law and Economics,* 2011, p. 37-47.

[574] United Nations Conference on Trade and Development, Trade and Development Report 2019 – Financing a Global Green New Deal.

[575] According to Cobham and Janský, this amounts to amounted to about $500 billion per year of which $194 billion was lost by developing and transition economies. *See* A. Cobham & P. Janský, *Global distribution of revenue loss from corporate tax avoidance: re-estimation and country results,* in *Journal of International Development,* 2018, p. 206-232.

[576] L.V. Falhaubert, *The Trouble with Tax Competition: From Practice to Theory*, in *Tax Law Review*, 2018, p. 364.

It is true that literature distinguishes between tax avoidance and tax competition. Tax avoidance centers on steps taken by taxpayers to lower the taxes they pay to one or more countries, as opposed to tax competition, which focuses on steps made by individual nations to alter their tax structures in order to compete with other nations[577].

Tax avoidance lacks a precise definition or a clear threshold for when it becomes damaging, similar to tax competition, and the literature often makes an effort to distinguish between legitimate tax planning and unlawful tax evasion[578].

Instead of restricting jurisdictional competition, laws intended to combat international tax evasion focus on keeping taxpayers from aggressively interpreting the law to lower their tax obligations. Multinational firms are complicit in tax competition, and nations are participating in tax evasion strategies. Therefore, recent measures to reduce tax evasion might be characterized as efforts to reduce tax competition. The last and most important point is that both recent antitax competition and anti-avoidance measures are forms of tax competition because anti-avoidance measures target international tax competition, and measures targeting international tax competition are attempts to shift competition in favor of the country or countries passing the antitax competition measure. Even according to the OECD report on harmful tax competition, harmful tax competition leads to tax evasion and avoidance and these were therefore linked to tax havens and harmful preferential tax regimes[579].

Offshore centers are mostly utilized for financial operations, particularly banking and insurance, they are frequently seen as centers of negative tax competition and money laundering due to their characteristics. One of the key prerequisites of the two phenomena is the tight bank secrecy they ensure. The authorities of those nations often refuse to divulge information on its inhabitants engaging in financial transactions in the country to the competent authorities of other countries. Some authors claim that the «*OECD exploits the confusion between tax competition and money laundering*» and that

[577] *See* J. Slemrod & S. Yitzhaki, *Tax avoidance, evasion and administration*, in *Handbook of Public Economics*, 2022, p. 1423-1425.

[578] M. Greggi, *Avoidance and Abus de Droit: The European Approach in Tax Law*, in *eJournal of Tax Research*, 2008, p. 23-44.

[579] 1998 OECD Report Harmful tax competition: An Emerging Global Issue, para 136: «*Harmful tax competition which leads to tax evasion by taxpayers of other countries may be encouraged if one country will not enforce the tax claims of another country. This position is based on concerns about the extra-territorial enforcement of tax claims, the lack of reciprocity, and procedural fairness. Also, the counteracting measures of some countries may be prevented from applying where a taxpayer has moved assets from one jurisdiction to another for tax evasion purposes*».

«*international financial centers may be competitors but, without exception, oppose money laundering*»[580], but these statements cannot be considered gospel truth.

Hence, given the potential intrinsic link between anti-money laundering and tax competition, international pressure has been growing for tax evasion to be treated as a corrupt practice under the United Nations Convention Against Corruption, and as a predicate offence for anti-money laundering legislation and strengthen international co-operation to fight harmful tax practices[581].

## 2. Main synergies between the two frameworks

Anti-money laundering might be employed to stimulate tax compliance objectives They might limit redundancy in the AML and tax compliance procedures. Money laundering and tax crimes share many parallels and synergies, and both are now classified as predicate offenses to money laundering under international law. The Financial Action Task Force, an intergovernmental organization founded in 1989 on the initiative of the G7 to develop policies to combat money laundering – has recently acknowledged the fundamental nexus between income tax evasion and money laundering[582]. However, the relationship between tax evasion and money laundering might go deeper than a simple predicate relationship. Tax evasion might not simply accompany money laundering but «*all tax evasion is itself necessarily a form of money laundering*»[583].

Initiatives to prevent harmful tax competition and increase tax transparency are interwoven with the fight against money laundering on a worldwide scale. The OECD Forum on Harmful Tax Practices was established in 1998 by the G-7 to address the "race

[580] P.D. Maynard, *The attack on international financial centers: marginalization, economic terrorism and the long march back to competitive advantage*, in *Journal of Financial Crime*, 2000, p. 145.

[581] For instance, the Tax Justice Network has taken the initiative in pushing a new tax agenda for development that benefits the poor. It has led the civil society calls for a new tax agenda to be decided at the Monterrey review conference in Doha and has actively pushed for key measures, including: (*i*) pushing for tax evasion to be treated as a corrupt practice under the UN Convention Against Corruption and as a predicate crime under the AML regimes of all countries providing financial services to non-resident clients; (*ii*) mandate the automatic submission of suspicious transaction reports for each customer that they suspect of tax evasion by all professionals subject to AML legislation. *See* B. Gurtner & J. Christensen, *The race to the bottom: incentives for new investment?*, in *Finance & Bien Commun*, 2009, p. 90-97.

[582] FATF *Report on the State of Effectiveness and Compliance with the FATF Standards, 2022.*

[583] D. Kemsley, S.A. Kemsley, F.T. Morgan, Tax evasion and money laundering: a complete framework, in *Journal of Financial* Crime, 2022, p. 589-602.

to the bottom" on corporate tax rates and to enhance the efficacy of domestic tax systems through increased international exchange of tax-related information. The G-7 committed to international action on tax related crime by gathering more intelligence through money laundering systems and providing for it to be shared internationally by tax authorities. It acknowledged that there is «*a potential weakness in international anti-money laundering systems by ensuring that financial institutions report suspicions about the movement of criminal assets regardless of whether they believe that the criminality involved is tax related. This is partly motivated by growing evidence that criminals can evade anti money laundering systems by presenting their affairs as tax related to reassure their bankers, brokers and professional advisor*»[584].

From a domestic perspective, the link between anti money laundering regimes and tax evasion – and thus indirectly with tax competition and the role in limiting the pervasive nature of offshore financial centers – is clear in some legal frameworks. For instance, the objective of Australia's 1988 Financial Transaction Reports Act[585] – the first AML legislation in Australia which has been largely replace today by the more advanced Anti-*Money Laundering* and Counter-Terrorism Financing *Act* of 2006 – was to «*facilitate the administration and enforcement of taxation laws*»[586]. In Australia, the Government appears to have deliberately blurred the difference between tax avoidance and tax evasion The AML/CTF Act would appear to designate that all measures to reduce and minimize income tax through the use of tax havens constitutes criminal activity. The fact that the rights of the taxpayer in terms of bank secrecy may be adversely affected and the taxpayer wrongly being accused of criminal activity is of no concern for the Government when trying to maximize government revenue.

Along these lines, since there is no income tax in most tax havens, there is no tax to avoid, hence tax avoidance is not conceived as a crime there. However, as the earnings arise from a crime, namely tax evasion, the failure to pay income tax by a taxpayer on

[584] HM Treasury Press Release regarding the G-7 Initiative on Harmful Tax Competition, Birmingham, 1998, where «*A major new initiative to tackle harmful tax competition was agreed by G7 Finance Ministers today at a meeting in London chaired by Chancellor of the Exchequer Gordon Brown*».

[585] Australian anti-money laundering legislation was implemented as a direct response to two Royal Commissions in the 1980s exposing the links between money laundering, major tax evasion, fraud and organized crime. See J. Walters, R.G. Smith, B. Davis, K. Raymond Choo, H. Chadwick, The anti-money laundering and counter-terrorism financing regime in Australia: Perceptions of regulated businesses in Australia, AIC Reports Research and Public Policy Series, 2012

[586] Financial Transaction Reports Act, para 4(1).

income received in an offshore bank account may be seen as money laundering. Tax-related criminal activity would fall under the purview of domestic law in tax havens that have enacted anti-money laundering legislation, particularly if the requesting nation could make the case that tax avoidance is an offense and that the subsequent laundering of the money through a tax haven might constitute the offense of money laundering[587].

## 3. Overview of beneficial ownership across the international taxation and money laundering frameworks

More generally, the beneficial owner is the natural person who ultimately owns, manages, or benefits from legal entities such as corporations, partnerships, and trusts for anti-money-laundering purposes Beneficial ownership transparency can expose genuine ownership, allowing for collection of fair taxes and prosecution of law enforcement agencies. The concept of beneficial ownership is key both for the tax and AML framework. Criminals and tax evaders frequently rely on secrecy to mask or hide their conduct, and they frequently employ opaque legal systems to do this.

Despite having the same general connotation, each system has its own specificities[588].

### 3.1. Beneficial ownership in international tax law

The "beneficial ownership" concept has originated from common law legal systems[589] and refers to «*the person who has the full privilege to directly benefit from the*

[587] *See* D. Kemsely, S. Kemsley, F.T. Morgan, *Tax Evasion and Money Laundering: A Complete Framework*, in *Journal of Financial Crime,* 2022; J. McLaren, *The Distinction between Tax Avoidance and Tax Evasion Has Become Blurred in Australia: Why Has It Happened?*, in *Journal of the Australasian Tax Teachers Association,* 2008, p. 141-163.

[588] For instance, in Mexico, for tax reasons, it is considered that an individual has control when, through the ownership of shares or titles, by contract or any other legal act, that person who maintains ownership of the rights that allow that person, directly or indirectly, to exercise the vote of more than 15% of the capital stock (Article 32-B Quarter of the Federal Tax Code). For AML reasons, Recommendation 24 allows the determination of the controlling shareholders of a company based on a threshold (for example, any persons owning more than a certain percentage of the company, such as 25%).

[589] Starting with the international taxation framework, from the 1940s through the 1960s, Australia, New Zealand, and the United States believed the idea of beneficial ownership to be inherent in tax treaties because it mirrored the underlying logic of executing tax treaties, namely that no treaty implementation would be possible without income allocation However, the United Kingdom added a new layer to that notion in the shape of its anti-treaty abuse function in 1960. The unusual legal restrictions in existence in the United Kingdom regulating the transfer of foreign-source revenue to trustees of UK trusts prompted this move. For an historical perspective of the notion of beneficial

*income*»[590]. It is generally conceived for taxpayers that might be benefiting indirectly from the advantages that a particular treaty provides by interposing a corporation in a tax-favorable jurisdiction to pay less tax than the corporation would pay in other jurisdictions. In fact, multiple legal systems have introduced a beneficial ownership requirement to distinguish improper treaty shopping from legitimate tax planning by denying benefits to a corporation that act merely as a conduit[591].

This notion was formally introduced for the first time in Art. 10 ("dividends"), 11 ("interest") and 12 ("royalties") in the 1977 version of the Model Double Taxation Convention on Income and Capital (hereafter, "OECD Model Convention") and subsequent versions of the Model have maintained it, on the basis of the US Model.

Nowadays, it has been included into most tax treaties between various jurisdictions.

The idea is critical in assessing whether or not a person is eligible for treaty benefits and in allocating the right to tax between the two contracting governments in the case of dividends, interest, and royalties. In this regard, tax treaties frequently include language requiring the individual claiming the treaty benefits (usually a lower withholding tax) to be the beneficial owner of the dividends, interest, or royalties[592].

The term "beneficial owner" was introduced in Articles 10, 11 and 12 of the OECD Model in 1977[593].

ownership, *see* B. Kuźniacki, *Beneficial Ownership in International Taxation and Biosemantics – Why a Redundant, Paradoxical and Harmful Concept Can Be a Potent Weapon in the Hands of the Tax Authorities*, in *Bulletin for International Taxation*, 2023, p. 42-53.

[590] UK: *Indofood International Finance Ltd v. JPMorgan Chase Bank NA Branch*, 2006 EWCA Civ 158 (2006).

