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CHAPTER I

INTRODUCTION. DEFINITION OF I.P. HOLDING COMPANIES. OVERVIEW OF THE OECD BEPS ACTION PLAN

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1. Introduction: aim of the thesis

The aim of this thesis is to deal with the delicate issues arising from the current legal framework in the International Tax Law system, as it

has been amended and integrated by the recent OECD BEPS (Base Erosion and Profit Shifting) Project.

The focus of the present work is the effectiveness of the anti-abuse tools set forth and provided by the tax systems which are to be examined.

The first part of the thesis explores the concept of I.P Holding Company, identifying its key features and main purpose, that is to say, its ability to minimize the tax liability of a Multinational Enterprise (hereinafter MNE) through a proficient allocation of profits in different tax jurisdictions and the way to attain this objective.

The main point of the second section of this Chapter is the inescapable relationship between tax planning and I.P.[1] and the impact that intangibles have had in the field of direct taxation, and, more broadly, in the globalized economy[2]. Intellectual property is said to have

[1] According to the 2017 *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*, § 6.6, an intangible item is "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstance". In addition, pursuant to § 6.7, "the determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterization for general tax purposes, as, for example, an expense or an amortisable asset". Convincingly, the *OECD BEPS Action 8-10 Final Reports* argue that "rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction". Such a ring-fenced definition of intangibles in the OECD Guidelines is aimed at meeting the requirements of the arm's length principle under Article 9 of the OECD Model by making the transfer pricing notion of intangibles universally interpreted in a cross-border situation and thus preventing the potential risk of double taxation due to inconsistent definitions under domestic tax laws.

[2] The interaction between I.P. and tax avoidance and the concerns thereof arising have been addressed from various parts, both at political and academic level. See, in this respect, DEPT. OF THE TREASURY, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, 2013, available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explenations-FY2014.pdf. To quote the exact words: "there is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base". It has also been concluded that the problem is "intractable" without a radical, disruptive reordering of international

"become the leading tax avoidance vehicle"[3], as MNEs are "stripping out of market countries and into tax haven intangibles holding companies"[4].

In contrast to tangible property, I.P. can be shifted, transferred to low tax jurisdictions or to tax havens, with the click of a button or through the submission of paperwork[5]. The very nature of the intellectual rights makes it extremely hard to establish their market value[6]. The 2017 OECD Transfer Pricing Guidelines[7], as amended by the OECD BEPS Action 8-10, provide definitions of two commonly used categories of intangibles, known as marketing intangibles and trade intangibles: while marketing intangibles are defined as intangibles that "relate to marketing activities, aids in the commercial exploitation of a product or service, and/or [have] an important promotional value for the product concerned"[8], trade intangibles are regarded as "commercial intangibles other than marketing intangibles"[9].

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tax law. In this respect, see E.D. KLEINBARD, *Stateless Income's Challenge to Tax Policy*, in *Tax Notes*, 2012; M.J. GRAETZ – R. DOUD, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, in *Columbia Law Review*, 2013; O. MARIAN, *Jurisdiction to Tax Corporations*, in *B. C. Law Review*, 2013.

[3] See A. STANEK-BLAIR, *Intellectual Property Solutions to Tax Avoidance*, in *UCLA Law Review*, 2015.

[4] See L. SHEPPARD, *Is Transfer Pricing Worth Salvaging?*, in *Tax Notes*, 2012.

[5] In this respect, see Y. BRAUNER, *Value in the Eye of the Beholder: The Valuating of Intangibles for Transfer Pricing Purposes*, in *Virginia Tax Review*, 2008.

[6] See J. DINE – M. KOUTSIAS, *The Three Shades of Tax Avoidance of Corporate Groups: Company Law, Ethics and the Multiplicity of Jurisdictions Involved*, in *European Business Law Review*, 2019.

[7] 2017 OECD Guidelines § 6.16.

[8] 2017 OECD Guidelines, Glossary, "Marketing Intangible". For instance, marketing intangibles could include trademarks, trade names, customer lists, customer relationships, proprietary market and customer data that are used or aid in marketing and selling goods or services to customers.

[9] 2017 OECD Guidelines, Glossary, "Trade Intangible". This category is provided to facilitate the discussion for purposes of transfer pricing analysis, rather than to delineate with precision various classes or categories of intangibles or to prescribe outcomes that are used or aid in marketing and selling goods or services to customers.

Also technological development has played a significant role in wide-spreading the use of I.P. in various and sometimes unimaginable ways, and has rendered it much easier to shape and rethink business models, suitable for the activities carried out by the MNEs and efficient for their purposes.

On the other hand, or better yet, as a consequence of such an intellectual property expansionism[10], huge concerns related to the misuse of I.P. have risen in various branches of law[11].

Also, the chapter evaluates the aim of the BEPS Action Plan or, better yet, the aim of the Actions that appear to have an impact on the chosen topic of this thesis. In other terms, this first part is going to give a general overview of said Action Plans. A more thorough investigation over the most crucial and interesting elements of the relevant Actions is going to be conducted in the next chapter, where

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[10] See C. BOHANNAN – H. HOVENKAMP, *IP and Antitrust: Reformation and Harm*, in *B.C.L. Rev.*, 2010, p. 905. Such I.P. expansionism is a key issue that requires special attention from various Institutions, as evidenced by the OECD BEPS Action Plan and the continuous monitoring activities and reports issued by the OECD itself. In this respect, see A. MODICA – T. NEUBIG, *Taxation of Knowledge Based Capital: non-R&D Investments, Average Effective Tax Rates*, Internal Vs. External KBC Development and Tax Limitations, in *OECD Taxation Working Papers*, No. 24, OECD Publishing, Paris. The paper at issue does not focus on I.P. from an anti-abuse point of view and it does not focus on R&D investments; rather, it is aimed at extending the tax analysis to other types of knowledge-based capital and to assist countries in their efforts to assess whether and how tax policy can most cost-effectively encourage investment in KBC. Conversely, the relationship between I.P. and anti-avoidance rules is highlighted by Å. JOHANSSON – Ø. BIELTVEDT SKEIE – S. SORBE, *Anti-avoidance rules against international tax planning: A classification*, in *OECD Economics Department Working Papers*, No. 1356, OECD Publishing, Paris.

[11] See C. BOHANNAN, *IP Misuse as Foreclosure*, in *Iowa Law Rev*., 2011, p. 475. The Author points out how exploiting intangibles unveils the flaws of the system. In this respect, according to the Author "although courts generally agree that the misuse doctrine relates to the use of IP licenses and other arrangements to obtain rights beyond the scope of a statutory IP right, the [I.P. misuse] doctrine lacks coherence and certitude in determining the types of practices that should be condemned and why". At the same time, the tax-avoidance concerns arising from the exploitation of I.P. could be tackled from a point of view that is not strictly related to tax law or international tax law and does not involve a revision of the present international tax framework. In this respect, see A. BLAIR-STANEK, *Intellectual Property Solutions to Tax-Avoidance*, in *UCLA Law Review*, 2015.

the BEPS Action Plan will be compared to the EU initiatives in the area of tax avoidance.

Despite this preliminary *caveat*, Action 3 (Designing Effective Controlled Foreign Company Rules), considering the anti-avoidance purpose of CFC provisions, Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), given the intuitive relationship between tax planning and the habitual practice known as "Treaty Shopping" and Action 8-10 (Aligning Transfer Pricing Outcomes with Value Creation), provided its essential role in tailoring the concept of Hard-to-Value-Intangibles (HTVI) and in ruling the Cost Contribution Arrangements (CCA), will be dealt with in the first chapter.

It is necessary to point out, however, that the thesis is not going to focus on any transfer pricing-related issues more than what is strictly needed, as a natural completion of a work on tax avoidance entailing the use of intangibles.

In addition, this chapter will expand its spectrum of analysis to the world of digital economy, its criticalities and the solutions suggested both at OECD level, as enshrined in BEPS Action 1 (Addressing the Tax Challenges of the Digital Economy), and at EU level, whose activity and proposals partially stem from the initiative of the OECD.

2. MNEs structures and agreements in the context of I.P.

2.1. I.P. Holding Companies: purposes and characteristics

In a globalized and technologically developed economy it is no surprise that companies continually search for ways to operate more efficiently to maximize earnings. A business with a substantial

number of intangibles may decide that an I.P. Holding Company[12] (hereinafter IPHC, or I.P. Company or IPC) will significantly improve its chances to use and manage its I.P. and, consequently, to reduce the tax liabilities of the business in high tax jurisdictions[13].

As a broad definition, an IPHC can be defined as a company which owns I.P. rights, isolated from another company with which such a company has direct or indirect equity links. The activity carried out by the IPHC does not always imply the direct use of the intangible. Conversely, the IP rights are often licensed to affiliate companies (either parent company or subsidiary), or even to companies that do not belong to the group. A holding company does not produce anything, but, as the name implies, is set-up to hold legal titles. Many companies are using shell, or letterbox companies, that do not have any employees.

A holding company does not produce anything, but, as the name implies, is set-up to hold legal titles, such as IP rights.

In principle, if the aim of a structure, such as the one at issue, is to minimize the tax base[14] and, thus, the tax liability of the whole group, the IPHC shall be set up in a low tax jurisdiction, where its income will be taxed. Of course, the tax scheme shall be exceptionally straightforward in order to guarantee the very existence of the IPHC

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[12] The U.S. offer various examples of I.P. Companies. For more details on I.P. Companies in the United States, see X.T.N. NGUYEN, *Holding Intellectual Property*, in *Ga. L. Rev.*, 2005. See also *infra* the third Chapter.