[591] The lack of a clear definition of the notion has led to its intense scrutiny. For a more general understanding of beneficial ownership, see, *ex multis*; S. Jain-J. Prebble, *Beneficial ownership and the contractual obligation to pass on income*, in *Bulletin for International Taxation*, 2018; A. Meindl.Ringler, *Beneficial ownership in international tax law*, Alphen aan den Rijn, 2016.; P.A Hernández González-Barreda, *Beneficial Ownership in Tax Law and Tax Treaties*, Oxford, 2020; P. Valente, I. Caraccioli, G. Campana, *Beneficiario effettivo e treaty shopping*, Alphen aan den Rijn, 2016; L. De Broe, *International Tax Planning and Prevention of Abuse*, Amsterdam, 2008. As for case law, see, *ex multis*, CA: *Velcro Canada Inc v. The Queen* (2012); CA: *Prevost Car Inc v. The Queen* (2008); FR: *Société Bank of Scotland*, Conseil D´État, N° 283314 (2006), AT: *B AG V. Regional Tax Office Upper Austria* (2000); SUI: *A Holding ApS v Federal Tax Administration* (2005).

[592] *See*, *ex multis*, B. Kuźniacki, *Beneficial Ownership in International Taxation*, Cheltenham, 2022; E. Kemmeren & A. Stricher, *Preface to Articles 10 to 12*, in E. Reimer & A. Rust, *Klaus Vogel on Double Taxation Conventions*, Alphen aan den Rijn, 2021, p. 817-900; J. Walser, *The Concept of Beneficial Ownership in Tax Treaties*, in The OECD Model Convention—1998 and beyond; the concept of beneficial ownership in tax treaties, Alphen aan den Rijn, 2000, p. 817-900; J. Bundgaard & N Winther-Sørensen, *Beneficial Ownership in International Financing Structures*, in *Tax Notes International*, 2008, p. 587; P.A. Hernández González-Barreda, *Beneficial Ownership in Tax Law and Tax Treaties*, London, 2021; D. Gutmann & S. Austry, *Tax treaties and beneficial ownership: the Sté Planet Decision*, in *European Taxation*, 2022, p. 501-5014.

[593] *Article 10(2) of the OECD Model (1977), for example, stated:* «*Such dividends, however, may be taxed in the Contracting State in which the corporation delivering the dividends is a resident and in accordance with the legislation*

As a result of the addition of the concept of beneficial ownership to the 1977 OECD Model Tax Convention, that notion was often introduced to tax treaties established or updated after 1977 across the world. *Because the 1977 OECD Model's formulation of the notion of beneficial ownership was exceedingly limited, consisting of only two words ("beneficial owner"), the duty of explaining this concept rested on the Commentary on Articles 10, 11, and 12 of the 1997 OECD Model*[594].

The concept of beneficial ownership remains a "strange tax animal". The malleable nature of that concept allows the tax authorities and the courts to view it as a legal concept at some times, and, at other times, as an economic-factual concept, depending on the desired effect, they want to achieve in a specific case by means of its application"[595].

As the wording of the concept of beneficial ownership in international tax law is extremely sparse – it usually consists of just two words, "beneficial owner" and "beneficially owned" – almost the entire source for its understanding lies with non-legally binding materials of the OECD and tax jurisprudence. It lacks a sufficient degree of legal certainty, which means that it may escape a proper judicial review[596]. The tax authorities continue to have a broad, economic and anti-abuse understanding of the concept of beneficial ownership, irrespective of the lack of relevant legal premises embedded within the wording of that concept to clearly lead to an anti-abuse effect.

The paradox of the concept of beneficial ownership emerges from its potential anti-abuse application that is restricted to situations in which it is necessary to rely only on facts and circumstances to determine an implied qualified obligation to pass on the received income. The obligation is implied, as it follows solely from the facts and the circumstances, rather than legal or contractual stipulations, and it is qualified, as it links the receipt of income with its further transfer to other persons, it would not have been

*of that State, but if the receiver is the beneficial owner of the profits, the tax thus imposed shall not exceed:5 % of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 % of the capital of the company paying the dividends; 15 per cent of the gross amount of the dividends in all other cases».*

[594] The OECD Commentary on Articles 10, 11, and 12 (1977) stated*: «the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bilateral negotiations».*

[595] B. Kuźniacki, *Beneficial Ownership in International Taxation and Biosemantics – Why a Redundant, Paradoxical and Harmful Concept Can Be a Potent Weapon in the Hands of the Tax Authorities*, in *Bulletin for International Taxation*, 2023, p. 42 et seq..

[596] A.M. Jimenez, Beneficial ownership: current trends, in *World Tax Journal*, 2010, p. 35-64.

obtained by a conduit[597].

The use of a Principal Purpose Test rule[598] eliminates the need for beneficial ownership when dealing with conduits. However, the idea still has some use when dealing with agents, nominees, and some trustees and is still the most prevalent anti-treaty shopping rule, despite being relatively out of date and ineffective in comparison to more modern anti-abuse provisions[599].

## 3.2. Interpretation of the Court of Justice of the European Union: the Danish Cases

In the context of the *Danish cases*[600], the Court of Justice of the European Union clarified the meaning of beneficial ownership for interest payments under the Interest and Royalty Directive as well as the extent of the exemption from withholding tax on dividend payments falling under the Parent-Subsidiary Directive.

In the *Danish cases* concerning the Interest and royalty directive, the Danish court raised the question of the interpretation that should be attributed to the term "beneficial ownership". According to Advocate General Kokott [601], there is an autonomous concept of beneficial ownership in EU law and there is no need to strictly contemplate the criteria set out in Art. 11 of the OECD Model Convention and the subsequent considerations of the Commentary. The opinion of the Advocate General is based on previous case-law of the Court of Justice of the European Union[602] and concludes that that – for the purposes of the Interest and Royalties Directive – the beneficial ownership is the person who is

[597] *See* C. Du Toit, *The evolution of the term "beneficial ownership" in relation to international taxation over the last 45 years*, in *Bulletin for International Taxation*, 2010, 500.

[598] The principal purpose test aims to prevent aggressive tax planning by multinationals and/or individuals. The benefits of a treaty may be denied if the principal purpose of a structure is to benefit from the treaty. See I.J. Mosquera Valderrama, BEPS principal purpose test and customary international law, in *Leiden Journal of International Law,* 2020, p. 745-766.

[599] A.M. Ringler, Beneficial Ownership, Beneficial Ownership in International Tax Law, Alphen aan den Rijn, 2016, p. 381.

[600] *N Luxembourg I et al* (C-115/16, C-118/16, C-119/16 and C-299/16) and *T Danmark et al* (C-116/16 and C-117/17).

[601] I. Lazarov, (*Un)Tangling Tax Avoidance Under the Interest and Royalties Directive: the Opinion of AG Kokott in N Luxembourg 1, Intertax*, 2018, p. 873.

[602] Court of Justice of the European Union *Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen-Süd (*C-397/09), para *99.*

entitled under civil law to claim payment of the interest: an interest recipient who collects the interest in his own name and on his own account is also the beneficial ownership.

The person or the company that does not act in its own name but on behalf of a third party on the basis of a fiduciary relationship cannot claim to be the beneficial owner for the purposes of the Interest and Royalties Directive. This interpretation has been inferred from Art. 1, paragraph 4 of the Directive, according to which an intermediary, trustee or representative is not to be regarded as a beneficial owner.

Conversely, the Court of Justice of the European Union, pursuant to Art. 1, paragraphs 1 and 4 of the Interest and Royalties Directive[603] illustrated that it considers beneficial ownership as a necessary requirement for the application of the exemption from withholding tax on interest paid to companies that are resident in a Member State and interpreted the term in a whole different way. More specifically, the Court of Justice of the European Union had to deal with the following aspects[604]:

1) Whether the notion of beneficial ownership in the Interest and Royalties Directive must be interpreted in accordance with the corresponding notion referred to in Art. 11 of the 1977 OECD Model Tax Convention.

2) If both meanings match, whether this notion should be interpreted exclusively in the light of the 1977 OECD commentary or also according to subsequent Commentaries.

3) In case the 2003 commentaries can be taken into consideration for the interpretation of beneficial ownership to ascertain that a company is not a beneficial owner, if there should be the effective channeling of funds to those persons who are deemed by the State in which the interest payer is resident to be beneficial owners of the interest in question and whether an additional condition is the fact that the transfer takes place at a point close in time to the payment of interest and/or takes place as a payment of interest;

[603] In general terms, Art. 1(1) of the Interest and Royalties Directive provides that the payment of an interest or royalty is exempt from withholding tax provided that the receiving company is the beneficial owner of the interest or royalty. Art. 1(4) instead, states that «*a company of a Member State shall be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorized signatory, for some other person*».

[604] S. Giannelli & F. Pitrone, *Beneficiario effettivo*, in D. Avolio, *Fiscalità internazionale e dei gruppi societari*, Milan, 2020, p. 720-726.

4) Whether, in the event that the 2003 commentaries can be taken into consideration in the hermeneutic approach, relevance should be attributed to the fact that most of the individuals to whom the interest have been transferred – that are considered beneficial owners of the interest of the State of residence of the interest payer – are resident in other Member States or in other States with which the source State has stipulated Double Tax Treaties so that, according to the tax legislation of the source State , the withholding tax would not have been applied had these subjects directly received the interest;

5) Whether a Member State is required to indicate who is the beneficial owner of the income in case the Member State does not intend to recognize that a company in another Member State is the beneficial owner of the interest and claims that that company in the other Member State is a so-called "artificial conduit company".

In relation to the questions referred, the Court replied that the notion of beneficial ownership of the interests cannot be based on notions of domestic law but has an autonomous meaning in EU law. Besides, beneficial ownership should be linked to a substantial definition and not a merely formal one[605]. According to the Court, in fact, such clause refers to economic reality: a company resident in a Member State is considered to be the beneficial owner of the relevant income solely if it receives this income in its own name and on its own account and not on the account of a third party, or as an intermediary, such as an agent, trustee or authorized signatory. The Court also examined the different language versions of the term "beneficial ownership" in the Interest and Royalties Directive and concluded that this notion does not refer to a formally identified recipient but to the entity which benefits economically from the interest received and accordingly has the power to freely determine the use to which it is put[606].

[605] Advocate General Kokott had emphasized that the civil law claim to interest is pivotal: a company resident in another Member State is the beneficial owner within the meaning of the Directive if the company owns the interest-bearing claim and fulfils further criteria set forth by the Directive unless it was not acting in its own name For a thorough analysis of AG Kokott's opinion, see also S. Baerentzen, *Cross-Border Dividend and Interest Payments and Holding Companies – An Analysis of Advocate General Kokott's Opinions in the Danish Beneficial Ownership Cases*, in *European Taxation*, 2018, p. 343-353.

[606] The Court noted in *N Luxembourg I et al* (C-115/16, C-118/16, C-119/16 and C-299/16), *para 10* that the «*term used in Art. 1(1) of Directive 2003/49 is, depending on the language version, the 'beneficiary'/'recipient' (in Bulgarian (бенефициерът), French (bénéficiaire), Latvian (beneficiārs) and Romanian (beneficiarul), the 'beneficial owner'/'actual beneficiary' (in Spanish (beneficiario efectivo), Czech (skutečný vlastník), Estonian (tulusaaja), English (beneficial owner), Italian (beneficiario effettivo), Lithuanian (tikrasis savininkas), Maltese (sid benefiċjarju),*

The “substance over form approach” followed by the Court is not surprising for at least two kinds of reasons. First and foremost, the historical moment of EU and international tax law and the related regulatory initiatives aimed at combating the phenomena of double taxation and aggressive tax planning. In light of this normative evolution, the formal definition of beneficial ownership as «*the person entitled under civil law to demand payment of the interest*»[607] seems rather anachronistic[608].

Secondly, the Court has acknowledged that the concept of beneficial ownership referred to in the Interest and Royalties Directive is to be interpreted on the basis of international conventions against double taxation and, in particular, in line with the dynamic notion of beneficial ownership set forth in the various commentaries to the OECD Model Convention which refer to the power of the recipient to dispose of the income legally and economically.

For our analysis, the definition of beneficial ownership in the Commentary of the OECD Model Convention cannot be left aside as this principle seems to have been acknowledged by the Court. The referring courts sought guidance on the relevance of the

*Portuguese (beneficiário efectivo) and Finnish (tosiasiallinen edunsaaja)), the ‘owner’/‘person entitled to use’ (in German (der Nutzungsberechtigte), Danish (retmæssige ejer), Greek (ο δικαιούχος), Croat (ovlašteni korisnik), Hungarian (haszonhúzó), Polish (właściciel), Slovak (vlastník požitkov), Slovenian (upravičeni lastnik) and Swedish (den som har rätt till)), or the ‘person entitled in the end’ (in Dutch (de uiteindelijk gerechtigde))*». From that analysis, the Court concludes in *N Luxembourg I et al* (C-115/16, C-118/16, C-119/16, C-299/16), para 89 that most language versions «*have recourse to expressions such as “beneficial owner”/”actual beneficiary’”(the Spanish, Czech, Estonian, English, Italian, Lithuanian, Maltese, Portuguese and Finnish versions), “owner”/”person entitled to use” (the German, Danish, Greek, Croat, Hungarian, Polish, Slovak, Slovenian and Swedish versions) or person entitled in the end (the Dutch version)*».