[13] In this respect, see P. S. CHESTEK, *Control of Trademarks by the Intellectual Property Holding Company*, in *IDEA - The Journal of Law and Technology*, 2001. See also M. A. LISI, *Intracorporate Licensing; A Domestic Trademark Holding Company Example*, in *Advanced Seminar on Licensing Agreements PLI Pat.In.* 1998; G. T. BELL (and others), *A State Tax Strategy for Trademarks*, in *Trademark Rep.*, 1991, p. 445; I. H. ROSEN, *Use of a Delaware Holding Company to Save State Income Taxes*, in *Tax Adviser*, 1989.

[14] Inter alia, see L. AMBAGTSHEER-PAKARINEN – A. J. BAKKER – A. BAL – B. BALDEWSING – R. BETTEN – S. BOON LAW – M. COTRUT – C. GUTIÉRREZ – R. HAMZAOUI – M. KINDS – M. NAOUM – R. OFFERMANS – L. G. OGAZÒN JUAREZ – A. PERDELWITZ – O. POPA – R. VLASCEANU, *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures*, Volume 2, ed. IBFD, 2015.

itself. In other words, said tax scheme must be able to justify the fee paid by the operating company in terms of royalties to the I.P. Company, in order to obtain the aforementioned tax benefit[15]. The profits from the operating company are collected by the IPHC and taxed at a lower tax rate. If it were not enough, the royalties paid for the license of the I.P. are deemed to be costs for the operating company which can be deducted to lower its tax base.

In the most basic and rudimental IPHC model, then, the parent company (Company A), resident for tax purposes in State A, establishes a wholly owned subsidiary (Company B) in State B, a low tax jurisdiction, and transfers (assigns) its intellectual property to the latter. Company B (the I.P. Holding Company) may develop the intangible and license it back to the parent company, that acts as operating company, that is to say, a company that actually carries out the business activity of the group.

The license-back contract allows the operating company to exploit and commercialise the intangible. In addition, the shareholders of the operating company contribute their shares to the IPHC and subscribe the equity of the latter. Eventually, the IPHC owns the I.P. rights and the royalties deriving from the license of the I.P. and these revenues are received by the shareholders in the form of dividends[16] (*see* Table 1).

[15] In addition to the tax benefits, the creation of an IPHC may increase corporate efficiency in the operation of the business As such, an IPHC may guarantee a centralized management of I.P. assets worldwide with a more global view on the exploitation of the assets.

[16] It is worth mentioning that, in order for the whole structure to be tax efficient, it is necessary that the distribution of profits in the form of dividends must not suffer from the application of any withholding taxes by the State of the distributing company. The topic will be further discussed, when the analysis of I.P. Holding Company will involve the interaction between the tax planning at issue and the application of tax Treaties' provisions and/or supranational provisions, such as EU pieces of legislation.

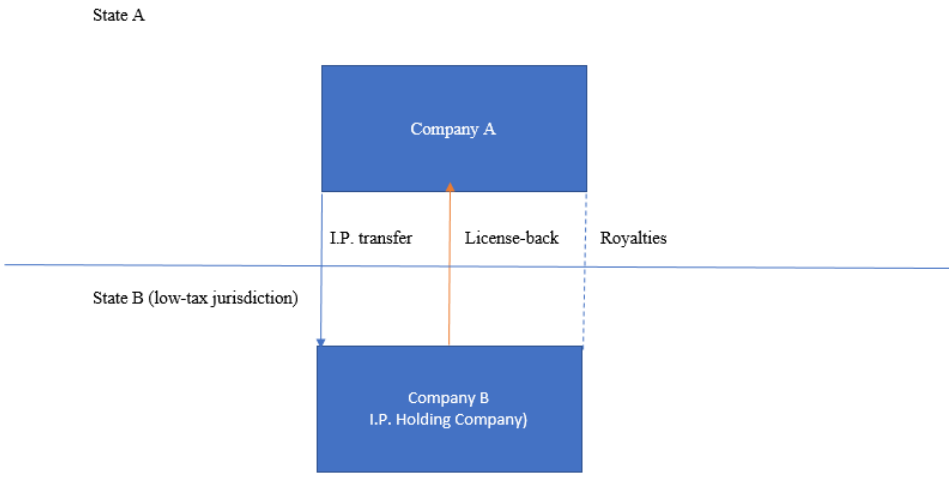

Table 1

As it is clear from Table 1, Company B is not set up to carry out any actual business activity, while it is meant to manage the I.P. and to receive royalties, which are taxed at a low rate[17]. At the same time, it is Company A that acts as an operating company and benefits from the license of the intangible. By establishing a subsidiary in a low tax jurisdiction[18], transferring the parent's intangible assets to the

[17] The reduction of tax obligations has also been defined as production of "nowhere income". In this respect, see E. F. CORRIGAN, *Interstate Corporate Income Taxation – Recent Revolutions and a Modern Response*, in *Vand. Law Review*, 1976.