[607] Court of Justice of the European Union, S*cheuten Solar Technology GmbH v Finanzamt Gelsenkirchen-Süd* (C-397/09), para 27: «*In this respect, Art. 2(a) of Directive 2003/49 defines that interest as “income from debt-claims of every kind”. Only the actual beneficial owner can receive interest which constitutes income from such claims*».

[608] In some authors’ view, Advocate General Kokott’s interpretation of beneficial ownership was indeed correct. and beneficial ownership should include subjects that (*i*) may have or lack legal ownership and/or record ownership and/or title ownership but always enjoy all powers of control and enjoyment thereof; (*ii*) receive the income from the legal, record or title owner in their own right and not at the discretion of the legal, record or title owner; (*iii*) have the full or almost full power to decide on the asset and/or the income; (*iv*) hold an interest that is quantified in a concrete manner (even if in relation to an undefined credit), so their right can be quantified *ab initio* as soon as the income arises in the hands of the intermediary, and not abstractly or conditionally; (*v*) are entitled to enforce the rights pertaining to their ownership against the intermediary and in some cases against third parties; (*vi*) whose right may be derived from the contract or arrangement itself from which the recipient acquired the position in relation to the right from which the income is derived, or might be derived from a different arrangement referring to or connected to accrual to the contract upon which the income arises in the hands of the recipient. See P.A. Hernández González-Barreda, *Holding Companies and Leveraged Buy-Outs in the European Union Following BEPS: Beneficial Ownership, Abuse of Law and the Single Taxation Principle (Danish ECJ Cases C-115/16, 116/16, 117/16, 118/16, 119/16 and 299/16)*, in *European Taxation*, 2019.

OECD Model Convention and the Commentary for the interpretation of the notion of beneficial ownership used in the Interest and Royalties Directive and the relevance of the evolution of the OECD Commentaries for the interpretation of the Interest and Royalties Directive. Despite Advocate General Kokott objecting to any automatic use of the OECD documents, the Court of Justice of the European Union considered the OECD Model Convention and Commentary as relevant for the interpretation of the notion of beneficial ownership. It should be noted that decisions of the OECD cannot be automatically transposed into the EU *acquis* because some Member States are not members of this international organization[609].

Nevertheless, the opinion of the Court of Justice of the European Union is that the notion of beneficial ownership defined in the Interest and Royalties Directive is an autonomous EU law concept[610] and the recourse to other sources, such as the OECD Model Convention, could be considered useful for the interpretation of the Interest and Royalties Directive. The OECD definitions can be deemed a valid intellectual inspiration for the interpretation of EU instruments (in this case, the Interest and Royalties Directive) and could be used as persuasive argumentation in court proceedings. In spite of the fact that the Interest and Royalties Directive contains a proper definition of beneficial ownership, without referring to the OECD's beneficial ownership definition, the Court held that the OECD Model and Commentary after the 1996 version are also relevant when interpreting the Interest and Royalties Directive's beneficial ownership concept.

[609] Bulgaria, Croatia, Cyprus, Malta and Romania are EU Member States that are not OECD Member countries. On 25 January 2022, the OECD decided to open accession discussions with six candidates to OECD membership: EU Member States Bulgaria, Croatia and Romania are three of them.

[610] This is due to several reasons: *inter alia*, the fact that the Interest and Royalties Directive contains its own definition of beneficial ownership (for instance, according to the Interest and Royalties Directive, trustees are explicitly excluded as being Bos whilst trustees can qualify as beneficial owner in certain circumstances following the OECD Commentary) and the fact that EU tax law and international tax law have their own interpretation methods. In particular, the teleological interpretation method of the Court of Justice of the European Union is fundamental for the former, while the latter is based on customary international law and specific provisions (for instance, of the OECD Model Convention and the Commentaries) to interpret double tax treaties. For a more thorough analysis about solutions in terms of global tax governance aimed at coordinating international tax treaty law and EU tax law as well as the current problems connected to this lack of coordination, see C. De Pietro, *Beneficial Ownership, Tax Abuse and Legal Pluralism: An Analysis in Light of the CJEU's Judgment Concerning the Danish Cases on Interest*, in *Intertax*, 2020, p. 1075-1086.

In addition, the OECD meaning of the beneficial ownership concept in the OECD Commentary becomes legally binding through the Interest and Royalties Directive since the legislative history reflects the democratic process of the EU[611].

Thus, it appears after all that the beneficial ownership concept is not a purely autonomous EU concept because the OECD Commentary is "relevant" in the interpretative process and the concept of beneficial ownership is «*an OECD Model Commentary-inspired EU concept*»[612]. The abuse of law doctrine, on the other hand, serves as a general principle of EU law and has a different function[613].

In other words, a company resident in a Member State is considered the beneficial owner of the relevant income only if it receives this income on its own account and not as a representative, authorized signatory, trustee of another person, therefore having the right to freely dispose of the destination of the income received. The EU Court underlines the need to adopt a look-through approach aimed at verifying whether in the specific case there is a company resident in an EU country that has the necessary elements to be qualified as beneficial owner and benefit from the exemption regime of that specific agreement or directive. Even in the case of a conduit company which cannot be recognized as a beneficial owner, this does not mean that is should be qualified as an abusive structure.

Therefore, for the purposes of any dispute as to the use of tax benefits established by the Interest and Royalties Directive, Tax Authorities are required to act as follows: *i*) first of all, assess whether the recipient company qualifies as a beneficial owner; *ii*) if not, proceed through the look through approach, in order to find any company resident in an EU state that can be considered a beneficial owner; *iii*) in case it does not find any, the exemption provided for by the Interest and Royalties Directive cannot be recognized; iv) in any case, the fact that the company does not qualify as a beneficial owner

[611] Relevant doctrine has emphasized that «*this counterargument of the CJEU is regrettable because it is too easy as it ignores the fact that nowhere in the Interest and Royalties Directive or its legislative history any reference is made that supports the interpretation of the beneficial ownership concept in the Interest and Royalties Directive in accordance with the OECD Model and Commentaries*». See L. De Broe, S. Gommers, *Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases*, in EC *Tax Review*, 2019, p. 270-299.

[612] The beneficial ownership concept in the Interest and Royalties Directive has an "international meaning, inspired by the OECD Commentary The disadvantage is the uncertainty over the relevance of the OECD Commentary See D. Weber, *European Union/International - EU Beneficial Ownership Further Developed: A View from a Different Angle*, in *World Tax Journal*, 2022.

[613] A. Zalasiński*, The CJEU's Decisions in the Danish "Beneficial Ownership" Cases: Impact on the Reaction to Tax Avoidance in the European Union*, in *International Tax Studies*, 2019.

constitutes a signaling element from which the financial administrations can proceed to a more in-depth examination aimed at the possible ascertainment of an abusive case[614].

In this regard, it should be noted that, according to relevant doctrine[615] beneficial ownership has been misinterpreted by the Court. Indeed, the Court's arguments: (*i*) do not thoroughly assess the definition of beneficial ownership in respects of Permanent Establishments; (*ii*) limit the analysis to conduit companies and in relation to the 2003 version of the OECD Model Convention without focusing on the 2014 modifications. On the basis of the OECD interpretation, the Court is of the opinion that the notion of "beneficial ownership" excludes conduit companies and must be conceived as a means to avoid double taxation[616]. Yet, it did not discuss the amendments included in the 2014 Commentaries to the text that refers to the concepts of beneficial owner and of conduit companies even though it did mention those changes. It is rather odd that no further attention was paid to these changes as they are very relevant to the OECD meaning of the concept of beneficial ownership.

As regards the interpretation of the Parent-Subsidiary Directive, there is no explicit beneficial ownership requirement that entitles to the exemption from withholding tax. Though there is no specific attention to the concept of beneficial ownership in the provisions of the Parent-Subsidiary Directive, the Court of Justice of the European Union seems to have introduced – also with reference to the exemption from withholding tax on dividends pursuant to the Parent-Subsidiary Directive and contrary to Advocate General Kokott's Opinions[617] – the requirement of the beneficial ownership[618].

[614] G. Corasaniti, *L'evoluzione della nozione di beneficiario effettivo tra il modello di Convenzione OCSE e la giurisprudenza della Corte di Cassazione e della Corte di Giustizia dell'Unione Europea*, in *Diritto e Pratica Tributaria*, 2021, p. 2516-2522.

[615] P.A. Hernández González-Barreda, *European Union - Holding Companies and Leveraged Buy-Outs in the European Union Following BEPS: Beneficial Ownership, Abuse of Law and the Single Taxation Principle (Danish CJEU Cases C-115/16, 116/16, 117/16, 118/16, 119/16 and 299/16)*, in *European Taxation*, 2019.

[616] *N Luxembourg I, X Denmark, C Danmark I and Z Denmark v. Skatteministeriet* (C-115/16, C-118/16, C-119/16 and C-299/16), *para 92.*

[617] *See* the Opinions of AG Kokott of 1 March 2018 in *T Danmark* (C-116/16 paras 78-86) and *Y Denmark* (C-117/16), *paras* 78-86.

[618] *See* W. Haslehner-G.W. Kofler, *Three Observations on the Danish Beneficial Ownership Cases*, in *Kluwer International Tax Blog*, 2019. For an alternative explanation, see J.M. Janssen-M.S. Garibay, *What Should Be the Scope of the Beneficial Owner Concept?*, in *Intertax*, 2020, p. 1087-1104. For an example of case law where an application in which the absence of the beneficial ownership status of the dividends was independently invoked in order to refuse exemption from withholding tax, see the French judgement *CAA Versailles, 1re ch., 3 juill. 2018,*

The Court of Justice of the European Union did not answer the specific question asked in this regard by the referring judge yet stated that «*where the beneficial owner of dividends paid is resident for tax purposes in a third State, refusal of the exemption provided for in Article 5 of Directive 90/435 is not in any way subject to fraud or an abuse of rights being found*»[619].

This interpretative passage is not crystal clear as it does not clarify exactly whether the reference to the concept of beneficial ownership constitutes an application requirement in order to benefit from the Directive regardless of assessments on the presence or absence of a situation of abuse of the Directive – or should only be viewed in the context of the indicators of abuse.

In spite of the wording used by the Court of Justice of the European Union, it is worth mentioning that, according to other authors[620] it would not be sufficient for Tax Authorities to demonstrate that the recipient is not the beneficial owner in order to deny the benefits of the Parent-Subsidiary Directive. It would instead be necessary to demonstrate the existence of an abuse of law in line with the new General Anti Avoidance Rule introduced by the Parent-Subsidiary Directive. Therefore, the beneficial ownership limitation represents a requirement that would be independent from the principle of abuse of rights.

The exemption from withholding tax pursuant to the Interest and Royalties Directive and the Parent-Subsidiary Directive cannot be applied in the presence of a situation of abuse of the directives and this regardless of the presence or absence of anti-abuse provisions in the domestic legislation of each Member State or conventional ones. Starting from the assumption that Member States are required to apply the general principles of EU law according to which abusive practices are prohibited, the Court of Justice of the European Union has expressed the principle according to which, even in formal compliance with all the application requirements provided for by the Interest and Royalties Directive and the Parent-Subsidiary Directive, Member States must in any case deny the exemption from withholding tax on interest and dividends paid if it is proven

*n° 17VE03170, Sté Eqiom et Sté Enka* as well as the related case note V.C. *Acard, Étude 120*, in *Revue de Droit Fiscal*, 2019 4, p. 12-13.

[619] *T Danmark et al* (C-116/16 and C-117/17), *para* 111.

[620] *See* A. Barba de Alba, D. Arribas, *The Interplay between Beneficial Ownership and Abuse in the Danish Cases on Dividends*, in *Kluwer International Tax Blog*, 2019.

that the taxpayer has relied on EU law for abusive or fraudulent ends. It should also be noted that – with reference to the Interest and Royalties Directive - the Court aligned the objectives of the Interest and Royalties Directive and Art. 11 of the OECD Model Convention[621] since they both aim at avoiding international double taxation. Thus, the Court seems to suggest that the concept of beneficial ownership should be interpreted in the same way as in the OECD Model Convention. This applies to the notion of beneficial ownership as included in the Interest and Royalties Directive and – as previously explained – to the Parent-Subsidiary Directive.

Obviously, this assertion now assumes relevance mainly with reference to periods prior to the mandatory general anti-abuse clause that was included in the amendment of the Parent-Subsidiary Directive as well as the adoption by the Member States of the general anti-abuse clause provided under the ATAD Directive[622] and the Principal

[621] Art. 11 of the Model Tax Convention on Income and on Capital: «*(1) Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. (2) However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation; (3) The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article; (4) The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply; (5). Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated. 6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention".*

[622] Art. 6 of the ATAD Directive, which provides a General anti-abuse rule (GAAR) applicable to all taxpayers subject to corporate tax in one or more EU Member States and has to be transposed into the domestic laws of Member States, reads as follows: "(1) *For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.* (2) *For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.* (3) *Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law*». Its main objective is to provide harmonization in the field of corporate tax law among all Member

Purpose Test[623] which will be gradually introduced in the conventions against double taxation stipulated between the Member States following the entry into force of the multilateral convention. Admittedly, beneficial ownership has a broader meaning in the *Danish cases,* but OECD tools might still prove effective to tackle abusive practices by resorting to the Principal Purpose Test regardless of the existence of beneficial ownership status. As for the impact on the *Danish cases* on the interpretation of Double Tax Treaties, there might be two possible situations: tax treaties concluded between Member States or between a Member State and a third country.

In the first case, the principles laid down in the *Danish cases* would be applicable in case of abuse of EU law; otherwise, companies may still invoke Double Tax Treaty protection given the potential lack of democratic legitimacy in the case at stake. Yet, it cannot be excluded that the Court of Justice of the European Union judgements in the *Danish cases* could still be taken into account by national courts interpreting the Double Tax Treaty concluded between two EU Member States. In fact, given that Double Tax Treaties sometimes state that those terms can be interpreted in light of domestic law and in light of Art. 3(2) of the OECD Model[624], this could lead to interpretation in accordance with the *Danish cases* since domestic law itself has to be interpreted in compliance with EU law.

States. The measures of Member States should thwart artificial arrangements, but Member States are on the one hand obliged to transpose the Directive, under the threat of an action for infringement initiated by the European Commission, and on the other hand be aware of possible actions by the Court of Justice which could reproach them for the violation of one of the fundamental freedoms guaranteed by the TFEU. It is worth noting that the general anti-abuse clause of the ATAD is very similar to the one of the Parent-Subsidiary Directive, except that the latter limits its scope to the exemption from withholding tax on dividends distributed in the State of the subsidiary and the exemption of this income or the granting of a tax credit in the State of the parent while the ATAD anti-abuse measure protects the integrity of corporate tax legislations of Member States by referring to obtaining «*a tax advantage that defeats the object or purpose of the applicable tax law*».

[623] The PPT can be a powerful tool for contracting states to address tax treaty abuse. In the future, there will be a recurring use in tax treaties of a self-standing treaty-based anti-avoidance rule following the work the OECD through the BEPS project (final report on Action 6) and the introduction of the Multilateral Convention (MLI). In fact, an anti-abuse clause (known as the "Principal Purpose Test Rule" or "PPT") was included in the OECD Model Convention of 2017 in Article 29(9): «*Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention*».

[624] Art. 3(2) of the OECD Model: «*As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State*».

In the event of an EU Member State concluding a tax treaty with a third party, in light of the general principle that EU law cannot be relied upon for fraudulent or abusive ends, the Court of Justice of the European Union clarified that «*it is immaterial that some of the beneficial owners of the interest paid by the conduit company are resident for tax purposes in a third State which has concluded a double taxation convention with the source Member State*»[625]. It is a matter of abuse, not of mere residency.

In spite of the impossibility to rule out that a national court of an EU Member States might possibly still take into consideration the *Danish cases*, it is worth noting that there is no automatic abuse of tax law when a company benefits from a reduced withholding tax by invoking a Double Tax Treaty and therefore there would be no application *per se* of the *Danish cases*. Indeed, treaty protection may be limited by resorting the Principal Purpose Test, which would be interpreted in light of the OECD Commentary.

### 3.3. Beneficial ownership in the Anti-Money Laundering framework

Beneficial owner refers to the natural person who ultimately[626] owns or controls a customer[627] and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement[628].

Identification of the natural persons who may be accountable for the underlying conduct of concern or who may have pertinent information to further an inquiry can help law enforcement and other competent authorities. In financial investigations involving questionable accounts or assets held by corporate vehicles, this enables the authorities to conduct their investigations by focusing on the transfer of funds. Locating a specific person's assets inside a jurisdiction can also be made easier with the aid of beneficial ownership information. The implementation of policies to guarantee the timely

[625] *N Luxembourg I, X Denmark, C Danmark I and Z Denmark v. Skatteministeriet* (C-115/16, C-118/16, C-119/16 and C-299/16), *para 135; Skatteministeriet v T Danmark and Y Denmark* (C- 116/16 and C-117/17) *para 108*.

[626] Reference to "ultimately owns or controls" and "ultimate effective control" refer to situations in which ownership/control is exercised through a chain of ownership or by means of control other than direct control.

[627] This definition should also apply to beneficial owner or a beneficiary under a life or other investment linked insurance policy.

[628] FATF guidance, Transparency and beneficial ownership, 2014. See also M. Riccardi – E.U. Savona, *The identification of beneficial owners in the fight against money laundering - Final Report of project BOWNET*, 2013.

availability of accurate beneficial owner information, however, is fraught with difficulties for many nations. This is especially difficult when there are legal entities and legal agreements distributed across numerous nations.

It is necessary to distinguish between the concepts of legal ownership and control and the FATF definition of beneficial owner in the context of legal persons. On the one hand, legal ownership refers to the natural or legal individuals who legally own the legal person in the relevant jurisdiction. Contrarily, control refers to the capacity to enforce pertinent choices within a legal entity and can be obtained in a variety of ways (for instance, by controlling a block of shares).

The FATF definition of beneficial owner, however, includes the idea of ultimate ownership and control in addition to legal ownership and control, which is a crucial component. In other words, rather than just focusing on (natural or legal) persons who are legally entitled on paper to do so, the FATF definition places more emphasis on the natural persons who actually own and benefit from the capital or assets of the legal person, as well as on those who actually exert effective control over it (regardless of whether they hold formal positions within that legal person)[629].

The fact that natural people are included in the FATF definition of a beneficial owner even though they do not really or legally own or control the customer is a crucial component of the definition. This part of the FATF definition of a beneficial owner focuses on the people who are essential to a transaction, even when that transaction has been purposefully set up to prevent consumer control or ownership while maintaining the transaction's financial benefits.

As for legal arrangements[630], FATF defines beneficial owner as the natural person at the end of the chain who ultimately owns or controls the legal arrangement, including those who exercise ultimate effective control over the legal arrangement, and the natural person on whose behalf a transaction is being conducted. This definition also applies in the context of legal arrangements. However, in this situation, it is more difficult to identify the beneficial owner in reality due to the unique features of legal arrangements.

[629] In March 2022, the FATF agreed on tougher global beneficial ownership standards in its Recommendation 24 by requiring countries to ensure that competent authorities have access to adequate, accurate and up-to-date information on the true owners of companies.

[630] FATF is conducting a review of Recommendation 25 on the transparency and beneficial ownership of legal arrangements to better meet its stated objective to prevent the misuse of legal arrangements for money laundering or terrorist financing.

For instance, in a trust, the equitable rights in an asset are kept distinct from the legal ownership and management of the item.

Accordingly, depending on the requirements of the document forming the trust (such as the trust deed), different individuals may own, benefit from, and control the trust. The settlor, beneficiary, and occasionally even the trustee may be the same person under the trust legislation of various nations. Trust deeds differ and may include clauses under which the settlor reserves certain powers (such as the authority to cancel the trust and have the trust funds returned). These clauses may have an impact on who has ultimate control over the trust assets. This could be useful in figuring out who really owns a trust and the people that are connected to it.

If we focus instead on the European Union – which is being at the forefront of the battle against Anti-Money Laundering given the new Anti-Money Laundering package that is being approved by the co-legislators and the creation of a new *EU* authority to counter *money laundering – the definition is based on the specific type of entity*[631].

For corporate entities, a beneficial owner is someone who owns more than 25% of the shares or voting rights in a legal business. Exceeding this threshold, a person must be disclosed as a company's beneficial owner on a centrally kept register. Ultimately, regardless of how many layers of ownership exist, a natural person(s) must be identified and registered on the Register as the beneficial owner(s) of the business. If no natural person is identified as a beneficial owner after exhausting all possible means and there are no grounds for suspicion, or if there is any doubt that the person(s) identified are the beneficial owner(s), the natural person(s) who hold the position of Senior Managing Official(s) shall be recorded on the Register as the beneficial owner[632].

Nonetheless, this study reveals that the 25% barrier, which determines whether the beneficial owner of a firm must be declared, is meaningless[633]. Even lowering this barrier would not preclude criminals from disguising beneficial ownership by stacking corporate ownership. As a result, regardless of the amount of their ownership or influence, every individual participating in corporate ownership should be registered.

[631] Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015.

[632] Art. 3(6) of Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015.

[633] L. Campbell, *Dirty cash (money talks): 4AMLD and the money laundering regulations 2017*, in *Criminal Law Review*, 2018, p. 102-122.

Implementing registers of beneficial owners seems to be a sensible step towards enhancing corporate transparency

As for trusts, they are of particular interest to authorities since they are less regulated and make it simpler to conceal beneficial owners than other corporate organizations. Yet, trusts' secrecy may explain the uncertainty around their illegal exploitation[634].The definition of beneficial owners usually entails identifying all parties: settlor, trustee, protector, beneficiaries and classes of beneficiaries, and any other individual with effective control over the trust[635].

It is worth noting that one of the main hurdles to retrieve beneficial ownership information is banking secrecy and governments should increase their pressure on tax havens and fight banking secrecy. Banking secrecy may be the principal reason that foreign jurisdictions do not share beneficial ownership information about their clients with other authorities[636].

## 4. Synergies of *modi operandi* and the importance of beneficial ownership

Tax evasion and money laundering are two interconnected actions that frequently occur in the same causal chain. Furthermore, offenders of both tax crimes and money laundering charges generally use similar types of obfuscation strategies to avoid detection. Coordinated international action in this area would strengthen existing anti-money laundering mechanisms and would increase the effectiveness of information exchange arrangements in tax issues[637]. The facilitation of tax evasion and money laundering is described in paragraph 53 of the 2000 OECD report as «*particularly harmful characteristics of a tax haven*». So, it appears that nations who want to avoid

[634] B. Zagaris, *A Brave New World: Recent Developments in Anti-Money Laundering and Related Litigation Traps for the Unwary in International Trust Matters*, in *Vanderbilt Journal of Transnational Law*, 1999, p. 1023-1116.

[635] Art. 3(7) of Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015.

[636] P.M. Gilmour, *Lifting the veil on beneficial ownership,* in *Journal of Money Laundering Control* , 2020, p. 701-734.

[637] *See* J.D. Wilson, *Theories of Tax Competition*, in *National Tax Journal*, p. 269; P. Genschel & P. Schwarz, *Tax Competition: A Literature Review*, in *Socio-Economic* Review, 2011, p. 339.

being classified as tax havens by the OECD, or who want to be deemed "cooperative" and so avoid tax fines, would profit by exhibiting vigilance against money laundering[638].

There are synergies between actions aimed at perpetrating money laundering and tax evasion through aggressive tax planning schemes and, indirectly, harmful tax competition. Several investigations – Panama Papers, Paradise Papers, Pandora Papers, and, most recently, the Credit Suisse Leaks[639] – such as into how politicians, multinational corporations, celebrities, and high-net-worth people have shown the use sophisticated structures to shield their revenues from tax authorities and potentially obtained through money laundering.