[18] Provided that the third Chapter of the thesis will deal with the U.S. Tax Cut and Reform Acts (2017), it might be useful to point out that some States provide favourable conditions for setting up I.P. Holding Companies. For instance, Delaware does not tax corporations engaged exclusively in the maintenance and management of intangible investment located outside of the state (See Delaware Code Ann. Tit. 30 § 1902(b)(8) (1997), Nevada imposes no corporate tax, and Michigan exempts royalty income from taxation. In this respect, see P.L. FABER, *State and Local Income and Franchise Tax Aspects of Corporate Acquisitions*, in *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations, and Restructurings*, 1996; S.J. OFFER, *Representing the Buyer, in State and Local Income and Franchise Tax Aspects of Corporate Acquisitions*, in *Tax Strategies for Corporate Acquisitions*, 1995. See also Case Mobil Oil Corp v Dep't of Treasury, 373 N.W. 2d 730 (Michigan 1985), which stated that the Michigan Single Business Tax Act taxes the one who pays royalties, not the one

subsidiary, paying the subsidiary royalties for the parent's use of the intellectual property, a certain amount of taxation (which would otherwise be applied) is avoided[19].

Such IPCs can have various legal forms, being stock companies and limited liabilities the most common ones. Even Permanent Establishments can act as IPHCs.

The above-described structure hardly ever appears to be used by MNEs. Companies happen to prefer more complicated structures, that involve one or more intermediary holding companies. These additional levels of complexity are usually requested for tax reasons. In fact, the aim of such structures is to exploit a huge network of double tax treaties, especially when it comes to the choice of the place of seat of the holding company, as this choice is essentially made taking into consideration the least expensive tax treatment. This kind of practice involves the exploitation of tax tools provided by various tax systems and usually involves what is known as treaty shopping and the (mis)use of EU Directives' provisions[20].

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who receives them. This last statement may apply to structures whose IPHC is resident for tax purposes in Michigan.

[19] Again, if we give a glance at the U.S. system, there is a considerable number of cases regarding the tax consequences of setting up I.P. Holding Companies in low tax jurisdictions, see Case Geoffrey Inc. v South Carolina Tax Comm'n, 437 S.E. 2d 13 23-24, 1993, which required that foreign trademark holding companies had to pay state taxes on royalties earned in state; Case In re Burnham Corp., DTA No. 814531, 1997 WL 413931, N.Y. Tax. App. July 10th, 1997, which held that parent and subsidiary were required to file combined return, resulting in greater tax liability to New York; In Case re Express, Inc., DTA Nos. 812330-34. 1995, WL 561501, N.Y. Tax App. September 14th, 1995, which held that four trademark holding companies and their respective retailers had arm's length relationship for tax purposes and were therefore not required to file combined tax returns. Case In re Express is said to be a textbook example of how to set up and operate a trademark holding company, and how to defend it when challenged by tax authorities.

[20] For a general introduction on treaty shopping and directive shopping, see L. DE BROE, *International Tax Planning and Prevention of Abuse*, IBFD, 2008.