They are intended to conceal the financial trail of revenue and obscure ownership information in order to conceal the illicit or taxable nature of money and their connection to the offenders. The most common techniques include the use of shell companies, the abuse of fiduciary vehicles (such as trusts and other similar legal arrangements), reliance on professional intermediary services, the use of formal and informal nominee directors and shareholders, the production of fraudulent business and accounting records. This more often happens in the international arena: criminals may purposefully separate the location of legal vehicles, asset ownership and administration, professional advisers, and bank accounts across many nations as it would be more challenging for national authorities (either Financial Intelligence Units or Tax Authorities) to continue their investigations.

Those perpetrating tax evasion, including through aggressive tax planning schemes incentivized by harmful tax competition, and those carrying out money laundering activities are usually not able to act alone.

They frequently rely on the services of financial intermediaries and associated professions to wash the underlying profits. Financial intermediaries play a critical role in allowing criminal profits to enter the financial system. Criminals frequently have no alternative but to enter their unlawful gains or otherwise taxable revenue into the

[638] On June 26, 2000, the OECD released a list of 35 tax havens identified by the Forum, together with a report. *See* OECD, Toward Global Tax Cooperation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs, 2000.

[639] Switzerland has shed its image as a haven for tax evasion, money laundering and the embezzlement of government funds, practices carried out through the misuse of its banking secrecy policies. This was maked for the last time in 2022. An extensive leak from Credit Suisse, one of the world's largest private banks, has revealed the hidden riches of clients implicated in torture, drug trafficking, money laundering, corruption, and other major crimes.

financial system's circulation, not least as part of the laundering process itself. This is also owing to the difficulties of physically carrying big sums of cash, as well as the financial system's flexibility in freely disposing monies in everyday life and commercial transactions. Experts giving tax advise have severe reporting requirements in many nations but – as we said – their action can potentially lead to money laundering[640].

The common ground amongst obfuscation techniques used to perpetrate tax crimes or money laundering schemes is the concealment of beneficial ownership. The idea of "beneficial ownership" is pivotal: entity transparency is critical to the integrity and successful implementation of both AML and tax frameworks. Beneficial ownership refers to a natural person who actually owns, controls, or profits from a legal vehicle, transaction, or other assets[641]. It may differ from the legal owner, who does not have to be a natural person and may not actually own or control an asset or income.

On the one hand, beneficial ownership is essential to safeguard the integrity of the tax system. For instance, research shows that the majority of financial assets are held by entities such as trusts rather than natural persons and the location of the beneficial owner is generally not the same as the one of the legal owners. Hence, it is extremely important for tax authorities to effectively collect, verify and make use of beneficial ownership information.

On the other, beneficial ownership is also pivotal for anti-money laundering objectives in order to identify the person with ultimate control over funds in the account, whether through ownership or other mean. However, the way most rules, including FATF recommendations, define beneficial ownership is not always consistent. The FATF Glossary, for example, refers to «*a natural person who ultimately owns or controls an entity*». Yet, according to the FATF's customer due diligence part of Recommendation 10, beneficial owner involves determining «*anyone with more than 25% of shares*». In practice, the restricted and limited criteria for determining a beneficial owner frequently take precedence over the broader ones. This nitty-gritty technique to discovering who is truly in charge would be excellent in theory for financial institutions and attorneys

[640640640] In the EU, tax advisers and other individuals who provide help or advice on tax concerns are officially recognized as relevant AML “gatekeepers”. This represents a step ahead because FATF recommendations do not require so.

[641] General Glossary to the FATF recommendations.

visiting consumers and spending time analyzing business records, but worldwide scandals reveal that reality is easier said than done[642].

Beneficial ownership is pivotal through complex corporate vehicles making use of shell companies[643]. Using a shell corporation as nominal account holder adds a layer of secrecy between an account and its beneficial owner: essentially, accounts held through sham corporations are equivalent to numbered accounts, which are today prohibited by anti-money laundering regulations. Shell corporations notably also help avoiding taxes. Banks are required by anti-money laundering regulations to know at all times who are the ultimate owners of the assets they manage. They must provide this information to foreign authorities that file information requests under a treaty[644]. In this respect, the anti-money laundering beneficial ownership reporting might contribute towards singling out also critical issues for tax purposes[645].

According to the Tax Justice Network, «*there is no jurisdiction that meets the ideal transparency situation where all types of available legal vehicles have to register ownership information both at the legal and beneficial ownership level, and where information is publicly available online, for free and in open data format. In fact, no jurisdiction has beneficial ownership registration for all available types of legal vehicles,*

[642] A. Knobel, *Amendments to the EU AML Package Improving Beneficial Ownership Transparency*, Tax Justice Network, 2022.

[643] A shell corporation is a commercial firm that simply exists on paper, with no physical presence, staff, or operations. The term comes from the fact that it is a hollow thing, similar to an empty shell. Shell companies are legal entities that can be utilized for lawful objectives such as enabling mergers and acquisitions, asset protection, and investment management. However, because of their capacity to disguise ownership and financial transactions, they are frequently used for criminal activities like as tax evasion and money laundering. They are commercial entities that do not have active activities or significant assets. They are not necessarily unlawful; in fact, they are frequently utilized for legitimate commercial purposes such as asset holding. Their structure, however, makes them a suitable instrument for disguising financial activities, rendering them vulnerable to abuse in money laundering operations. See R. Berkhout & F. Fernando, *Unmasking Control: A Guide to Beneficial Ownership Transparency*, Washington, 2022; D. Nougayrede, *After the Panama Papers: A Private Law Critique of Shell Companies*, in *The International Lawyer*, 2022, p. 327-367.

[644] See N. Johannesen & G. Zucman, *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown*, in *American Economic Journal: Economic Policy*, 2014, p. 65-91.

[645] Some commentators share this view but claim that it should not be overstated. While it cannot be excluded that there might be circumstances where the tax authorities would benefit from having AML information, in consideration of the circumstance that shell companies are often set up in connection with the gaining of access to the directive or treaty benefits, the tax beneficial ownership information needs to be reported continuously, making technological solutions and direct cross-border reporting necessary. *See* P. Pistone, J.F. Pinto Nogueira, A. Turina, I. Lazarov*, Abuse through the use of shell companies and arrangements for tax purposes in the EU Feedback to the EU consultation by the IBFD task force on EU law*, in *International Tax Studies*, 2021.

*let alone with information available online*» and further improvements are needed to converge tax and money laundering beneficial ownership objectives[646].

A potential advantage that would prove to be beneficial for Tax Authorities and Financial Intelligence Units and create a centralized, publicly available beneficial ownership register for businesses and trusts. Beneficial ownership registers increase transparency since they are publicly available, allowing for the delaying and revealing of complicated company structures used to swindle, launder money, finance crime and terrorism, or divert assets.

Combating money laundering, tax evasion, corruption, and terrorist financing is fraught with difficulties and publicly available register would allow these organizations, the media, the public, and civil society to unmask those trying to hide their ownership and management. An individually assigned identification, name, correspondence address, country of residence for tax purposes, citizenship, month and date of birth, and the kind and extent of the beneficial interest possessed might all be included. in the context of tight inter-agency collaboration between AML and tax authorities, beneficial ownership registers might be formed or built on existing registers, including those controlled by tax authorities.

Some experts claim that the register information should ideally be centralized, free, and built in an open data format with searchable features but it is also true that a balance with the right of privacy of taxpayers should be carefully assessed[647].

## 5. Tax evasion as predicate offense for money laundering

The initial version of the FATF Recommendations, issued in 1990, left it up to individual nations to choose whether "serious crimes" might be regarded predicate offenses to money laundering[648]. A predicate offense for money laundering is a crime

[646] M. Harari, A. Knobel, M. Meinzer, M. Palanský *Ownership registration of different types of legal structures from an international comparative perspective State of play of beneficial ownership*, Tax Justice Network, 2020.

[647] *See* D. Meunier, *Hidden Beneficial Ownership and Control: Canada as a Pawn in the Global Game of Money Laundering*, C.D. Howe Institute, 2018. *See also* section 4.8.2. of this thesis to assess balance between the legitimate interests of a state to combat tax evasion and prevent the use of the financial system for money laundering and the taxpayers' rights.

[648] According to the 1990 FATF Recommendations, «*Each country should consider extending the offense of drug money laundering to any other crimes for which there is a link to narcotics; an alternative approach is to criminalize money laundering based on all serious offenses, and/or on all offenses that generate a significant amount of proceeds, or on certain serious offenses*».

that generates money which is subsequently laundered. This gave some flexibility, which was particularly beneficial to nations who saw tax evasion as an essential aspect of their national AML framework. The debate over whether to categorically classify tax crimes as predicate offenses under the FATF Recommendations dates back to the 2003 modifications, which not only established the idea of beneficial ownership but also added a non-exhaustive list of predicate offenses, including predicate offenses had strong ties to tax evasion.

The Financial Action Task Force on Money Laundering (FATF) took a real step in 2012 by include tax evasion on their official list of charges "predicate" to money laundering. The change was remarkable for including tax evasion alongside weapons trafficking, drug trafficking, sex exploitation, and other major felonies the revenues of which are frequently laundered by criminals. The FATF's goal was clear: making tax evasion a predicate violation for money laundering expands the instruments available to authorities to combat tax avoidance. As a result, legal options for publicly utilizing AML procedures to investigate tax offences were created, as well as a legal basis for tighter inter-agency collaboration between AML and tax authorities. It also aided in more effectively addressing the issue of a "tax excuse", in which obligated companies frequently failed to disclose suspected money laundering transactions and activities in accordance with the AML framework just because they involved tax-related transactions.

In spite of its benefits, the FATF-recommended predicate-offense strategy has not been widely used. Tax evasion, for example, is not a specified unlawful activity inherent in money laundering under US law. However, it is worth noting that prosecutors get it through the back door by classifying tax evasion – or rather tax fraud – as mail, wire, or bank fraud, all of which are designated as specific prohibited crimes[649].

Some commentators have been concerned about the designation of tax evasion as a predicate crime These issues are primarily peculiar to tax evasion; other FATF-

[649] When taxes are charged as money laundering, the government can get a restitution order for the amount of taxes owed, as well as a forfeiture order for the amount of monies involved in the violation, at sentencing (*United States v. Waked Hatum*) The IRS may then pursue civil penalties for fraud in the amount of 75% of the taxes owed, plus interest under 26 U.S.C. § 6663. The combination of a criminal restitution order for the tax loss and a forfeiture order, as well as the prospect of a criminal fine and a civil tax fraud prosecution, greatly increases the final exposure for the violation. According to relevant doctrine, Congress had meant for taxes to be used as a basis for money laundering, it might have said so plainly in the act, but it did not. See I.M. Comisky, *May Tax Evasion Be Charged as a Money Laundering Offense? The Times Are A-Changing*, in *ABA Tax Times*, 2020.

recommended predicate crimes have not been met with comparable mistrust. Given the possible singularity of tax evasion, the question arises whether it is appropriate to see tax evasion as a normal predicate for money laundering, or if the predicate label mischaracterizes the entire nexus of tax evasion and money laundering[650].

Furthermore, it has been claimed that tax evasion does not satisfy a major requirement for being deemed a typical predicate crime for money laundering. In particular, tax avoidance does not always necessitate a separate, subsequent money laundering operation. All other offenses based on money laundering necessitate this procedure; hence, the tax evasion predicate is unique. However, tax evasion does not merely accompany money laundering. In fact, according to the FATF's definition of money laundering, tax evasion is a type of money laundering in and of itself. Tax evasion simultaneously achieves illicit tax savings and launders criminal gains by hiding or obscuring their unlawful origin.

Property obtained from the commission of an offense is included in the definition of the profits of crime. It is typically unnecessary to conceal the source of the tax savings in a separate stage. During the evasion process, tax evaders make misleading statements about their income and tax due. If the evasion is effective, unwary tax officials agree, and illegal tax savings are generated and cleaned up in a single move. The offense is complete at that moment, and there is no need for the requisite further washing of the funds. As a result, unlike other predicate crimes, there is no obvious dividing line between the completion of the tax evasion procedure and the start of a discrete money laundering stage[651].

Considering tax evasion as a predicate offense for money laundering is useful because otherwise transactions involving money earned purely from a tax infraction (e.g., unreported sales) may not be deemed money laundering offenses. Yet, it is still challenging for prosecutors[652]. For instance, it is worth noting that tax crimes were not

[650] A.M. Maugeri, *Self-laundering of the proceeds of tax evasion in comparative law: between effectiveness and safeguards*, in *New Journal of European Criminal Law*, 2018, p. 83-108.

[651] D. Kemsley, S.A. Kemsley, F.T. Morgan, Tax evasion and money laundering: a complete framework, in *Journal of Financial* Crime, 2022, p. 589-602.

[652] There are concerns raised by the idea that tax evasion is incompatible with the scheme of proceeds derived from an offense as money laundering is the exchange of money derived in some way from criminal activity. Although a gain from the illegal act of tax evasion, an unassessed tax claim does not come from the criminal conduct itself but exists independently of it. The criminal gains nothing by tax avoidance, but rather keeps something that was already

defined by the FATF, leaving leeway for countries to incorporate this term into their legislation as they saw fit. This has been highlighted in doctrine.  Rossel, Unger and Ferwerda discovered differences in (*i*) whether a case is prosecuted through an administrative or a criminal procedure; (*ii*) whether a case is prosecuted as a tax crime, a money laundering crime, or both; and (*iii*) whether this prosecution results in the same punitive consequences for those who commit the crime, both in the books and in practice. The distinctions are stark. The same offense can result in a six-month sentence in Malta and a six-year one in Sweden or Spain[653].

## 6. Cooperation between AML and tax authorities

Anti-Money-Laundering Rules can become "Tax Authority's New Best Friend"[654]. For many years, the tax community relied on the so-called tax excuse, which held that suspected tax-related transactions did not need to be reported to appropriate anti-money laundering authorities since they dealt with tax issues. That mindset has subsequently grown to the point that the Financial Action Task Force categorized tax evasion as a precursor violation to money laundering in 2012. This created a legal foundation for anti-money laundering and tax officials to work together more closely. Since then, the OECD has advocated for this strategy making tax crimes a predicate offense for money laundering[655]. A person who has committed money laundering may also face charges for the underlying predicate offense.

This may provide authorities more leeway in obtaining a conviction and/or imposing harsher punishments. In practice, whether one or both charges are investigated or prosecuted will depend on the case and circumstances such as the nature of the evidence and the components of the offence to be proven. The Financial Intelligence Unit analyzes Suspicious Transaction Reports and distributes pertinent intelligence to domestic competent authorities in charge of investigating and/or prosecuting the applicable predicate offence. As a result, the Financial Intelligence Unit may share

in his or her own. *See* P. Behrendt, *Tax evasion as the predicate offense of money laundering under German and US law*, in *Zeitschrift für Internationale Strafrechtsdogmatik*, 2020, p. 196-209.

[653] *See* L. Rossel, B. Unger and J. Ferwerda, *Shedding light inside the black box of implementation: Tax crimes as a predicate crime for money laundering*, in *Regulation & Governance*, 2022, p. 781-800.

[654] *See* N.A. Sarfo, *Anti-Money-Laundering Rules — A Tax Authority's New Best Friend*, in *Tax Notes*, 2023.

[655] OECD, *Fighting Tax Crime: The Ten Global Principles*, Paris, 2017, p. 58-60.

Suspicious Transaction Reports with the body in charge of investigating or prosecuting tax offences.

In this framework, the OECD's Committee on Fiscal Affairs has established a dialogue with the Financial Action Task Force and continues to examine ways of improving co-operation between tax and anti-money laundering authorities. Joint workshops with tax and anti-money laundering officials have been held allowing experts to share experiences on some of the practices that are common to both tax evasion and money laundering. OECD work on tax crime and money laundering is designed to complement what has already been carried out by FATF[656].

Domestic AML and tax authorities are increasingly drawing on the interconnections and parallels between the two regimes. The Egmont Group – an international organization that facilitates cooperation and intelligence sharing between national financial intelligence units to investigate and prevent money laundering and terrorist financing[657] – issued best practices on anti-money laundering and tax cooperation[658].

The best practices emphasize the importance of (*i*) facilitating effective cooperation between Financial Intelligence Units and tax authorities, (*ii*) developing a national strategy to strengthen the fight against serious tax crimes.

As for the first point, facilitating effective cooperation between Financial Intelligence Units and tax authorities entails proving the national interaction between tax officials and the Financial Intelligence Unit. This can be implemented by establishing formal or informal agreements between the Financial Intelligence Unit and tax authorities (e.g., memorandum of understanding); encouraging nationwide public-public and public-private partnerships; allowing for the presence of a liaison officer or secondments in both the offices of Financial Intelligence Units and the tax authorities. Regular joint meetings between tax authorities and FIU employees would be important

[656] The Oslo dialogue: a whole of government approach to fighting financial crimes, *A Closing Statement by Italy, as host, and the OECD*, 15 June 2012.

[657] According to the FATF Interpretive Note to Recommendation 29, a country's FIU should apply for Egmont Group membership if it complies to the Egmont Group's Statement of Purpose and Principles for Information Exchange. The Egmont Group texts give crucial guidelines on the nature and activities of FIUs, as well as the methods for information exchange.

[658] Egmont Group*, Money Laundering of Serious Tax Crimes, Enhancing Financial Intelligence Units' Detection Capacities and Fostering Information Exchange*, Public Bulletin of July 2020.

create operational awareness of the subject matter while secondments and other operational actions to promote cross skilling and active, direct, and intensive information exchange in real time while building professional networks.

As for the second point, developing a national strategy to strengthen the fight against serious tax crimes would be pivotal. To identify tax fraud, tax authorities should be able to submit information to the national Financial Intelligence Unit, and the Financial Intelligence Unit should be able to relay pertinent information to the tax authorities. The Financial Intelligence Unit should take an active role in advising the government on legislative changes that would reduce the chances to launder money from tax offences, in collaboration with tax authorities. Also, it would be important that tax authorities formally alert the Financial Intelligence Unit when the tax authority refers to the judiciary the alleged commission of a crime that fits within the Financial Intelligence Unit's mandate. Financial Intelligence Units, particularly in low- or no-tax jurisdictions, may explore collaborating with both tax authorities and international partners to execute specific measures to disrupt money laundering of significant tax crimes.

In the domestic context, a notable example of interagency cooperation is Australia, Direct access to the data gathered by the Australian Financial Intelligence Unit ("AUSTRAC"), is provided to the Australian Taxation Office ("ATO"). The 1988 Financial Transactions Reports Act and a Memorandum of Understanding between the two authorities crystallized this thorough cooperation between tax and anti-money laundering authorities and might bear a substantial deterrent effect. More importantly, the use of information by the tax authorities is not subject to any particular limitations[659].

In the international arena, there are few examples of international cooperation that bring together authorities in the realm of tax crime and money laundering.

One of the most notable ones is the Joint Chiefs of Global Tax Enforcement ("J5") is in charge of combating worldwide tax evasion and money laundering, including cryptocurrency threats and those that engage in, allow, or support global tax evasion. The J5 was founded on July 2018 in response to the OECD's request on governments to do more to combat the facilitators of tax evasion. The group brings together the top tax,

[659] The Commissioner of Taxation and any taxation officer are permitted to access AUSTRAC information for any reason pertaining to the facilitation of the administration or enforcement of a taxation legislation, according to section 125(1) of the 2006 AML/CFT Act.

offshore tax evasion, cryptocurrency, and cyber specialists, as well as experts from the United States, Canada, and the Netherlands.

These countries share intelligence quickly, create capabilities, and eventually conduct operational actions. The J5 is collaborating on a variety of investigations aimed at sophisticated international tax evaders. This includes focusing investigations on financial institutions and intermediaries who help taxpayers conceal their income and assets, as well as carrying out cryptocurrency money laundering and tax fraud and evasion.

For instance, thanks to the sharing of information amongst J5 countries, the Dutch tax authorities and the Fiscal Intelligence and Investigation Services detained two individuals in February 2020 on suspicion of laundering millions of euros in cryptocurrencies. The Fiscal Intelligence and Investigation Services detained two Dutch people in separate tax evasion investigations. Approximately $260,000 in unidentified cryptocurrency and almost three kilograms of gold were recovered[660].

Argentina, Costa Rica, and Paraguay have launched a pilot effort to expand the use of treaty-exchanged tax information to combat illicit money flows and nontax financial crimes in Latin America. Data interchange is increasingly being utilized to combat illegal money flows and increase domestic revenue mobilization and they essentially have the local and international legal framework to utilize and exchange tax information for AML and other reasons. The majority are signatories of the Convention on Mutual Administrative Assistance in Tax Matters[661], which is significant since the Convention on Mutual Administrative Assistance in Tax Matters offers an international legal framework for using information exchange data for nontax reasons. Mutual legal help treaties, such as the Inter-American Convention on Mutual help in Criminal Matters (which contains an optional protocol covering tax demands), are another possibility.

[660] *See* A. Faccia, N.R. Mosteanu, L.P.L. Cavaliere, L.J. Mataruna-Dos-Santos, *Electronic Money Laundering, The Dark Side of Fintech: An Overview of the Most Recent Cases,* Proceedings of the 2020 12th International Conference on Information Management and Engineering, 2020.

[661] The OECD and the Council of Europe adopted the Convention on Mutual Administrative Assistance in Tax Matters in 1988, and it was updated by Protocol in 2010. The Convention is the most comprehensive international mechanism available for combating tax evasion and avoidance in all forms. It promotes international cooperation to improve the operation of national tax legislation while protecting taxpayers' basic rights. It allows for all types of administrative cooperation between governments in tax assessment and collection. This collaboration covers from information interchange, including automated exchanges, through the recovery of foreign tax claims.

In the European Union, starting on January 1, 2018, the Fifth EU Directive on Administrative Cooperation ("DAC5") allows tax authorities access to ultimate beneficial ownership information and other information gathered by obliged entities under the anti-money laundering directive[662].

Also, the money laundering regime in the European Union is becoming advanced as the new p*ackage* of legislation to strengthen the EU's anti-money laundering is about to become law and this included the creation of an EU-wide Anti-Money Laundering Authority ("AMLA")[663]. Its creations will enable decentralized supervision of Anti-Money Laundering practices but also «*at least indirectly, reveal Member States' tax enforcement policies when the underlying predicate offense is tax evasion*»[664].

The International Monetary Fund is paying particular attention to the interaction between money laundering and tax crimes, including tax avoidance and evasion also indirectly triggered by harmful tax competition. The Legal Departments has been increasingly scrutinizing the relation between money laundering, tax competition and tax crimes and countries can seek assistance, For example, in the month of September 2023, national authorities from one country asked the International Monetary Fund assistance in relation to promoting their efforts to review and reform the legislative, institution and operational frameworks relating to interagency cooperation between the anti-money laundering and tax authorities[665].

The objective is to improve tax compliance and better tackle financial crimes such as money laundering and tax crime as part of a whole of government approach. Specifically, technical assistance has been sought in connection with the following:

[662] *See* R. Korver, *Money laundering and tax evasion risks in free ports,* Study at the request of the Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance, 2018.

[663] *On April 19, 2023, the EU Parliament approved its negotiation mandate for three of the four proposed pillars of the much-anticipated new EU Anti-Money Laundering and Countering Terrorist Financing package. The trilogue negotiations between the EU Parliament, the Council, and the EU Commission have begun, and once agreement is reached, the Anti-Money Laundering Package must be formally approved by the EU Parliament and the Council of the EU before it can be implemented.*

[664] *See* P. Denk, *Tax competition and the EU Anti-Money Laundering regime,* in *Intertax,* 2022, p. 803-812.

[665] The author of this doctoral thesis is currently working as a FIP research fellow in the Legal Department of the International Monetary Fund and is working, *inter alia,* on this project. More details are strictly confidential at this stage.

*(i)* review of legislative framework relating to cooperation, coordination and sharing of information between the anti-money laundering and tax authorities as well as sharing of information between the anti-money laundering and tax authorities.

*(ii)* review of the institutional framework and mandates of the anti-money laundering and tax authorities in relation to money laundering and tax crimes.

*(iii)* review of the operational arrangements between the anti-money laundering and tax authorities. In particular, review of the relevant processes, procedures and memoranda of agreement and the extent to which they are conducive to effective cooperation and exchange of information.

*(iv)* ability to leverage relevant anti money laundering measures to improve tax compliance and help mobilize domestic revenues.

*(v)* capacity development and raising awareness on the synergies between anti money laundering and tax frameworks and their mutually reinforcing effect.

This represents an innovative project: some countries know of the existence of tax crimes, understand the vulnerabilities of legal frameworks connected to money laundering yet see these two concepts as separate and not intertwined. The AML and tax systems should be viewed as complimentary. Given the tight synergies, removing needless redundancies and inefficiencies will strengthen the two frameworks' efficacy and integrity.