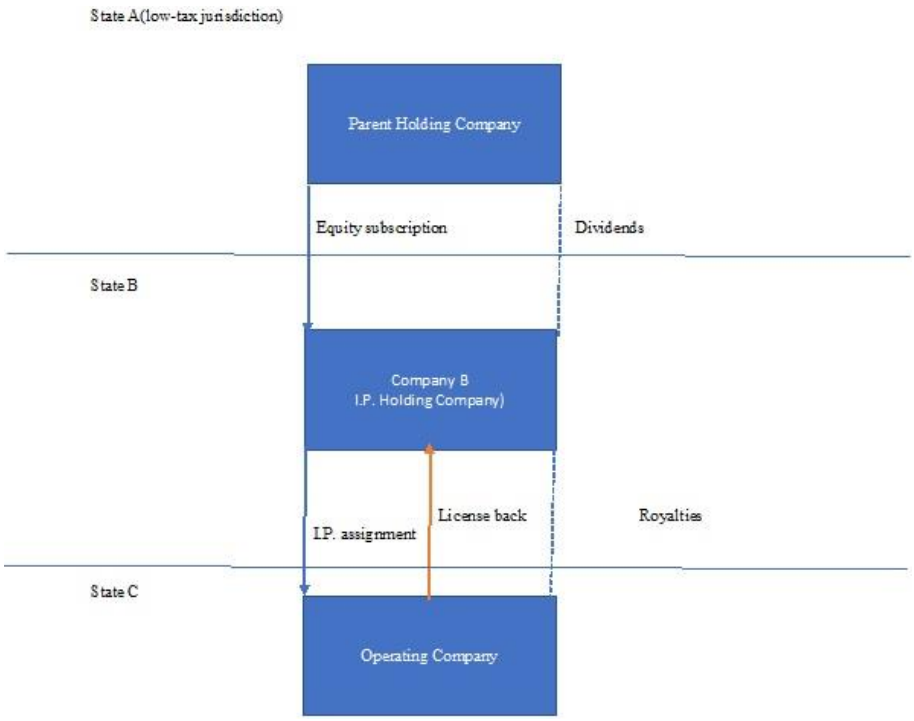

Table 2

Table 2 shows an example of a more complex structure: Company C (operating company), set up in State C (high-tax jurisdiction), creates an IP Company in State B, with which country C has signed a double taxation treaty, so as to avoid the application of any withholding taxes on dividends, interest or royalties paid by the operating company. The IP Company does not have its legal seat in State A, despite its attractiveness in terms of tax treatment. This choice is justified by the fact that Country B has not signed a double taxation treaty. However, a second holding entity, the parent company of the IPHC, is located in State A, an offshore jurisdiction.

As shown in Table 2, the Operating Company, located in State C, deducts the full amount of the royalties it pays to IPHC, which pays the majority of its income in the form of dividends to Company A, the Parent Holding Company. As previously mentioned, Company A is

set up in a low-tax jurisdiction, where the dividends are subject to minimum tax or are completely tax free.

As a result, the royalties paid by the Operating Company are not subject to withholding tax, as much as the dividends paid by the IPHC to the Parent Holding Company.

The most evident example of this type of structure companies is the "Double Irish With a Dutch Sandwich", that has been used by companies like Google[21]. The Double Irish with a Dutch Sandwich is generally considered to be an aggressive tax planning strategy, which came under heavy scrutiny in 2014 from the U.S. and the EU, that involves sending profits first through one Irish Company, then to a Dutch Company, and finally to a second Irish Company headquartered in a tax haven.

[21] The BEPS concerns arising from a structure such as the one at issue are described by the OECD, *Addressing Base Erosion and Profit Shifting*, OECD, 2013, point 74-76. See, also, E.D. KLEINBARD, *Through a Latte, Darkly: Starbuck's Stateless Income Planning*, in *Tax Notes*, 2013; M. BRITTINGHAM . M. BUTLER, *OECD Report on Base Erosion and Profit Shifting: Search for a New Paradigm or Is the Proposed Tax Order a Distant Galaxy Many Light Years Away?*, in *International Transfer Pricing*, 2013; S. SIMONTACCHI – K. VAN RAAD, *Materials on TP and EU Tax Law*, 14th edition, *International Tax Center Leiden*, 2014.

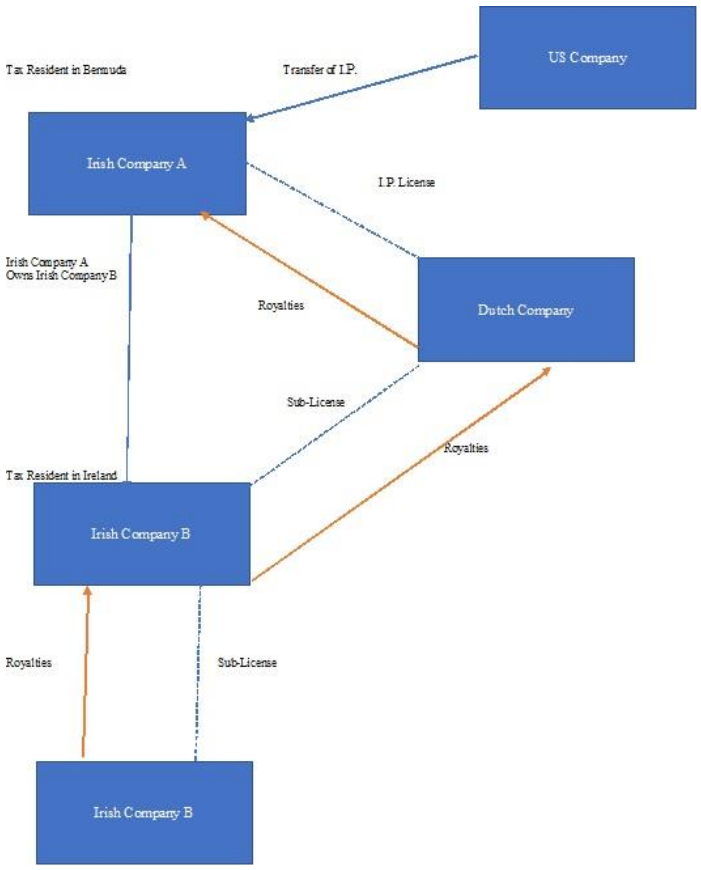

Table 3

Schematically, the first Irish Company, resident for tax purposes in a tax haven (*e.g.* Bermuda), would receive the I.P. from a U.S. Company, license it to a Dutch Company and receive royalties paid at arm's length. Then, the Dutch Company would sub-license the I.P. obtained to Irish Company 2, resident for tax purposes in Ireland, and wholly owned by Irish Company 1.