## 7. Anti-money laundering measures at the service of tax compliance

The anti-money laundering framework encourages formalization of business interactions and transparency, both of which are important for tax purposes, through its rules of financial and nonfinancial intermediaries. The information gathered by such AML-compliant organizations can assist in identifying taxpayers and learning about their wealth, income, and business transactions that may result in a tax burden. In many countries, tax officials can access information gathered through Customer Due Diligence, including that contained in beneficial ownership registers maintained by anti-money laundering authorities.

AML preventive measure require obligated companies to undertake Customer Due Diligence on their clients and retain records[666], Customer Due Diligence is performed on a simplified, comprehensive, ongoing and risk-sensitive basis. However, its enforcement differs according to the level of money laundering risk a customer poses to the financial institution[667]. This is a continuous process that entails continual due diligence of the business relationship to verify that the paperwork on file is up to date and that the transactions being undertaken are consistent with the customer's business and risk profile.

In particular, Customer Due Diligence information as mandated by Recommendation 24 ("Beneficial ownership of legal persons") and 25 ("Beneficial ownership of legal arrangements")[668]. The organization is currently updating its beneficial ownership disclosure standards. The FATF adopted the revision of Recommendation 24 on beneficial ownership disclosure for legal persons such as corporations and organizations in March 2022. The obligation for nations to establish beneficial ownership registers was the most significant reform. The Recommendation n. 25 on beneficial ownership of trust is particularly important, given that trusts are frequently utilized in complicated institutions that provide challenges to authorities[669]. This information is extremely useful in investigations when shared with tax authorities.

[666] FATF recommendations 5-25 deal with the preventive measures to be taken by financial institutions and certain other businesses and professions.

[667] *See* A. Damais, *The Financial Action Task Force,* in E.H. Muller C.H. Kalin, J.G. Goldsworth, *Anti-money laundering: international law and practice*, Chichester, 2007, p. 69-73.

[668] The author of this thesis worked and conducted research as a Donato Menichella particularly deserving candidate at the Bank of Italy's Directorate General for Financial Supervision and Regulation – Regulation and Macroprudential Analysis Directorate where he participated in the FATF rounds of discussions to review Recommendations 24 and 25.

[669] In the view of this author, it come as no surprise that the American College of Trust and Estate Counsel – with extensive experience in providing advice to taxpayers on matters of federal taxes, generation-skipping transfer tax planning and fiduciary income tax planning – claims that «*trusts should be dealt with differently in the interpretation and application of R.25*». Furthermore, they have affirmed that «*the definition of beneficial owner within the context of customer identity differs from that of the individuals entitled to a benefit from a trust at a time and manner determined by the trustee (i.e., the beneficiaries), and a different standard should apply for purposes of identifying the parties responsible for preventing the use of trusts for illegal means. Trust beneficiaries have no actual access or control over the assets held in a trust until the trustee says so. The proper responsible parties in the context of a trust are the trustee(s) and the protector (if any). Protectors are often named in modern trusts and a protector is typically charged with the duty of removing and replacing a trustee. Since a protector has control over the identity of the trustee, this control position would warrant including such person with the trustee under a trust reporting standard*». This author believes that this opinion strengthens the perception that international tax planning and money laundering are strictly related. *See* ACTC comments on potential revisions of Recommendation 25 – area of focus for private sector engagement, December 6, 2022.

The use of the anti-money laundering enforcement legal framework in tax crime investigations and prosecutions can greatly improve tax compliance. Given that tax offenses are predicate offenses to money laundering, the AML enforcement measures used to pursue money laundering charges can also be used to investigate and prosecute the underlying tax offenses, for example, through parallel investigations. Indeed, continuing concurrent investigations and prosecutions may maintain a criminal conviction route where the evidence necessary to show either money laundering or tax offences is insufficient.

Moreover, coupling the money laundering offense with the tax offense may allow a longer duration of the statute of limitation for money laundering and law enforcement agencies might have more time to seek tax evaders[670]. For instance, in Italy the statute of limitation for money laundering is twelve years[671] while the statute of limitation for tax crimes is shorter, usually six years[672].

On the subject of taxing multinational companies, the link between tax crimes and money laundering is crucial. They are programs intended at improving tax revenue, enhancing tax honesty and compliance, and/or allowing asset repatriation may have a detrimental impact on anti-money laundering effectiveness if they exclude anti-money laundering measures from application. For nations seeking assistance on this, the FATF issued four key principles on voluntary tax compliance programs in 2012[673].

The first premise is that governments must, as a requirement, effectively deploy anti-money laundering preventive measures to their voluntary tax compliance programs.

The second point is that voluntary compliance programs should not provide any complete or partial exemptions from anti-money laundering obligations. Any such actions plainly contradict the FATF's guidelines.

The third aspect is about inter-country cooperation. When adopting voluntary compliance programs, governments should guarantee that domestic authorities can collaborate when money laundering violations arise. This implies they must ensure that

[670] E. Mathias & G. Esposito, *Using anti-money laundering measures to improve tax compliance*, in G.M.M. Michielse & V. Thuronyi, *Tax Designs Issues Worldwide*, Alphen aan den Rijn, 2015, p. 288.

[671] Article 648 *bis* of the Italian Criminal Code.

[672] Article 157 and 161 of the Italian Criminal Code.

[673] FATF, Best Practices: Managing the anti-money laundering and counter-terrorist financing policy implications of voluntary tax compliance programs, 2012.

all domestic agencies may communicate information in order to coordinate and cooperate in identifying, investigating, and punishing money laundering violations.

The fourth principle is concerned with international cooperation. When money laundering violations occur, nations should provide as much information sharing and mutual legal aid as feasible in investigations, prosecutions, and associated actions. Asset recovery investigations and actions are included.

## 8. Dissuasive effect to improve tax compliance

The increased transparency stemming from the coordination between the tax framework and the anti-money laundering framework has the potential to deter certain tax evaders and their collaborators from aiding the laundering of the underlying funds. Customer Due Diligence obligations and the submission of Suspicious Transaction Reports, which are subject to anti-money laundering authorities' oversight, bolster transparency and create higher risks for offenders.

Deterrence would become a reality since perpetrators would know that they cannot use the banking systems to channel the funds to potentially launder illicit funds and tax authorities would potentially get notified if there is any suspicion. This can assist tax authorities in recovering overdue taxes and deterring prospective offenders. Additionally, such deterring effect is reinforced:

*(i)* when tax authorities have direct access to the information collected the Financial Intelligence Units with no particular limitation[674].

*(ii)* through anti-money laundering provisions, including preventive measures *lato sensu* and Customer Due Diligence measures, as they promote entity transparency and, in turn, this would facilitate tax audits.

*(iii)* by the fact that prosecuting the laundering of tax evasion funds rather than tax evasion itself allows the money laundering violation to be prosecuted even if the tax owed has been paid and the issue with the tax administration has been resolved.

[674] *See* the cooperation between AUSTRAC and ATO in Australia, as highlighted in section 4.5. of this thesis.

*(iv)* given that there might be higher penalties involved, including incarceration, and a money laundering offense also entails confiscation of the laundered asset and the consequent easier recovery of taxes due.

## 9. Challenges to reverse the *status quo* of tax havens

There are two main kinds of challenges that have to be addressed to drive change and counter tax havens: (*i*) political challenges and (*ii*) legal challenges.

### 9.1. Political challenges

Unless pressured by the international community and international norms, offshore financial center may be unwilling to reform their methods. Even yet, they may discover methods to shape these rules to their benefit while remaining within the politically established minimum criteria. As a result, the international community's commitment, especially an engaged civil society, is critical to overturning the status quo and ensuring a fair playing field. This is mostly pursued in the AML area through peer reviews conducted by the FATF Evaluation Reports as well as the associated "listing" procedure of the FATF and other regional bodies such as the EU[675]. *Strong political pressure by the most influential states and internal organizations is essential to change the status quo.*

Countermeasures would likely take the form of obligating required organizations to use Enhanced Due Diligence while doing business with such nations, increasing compliance costs and the prospect of fines for noncompliance. As a result, banks and other intermediaries may opt to withdraw from such nations entirely, closing local branches, franchises, and asset management seats. All of this would put strain on the associated financial connections. Access to foreign direct investment, finance, and, more broadly, the business prospects of the listed nations may suffer as a result of reputational harm[676].

[675] E. Mathias & A. Wardzynski, *Leveraging Anti-money Laundering Measures to Improve Tax Compliance and Help Mobilize Domestic Revenues*, IMF Working Papers, 2023.

[676] *See* M. Riccardi, *Money Laundering Blacklists*, Abingdon, 2022; M. Kida & S. Paetzold, *The impact of gray-listing on capital flows: an analysis using machine learning*, IMF Working Papers, 2021.

In essence, offshore financial centers can be included in the blacklist – the most credible and effectives ones being the one drafted by FATF and the EU despite the existence of more than more than 400 blacklists globally[677] – by reputational costs on a state via stigmatization and financial costs via sanctions and restrictions. Blacklisting «*is not just cheap talk or signaling but is a stick that can be used to beat small tax havens and much larger states into regulatory reform*»[678].

This is part of the efforts of the G-7 to bring countries that do not follow international tax and money laundering standards under global governance. This entails spill-over costs for blacklisted states that replicate sanctions through substantially damaged reputation. In terms of financial implications, the FATF blacklist threatens "countermeasures" ranging from increased due diligence in the international banking system to full prohibition. The OECD blacklist promised "defensive measures," which effectively meant raising taxes on trade with tax havens.

Essentially, the FATF blacklist classifies transactions involving a state's entities as possibly unlawful and will impose greater administrative and trading expenses as a result of more due diligence. They might be completely shut off from cross-border banking and investment activities at the most. Even if there is no genuine risk of money laundering, the additional expenses of such transactions render most businesses unviable. It has been argued that he two most important criteria in a state complying with requests in international relations are (*i*) credibility and (*ii*) severity[679].

The instance of Liechtenstein demonstrates that when the country was blacklisted for an act that carried enormous shame and faced the realistic possibility of harsh sanctions, its government responded fast and forcefully. In contrast, when banned for a less stigmatized behavior with no punishments, the blacklist was less effective. While both blacklists had credibility issues that limited their impact, legitimacy is critical in soft power activities. The OECD lacked the FATF's hard power, whose legitimacy issues

[677] C. Liss & J.C. Sharman, *Global corporate crime-fighters: Private transnational responses to piracy and money laundering*, in *Review of International Political Economy*, 2015, p. 693-718.

[678] J.C. Sharman, *The bark is the bite: International organizations and blacklisting*, in *Review of International Political Economy*, 2009, p. 573-596.

[679] The credibility and severity of the FATF blacklist's financial consequences imposed on governments were greater than those imposed by the OECD blacklist, which lacked the hard power of the FATF in terms of sanctions and lower financial and reputational costs when compared to the FATF blacklist. *See* D.A. Baldwin, *The Sanctions Debate and the Logic of Choice*, in *International Security*, 2000, p. 80-107.

were often outweighed by the higher reputational and financial implications of its blacklist[680].

In brief, the inclusion in the FATF, OECD or EU blacklist has two main problems for the countries concerned[681]:

*(i)* anti-money laundering obliged entities in many countries are required to conduct Enhanced Client Due Diligence on transactions involving clients and intermediaries from blacklisted countries.

*(ii)* While no sanctions are involved, noncompliance might carry reputational fallout at a time, with the attendant implications for the ease of doing business, financial transaction flows and cross-border trade. Hence, is also critical for the authorities of the involved state to continue their public awareness and outreach activities to local stakeholders as well as external stakeholders such as financial regulators, financial institutions, and correspondent banks to keep them updated on FATF or EU compliance progress.

### 9.2. Legal challenges

In order to bolster the efficiency of interagency cooperation between tax and money-laundering authorities, the legislative framework must expressly acknowledge the linkages between the two systems. The types of legal challenges that are frequently mentioned in this context concern confidentiality and professional secrecy issues, the protection of taxpayers' rights, the problem of "dual criminality", and the international understanding of what is meant by the term "tax crimes" which is critical for effective international cooperation under mutual legal assistance and other forms of international cooperation.