Consequently, the royalties paid by Irish Company 2 would not be subject to withholding tax thanks to the EC Interest and Royalties Directive[22]. Pursuant to Art. 3 (a) of said Directive, no withholding tax

[22] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States OJ L 157/49. The purpose of the Interest and Royalties

is to be applied to royalties and interests paid upstream (by a subsidiary to a parent company), downstream (by a parent company to a subsidiary) and side stream (between sister companies), if certain conditions are fulfilled[23].

As it was previously mentioned, the potential clash between national anti-abuse provisions and EU Law will be dealt with in the following Chapter.

It is necessary to underline, however, that International Tax Law and EU Tax Law concerns arise altogether where I.P. Companies are involved and overlapping between the principles belonging to these two different, albeit connected, branches of law are more frequent than it may appear at first sight.

2.2 The Cost Sharing Agreements (CSA) or Cost Contribution Arrangements (CCA): from the origins to the BEPS Action 8-10 "Aligning Transfer Pricing Outcomes with Value Creation"

As an alternative to the I.P. assignment, the IPHC and the operating company may enter into a Cost Sharing Agreement (CSA) or into a Cost Contribution Arrangement (CCA)[24], the aim of which is to share the costs of the development of an intangible, in proportion to the anticipated revenues[25]. Preliminarily, it can be stated a CCA "has a

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Directive is to ensure the freedom of establishment through the elimination of double taxation and cash-flows disadvantages of cross-border intra-group interest and royalty payments, mainly caused by withholding taxes.

[23] A company that wants to take advantage of the benefits set by the Interest and Royalties Directive: (i) must be incorporated as a legal entity included in Annex I of the Directive; (ii) must be subject to tax in the Member State where it is incorporated; (iii) must be resident for tax purposes in a Member State.

[24] For the purposes of transfer pricing, the concept of cost contribution arrangement (CCA) has been known since 1968.See E. KING, *Transfer Pricing and Valuation*, in *Corporate Taxation: Federal Legislation vs. Administrative Practice*, ed. Kluwer Academic Publishers, 1994.

[25] See, ex multis, W. SCHÖN – K. A. KONRAD (edited by), *Fundamentals of International Transfer Pricing in Law and Economic*, 2012, ed. Springer, p. 200; L.

hybrid character since it involves as modes of interaction both elements of: (a) transactional exchanges; and (b) the unification of individual contributions in the quest for a common goal" [26].

The concept of CSA has been known since 1968[27], when the US Internal Revenue Service (IRS) and Treasury announced new regulations which included extensive rules for CSAs[28].

The idea of CSA (or CCA) has changed since it was first theorized in the 20th century[29]. With the 1968 US Treasury Regulation, the IRS implemented "safe harbour" provisions to avoid complex valuation of the relevant intangible[30]. In fact, initially cost sharing agreements were considered a strong alternative to the vigorous and difficult compliance costs and audit exposure inherent in royalty charges[31]. Also, the provisions of the Regulation targeted at the elimination of the risk of PE recognition for tax purposes, so as the CSA could not be deemed to be a partnership.

BRYER – M. ASBELL, *Combining Trademarks in a Jointly Owned IP Holding Company*, in *Trademark Reporter*, 2005.

[26] S. SCHNORBERER, *The Taxation of R&D Cost Sharing: An Economic Approach*, in *Intertax*, 1997, p. 419.

[27] In the report of the 1969 IFA Congress held in Rotterdam, it was observed that "in the context of arm's length prices (for services) cost sharing arrangements should not be overlooked. Many independent concerns enter into arrangements whereby costs are shared between them in order to provide a service which is to their joint benefit. Such an arrangement could equally well apply between a domestic parent and foreign subsidiary, providing it was not part of the normal trading activities of the company providing the service"

[28] US Treasury Regulation § 1.482-7T(a), 1968. For further details on the US legislation, see P. CARMICHAEL – B. A. CROMWELL – H. GLENN – R. S. KIRSCHENHAUM – G. D. LEMEIN – M. M. LEVEY – H. K. MC CLELLAN – M. G. NIJHOF – J. M. PETERSON – S. R. RAHIM, *IRS Issues Long-Awaited Temporary Regulations on Cost-Sharing Arrangements*, in *Intertax*, 2009.

[29] For more details regarding the origins and the evolution of the CSA, see Y. BRAUNER, *Cost Sharing and the Acrobatics of Arm's Length Taxation*, in *Intertax*, 2010.