First, «the *countries that tend to carve out* […] *tax crimes tend to be those with bank secrecy laws*»[682]. Investigations into money laundering tied to corruption have frequently been hampered by confidentiality regulations in international financial centers. The FATF Recommendations are intended to remove opacity as an impediment.

[680] *See* K. Ekkenberger, *When is blacklisting effective? Stigma, sanctions and legitimacy: the reputational and financial costs of being blacklisted*, in *Review of international Political Economy*, 2018, p. 483-504.

[681] Allan Wright Alicia Nicholls, *The EU AML/CFT List of High-Risk Third Jurisdictions: Implications and Options for The Bahamas*, Policy brief nº IDB-PB-319, 2019.

[682] U.S. Senate Hearing 110-614, Tax Haven Banks and U.S. Tax Compliance, 2008.

Indeed, the FATF Recommendation 9 clearly state that «*financial institution secrecy laws do not inhibit implementation of the FATF Recommendations*». As a result, bank secrecy should no longer pose an insurmountable barrier to getting financial information in international money laundering cases involving corrupt proceeds.

This is easier said than done, as law enforcement agencies face obstacles in conducting investigation with respect to money laundering activities due to bank secrecy[683].

Second, practitioners and policymakers are frequently challenged with conflicting needs for data protection and money laundering. On the one hand, anti-money laundering provisions necessitate private institutions and public authorities gaining access to individuals' financial or other information. On the other hand, the collection, treatment, conservation, and dissemination of personal information is protected by the fundamental right to privacy[684].

Implementing registers, whereby information held on beneficial owners is publicly accessible, seems to be a positive step towards controlling money laundering, but also, preventing criminals exploiting jurisdictions like offshore financial centers. this regard, FATF Recommendations, which are the international anti-money laundering standards, require that access to beneficial ownership registers to be allowed to competent authorities rather than the general public[685]. Some countries like the United Kingdom grant the general public access to the registers unless there «*is a logical measure to protect sensitive data and reduce potential risk to personal safety*»[686].

Interestingly, the Court of Justice of the European Union has recently invalidated the provision of the Fifth Anti-Money Laundering Directive pursuant to which the public now had access to basic information about anyone who owned more than 25% of a

[683] See M. Fadarisman & B.T. Bawono, *Implementation of disclosure of bank confidentiality in the effort to eradicate money laundering crime*, in *Law Development Journal*, 2021, p. 390-398.

[684] See, for instance, Article 8 of the European Convention on Human Rights (ECHR); Article 8 of theCharter of Fundamental Rights of the European Union; Article 17 of the International Convention On Civil and Political Rights.

[685] FATF Recommendations 24.

[686] The UK's "Persons of Significant Control" register, held by Companies House, is open to public scrutiny. See P.M. Gilmour, *Lifting the veil on beneficial ownership*, in *Journal of Money Laundering Control*, 2020, p. 717-734.

company's shares or who exerted other forms of control over it[687]. This shows where limits lie when striking a balance between the legitimate interests of a state to combat tax evasion and prevent the use of the financial system for money laundering and the taxpayers' rights[688].

Third, in the absence of an internationally established definition, the "dual criminality" concept may be implicated under the appropriate international cooperation processes. According to this concept, the same sorts of acts and behavior must be criminalized in both nations before foreign help can be provided through mutual legal assistance. One approach to tackling this issue is to eliminate any "form over substance" distinctions. The FATF Recommendations emphasize that the focus should be on the underlying behavior rather than the labeling of the behavior[689]. However, this is not a general method. As highlighted by Mathias and Wardzynski[690], the stringent application of the idea of dual criminality, for example, was identified as a problem in Saint Lucia's mutual evaluation report[691].

Turning our attention to the European Union, there are legal challenges connected to the definition of "tax crime". The worldwide implications are obvious because the EU, like the FATF, did not provide a clear definition of tax offenses. The choice on whether tax violations are designated as crimes was left up to each member state, potentially leading to different application of this principle and other anti-money laundering provisions[692]. The lack of a common definition of tax offences under the EU *acquis communautaire* is due to a lack of agreement among Member States[693].

[687] Court of Justice of the European Union Luxembourg Business Registers, Joined Cases C-37/30, C-601/20). In particular, the Court's judgement was contrary to the Opinion of Advocate General Pitruzzella. Due to the fact that it did not reveal sensitive information about the individuals involved' private lives, the Advocate General did not view this interference as being particularly problematic. Overall, he believed that the legitimate interests in stopping money laundering and terrorist financing justified disclosure.

[688] *See* M. Siems, *Privacy vs. shareholder transparency: did the ECJ decision in WM and Sovim SA impair the global fight against money laundering?*, in *Common Market Law Review*, 2023, p. 1137-1152; M. Papis-Almansa, *The end does not justify the means: on how the secondary EU law infringes the primary EU law in the light of the recent judgments of the CJEU*, in *Intertax* 2023, p. 612-629.

[689] FATF Recommendation 37.

[690] E. Mathias & A. Wardzynski, *Leveraging Anti-money Laundering Measures to Improve Tax Compliance and Help Mobilize Domestic Revenues, IMF Working Papers, 2023.*

[691] FATF, Santa Lucia Mutual Evaluation Report, 2021.

[692] V. Mitsilegas & N. Vavoula, *The Evolving EU Anti-Money Laundering Regime: Challenges for Fundamental Rights and the Rule of Law*, in *Maastricht Journal of European and Comparative Law*, 2016, p. 261-293.

[693] U. Turksen & A. Abukari, *OECD's global principles and EU's tax crime measures*, in *Journal of Financial Crime,* 2020, p. 406-419.

In its Impact Assessment, the Commission argued that developing detailed rules for the circumstances under which the offence is committed would be the best option because it would ensure coherence across the EU, send a clear signal regarding tax crimes, and ensure the efficacy of cooperation[694]. It did, however, state that it would entail substantial delays due to political difficulties in agreeing on a common list of types of tax evasion. As a result, the Commission chose an approach in which the current threshold for severe offenses would be used without the development of a clear definition. The Parliament favored a different approach by underlining the link between aggressive tax planning and money laundering[695].

[694] European Commission, Impact assessment accompanying the document proposal for a directive of the European Parliament and of the council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups, SWD(2013) 127 final.

[695] It noted that «*in the case of credit and financial institutions and providers of gambling services, competent authorities shall have enhanced supervisory powers, notably the possibility to conduct on-site inspections. Competent authorities in charge of supervising credit and financial institutions shall monitor the adequacy of the legal advice they receive with a view to reducing legal and regulatory arbitrage in the case of aggressive tax planning and avoidance*». *See* Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing*, 7387/14.

# CONCLUSION

Digitalization and globalization have had a profound impact on countries and people around the world, and this impact has only accelerated in the XXI century. These changes have brought with them challenges to the rules for taxing international business income, which have prevailed for more than a hundred years and resulted in multinational companies not paying their “fair share of tax”.

Tax avoidance has become a never-ending issue in taxation, particularly in the cross-border context, but international efforts to curb harmful tax practices have intensified despite not always been successful or at least effective. The OECD has been leading international efforts since the 1990s to enable countries to prevent tax evasion and corporate tax avoidance. In this framework, the 2021 two-pillar solution is a step ahead to curtail harmful tax competition.

Pillar One, which is essential for all participating countries and necessitates a multilateral agreement, concerns a reform of the allocation of the authority to tax major multinational companies among participating states and current digital service taxes will be repealed.

Pillar Two imposes a 15% minimum effective tax rate on profits exceeding a substance-based income exclusion in each jurisdiction where a multinational company operate and introduces consolidation of profits and formulary apportionment.

While Pillar Two is well ahead in its potential implementation, Pillar One is trailing and encountering some opposition: the draft international convention has not yet been finalized, and its implementation is contingent on achieving a “critical mass” of nations that would agree.

At the moment, the United States is unlikely to apply Pillar Two guidelines, owing to significant resistance from the Republican majority in Congress. The implementation of the global reform by the United States is particularly important but its approval is still controversial, and House Republicans have recently proposed retaliatory taxes for Pillar 1 and 2. Besides, in a visit with EU finance ministers to Luxembourg in October 2023, U.S. Treasury Secretary Janet Yellen has confirmed that «there are some matters that are important to the United States and other countries that remain unresolved» and these «*need to be resolved before the treaty can be signed, so these processes will take into next year*»[696].

Although the United States has yet to pass legislation to implement Pillar 2, other OECD countries have committed to enacting legislation in 2023 that would normally take effect in 2024. Pillar Two has been translated into the EU Minimum Tax Directive, which will enter into force in January 2024, following unanimous adoption by Member States in December 2022. The EU Directive, while closely linked with the OECD model guidelines, varies in important ways. Its adoption is required for all Member States, deviating from the OECD's more "voluntary" approach, and it also applies to exclusively domestic groups.

The agreement on the two pillars, as well as the progress achieved in their implementation, albeit at a slower pace than expected, represent significant progress and a step forward in international tax cooperation.

Nonetheless, various questions have been expressed about the OECD two-pillar solution. In particular, this regards the new rules' complexity, which include complicated calculations requiring information from financial reporting and fiscal returns on all entities of a multinational group. Furthermore, the complications throw doubt on the ability of national tax administrations, not only the less technically adept, to appropriately manage the additional responsibilities. There is also absence of dispute resolution mechanisms in both the OECD rules and the EU Directive and the potential of inconsistent implementation of regulations between countries, litigation with taxpayers, and differing interpretations and application of the agreed rules by tax authorities.

It is paramount to eliminate administrative burden and, in the context of the European Union, coordinate the newly conceived framework of Income Taxation with the EU Minimum Tax Directive and any future potential EU action in response to OECD Pillar One and Two. This approach is pivotal, given the unsuitability of the State aid regime as an instrument to fight all harmful tax competition practices, as highlighted by the Court of Justice of the European Union. The challenges linked with profit shifting

[696] P. Tamma & B. Smith-Meyer, Yellen says US is not ready to sign global tax treaty just yet, Politico, 16 October 2023.

arise from cross-border commerce and State aid is a strategy for combating one Member State's selective advantage, not necessarily divergent legal frameworks.[697]

This proactive but not necessarily legally viable viewpoint of the European Union risks hampering fiscal sovereignty of member states. Over time, the ongoing relationship between national tax laws and state aid regulations has helped to change the European Commission's ability to use the Article 107 (1) TFEU prohibition on selective aid as a powerful tool for policymaking while also significantly limiting the tax sovereignty of EU member states. The Commission started using the discipline on the prohibition of state aid as the specific goal of its action, of approximation of direct taxation. This is closely related to the fact that the principle of unanimity set forth in Article 115 TFEU, which essentially has always guaranteed each country the right of veto, has prevented any significant progress in this area up until this point in time.

The Commission's new approach to taxation, the expansion of State aid control, and the new definition of aid all have a significant practical impact on taxpayers as recipients of a fiscal measure that could potentially qualify as State aid and result in them experiencing extreme legal uncertainty. Potential solutions could be the recourse to Article 116 TFEU could be suited to addressing phenomena of harmful regulatory competition, where absence of a proper regulatory framework causes a "race to the bottom".

Finally, this thesis focuses on a new perspective which is only recently being investigated. The "race-to-the-bottom" international tax competition has put welfare states in crisis and, besides the G-7, G-20 and the OECD, efforts by the Financial Action Task Force are pivotal to avoid that secrecy rules of offshore financial centers incentivize flows seeking outright tax evasion and money-laundering activities. As a result, blacklists of nations are created, which frequently have a severe influence on the reputation of the country and on business in general. This thesis advocates for better enforcement control as tax competition: this is the right momentum to realize greater utilization of AML measures in lowering international tax competition as the two notions are closely intertwined.

Indeed, tax competition is expected to persist even if minimal taxation removes competition based on statutory tax rates. This is because governments enforcement

[697] R. Lyal, *Transfer Pricing and State Aid*, in *Fordham International Law Journal*, 2015, p. 1043.

efforts and this might spur illicit financial flows, and this is exactly where the AML regime comes into play.

Tax evasion is now a predicate offence for money laundering in most countries thanks to the work of the FATF. The AML framework not only serves as a tool for appropriately addressing overseas tax evasion, but also for revealing, monitoring, and controlling, at least indirectly, the actions of countries in the fight against tax evasion. The other relevant benefit is the possibility to refill national coffers through better enforcement and this might at least partially offset the negative impact of the “race to the bottom” approach as  major spending and aid programs linked to the Covid-19 hammered government budgets.

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