[30] In this respect, see J. WITTENDORFF, *Transfer Pricing and the Arm's Length Principle in International Tax Law*, 2010, Kluwer Law International.

[31] See M.M. LEEVEY – W. GAROFALO, *The IRS is Closely Monitoring Cost-Sharing Agreements*, in *Intertax*, 2000.

As a consequence, the OECD issued the Multinational Enterprises and Transfer Pricing Report (1979), which made general remarks on the application of the safe harbour rules, claiming that there were potential problems due to the lack of harmonization, as a safe harbour in one country may create difficulties in another, and held safe harbours could serve as a basis for tax avoidance. What the OECD mostly focused on was the necessity for an adequate and more coordinate approach towards the issue of CSAs and, simultaneously, criticized the approach of the United States. In other terms, the OECD emphasized the need for harmonization between the US and the OECD member countries.

Between 1986 and 1988 the IRS issued two White Papers, suggesting the allocation of costs between participants should follow the commensurate with income standard. That is to say, the cost allocation should be proportional to the *reasonably anticipated profit* from the exploitation of the intangible[32].

In 1992 and 1996 the IRS issued Proposed and Temporary Regulations, which implemented some of the suggestions of the White Papers.

In response, the OECD issued a Task Force Report on Intercompany Transfer Pricing Regulation under US §482 of the Temporary and Proposed Regulations (1993), according to which one of the main issues raised by the Regulations was their consistency with the arm's length principle[33].

[32] In other words, the IRS suggested the commensurate income standard was to be interpreted in line with the arm's length principle.

[33] More specifically, the report held that, to the extent it relied on the use of hindsight, the implementation of the commensurate with income standard violated the arm's length principle, because its application depends on the evaluation of the facts and circumstances surrounding the relevant transactions at the time they take place.

In 1995, the OECD issued a revised version of its Transfer Pricing Guidelines for Multinational Enterprise and Tax Administration (hereinafter, the Guidelines, or the Transfer Pricing Guidelines), whose Chapter VIII was devoted to CCAs.

Pursuant to the definition given by the 1995 (and 2010) Guidelines, a CCA [the Guidelines refer to the concept of cost contribution agreement, which is a synonym for CSA] is a "framework agreed among business enterprise to share the costs and the risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and the extent of the interests of each participant in those assets, services, or rights".

Its mechanism might look quite simple, at least in principle: "group costs of the parent company are allocated to its subsidiaries in accordance with a predetermined allocation formula, *e.g.* local turnover as a proportion of world turnover, to give each company's contribution payable to the parent company"[34].

Consequently, the contributing companies have the right to utilize all services available within the group. The scope of the agreement known as CCA is wider than that of a patent royalty or technical assistance agreement, which is limited to the use of patents and technical know-how alone[35].

Although it has been pointed out the CCAs have been primarily used by MNEs as a way to transfer intellectual property to a different

[34] K. RIJKS, *Cost Sharing Arrangements*, in *Intertax*, 1974, p. 128. According to the Author, other allocation formulae such as capital employed, number of employees or production capacity are possible.

[35] In addition, the remuneration payable under these types of agreements is usually expressed as a fixed percentage of turnover whereas cost sharing arrangements are rewarded on an agreement method of cost allocation. In any case, a wide range of services are commonly included in the framework of cost sharing agreements, such as, for example: the license to use all trademarks, patents and other intangibles belonging to the group or concern; the right to benefit of research and development carried on by the group; assistance with respect to all aspects of production and sale of goods; managerial and administrative guidance.

jurisdiction while expanding their business[36], genuine CCAs have a strong practical and economic rationale behind them.

In a nutshell, a cost contribution arrangement is aimed at reducing the costs of each company taking part in the agreement and sharing the risks of certain investments (*e.g.* technology, scientific research).

The 1995-2010 OECD Transfer Pricing Guidelines have represented a milestone in the definition of what "transactions at arm's length principle" mean and they have enshrined principles and methods useful to determine whether infra-group transactions were compliant with such a definition. As expressed in the Introduction of the 1995-2010 Guidelines, "the Chapter discusses the arm's length principle, reaffirms its status as the international standard, and sets forth guidelines for its application"[37].

The Guidelines identify the tax-related risks that may derive from transactions among related parties, and state that, while independent enterprises that transact with each other determine the commercial and financial conditions of such transactions on the basis of their market value, associated enterprises may not be affected by external market forces in the same way.

Although tax administrations should not automatically assume associated enterprises have sought to manipulate profits, as there might be a genuine and intrinsic difficulty in determining the price of

[36] In this respect, see T. POLONSKA, *Cost Contribution Arrangements and Funding Activities*, in *International Transfer Pricing Journal*, 2018.

[37] A move away from the arm's length principle would […] threaten the international consensus, thereby substantially increasing the risk of double taxation. In this respect, see the OECD Transfer Pricing Guidelines, 2017, p. 38. Despite the undebatable role of the Guidelines, it is necessary to remind its soft law nature and the consequent lack of significant sanctions (at international level) where a transaction is not compliant with the arm's length principle. The difficult enforceability of the Guidelines is well expressed by D. SCHINDLER – G. SCHJELDERUP, *Transfer Pricing and Debt Shifting in Multinationals*, in *Centre of Economic Studies & Ifo Institute Working Paper* n. 4381, 2013.

a transaction, still the cost of the transactions might need to be adjusted according to the arm's length principle[38].

The Guidelines have shaped the concept of "arm's length principle"[39] on the grounds of Article 9, paragraph 1, of the OECD Model Tax Convention.

In few words, Article 9 sets forth an adjustment concerning the "profits which would […] have accrued to one of the enterprises"[40], in case of transactions involving associated enterprises at conditions that differ from those that would be made between independent parties.

In other words, Article 9 and the Guidelines seek to adjust profits by reference to the conditions which would have been applicable to a transaction, had such a transaction occurred between unrelated parties, and, to do so, it is necessary to identify comparable transactions in

[38] The Guidelines state that the consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes. In this respect, see the OECD Transfer Pricing Guidelines, 2017, p. 33.

[39] The Chapter will not deepen the arm's length principle. Since the thesis has its focus on the relationship between anti-avoidance provisions and I.P. Companies, a thorough study of the arm's length principle may appear mandatory. However, considering the approach of the thesis, it is preferable to deal with the arm's length principle under the filter of EU Law. It is necessary to highlight, however, that the BEPS Action 8-10 is aimed at building up new transfer pricing methods and at strengthening the existing ones. In this respect, it has been claimed that the value of the arm's length principle as an anti-avoidance tool "is eroded in light of the increased use of intangibles, and because its reliance on comparables. This not only decreases its ability to counter tax avoidance […], but arguably also increases the ease of doing so. Furthermore, the arm's length principle as a tool against anti-avoidance is further undermined by the fact that different countries have different rules and standards of Transfer Pricing, and the inherent interpretation problems with different courts and administrations that use these provisions against Multinationals". See A. T'NG, *The Modern Marketplace, the Rise of Intangibles and Transfer Pricing*, in *Intertax*, 2016.

[40] It is worth noting that the problem in determining the correct value of certain transaction has its ground also in the identification of the most proper transfer pricing method. It has been argued that in order "to provide more certainty in respect of tax regulations, a first step might simply involve the text of the OECD TPG […]. Objective parameters to be implemented for intangible transfers include, for example, which valuation method (or methods) to be used". In this respect, see A. MUSSELLI, *Anti-Abuse Notion of "Control over Intangible-Related Functions" Is Beyond the Arm's Length Principle"*, in *European Taxation*, 2018, p. 196.

comparable circumstances. The 1995-2010 Guidelines were amended and integrated as an inevitable consequence of the release of the BEPS Action Plan. More specifically, Actions 8-10 addressed issues more closely related to the purpose of the Guidelines and variously affected them. The content of the Guidelines has sensitively been increased and, for what matters in this context, a new and more modern approach towards the transfer pricing methods has been introduced, not to mention the definition of Hard-to-Value-Intangibles (HTVI) (which will be discussed in another Section of this Chapter) and rules on CCAs.

As underlined by the current version of the Guidelines, "the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business"[41].

Despite a very common statement regarding the nature of anti-avoidance tool of the arm's length principle, it has been claimed that such principle has been "misidentified as the primary tool to tackle certain abusive behaviours of multinational enterprises"[42].

In this respect, it has been observed that the anti-abuse tools are prerogatives of domestic law based on the substance-over-form doctrine and are applied unilaterally; conversely, the arm's length principle is a bilateral concept aimed at determining the appropriate allocation of profits between the companies that carry out a certain

[41] As referred in the 2017 Guidelines, "paragraph 1 of Article 9 of the OECD Model Tax Convention is the foundation for comparability analyses because it introduces the need for: 1. A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises is authorised under Article 9 of the OECD Model Tax Convention […]; and 2. A determination of the profits which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.

[42] M. PANKIV, *Post-BEPS Application of the Arm's Length Principle to Intangibles Structures*, in *International Transfer Pricing Journal*, 2016.

transaction. Thus, the role of such a principle in a tax treaty context is to put related parties on an equal footing with unrelated parties, regardless of the existence of abuse in either of these two situations[43].

In addition, the arm's length principle is a general principle of tax treaties, and its interpretation cannot be limited to the methodological guidance of the OECD Guidelines only, whereas it should be based on the general principles of interpretation laid down in the Vienna Convention on the Law of Treaties.

In the view of the writer, this opinion cannot be accepted: in fact, the concept behind the arm's length principle is the idea of establishing the correct price of a determined transaction, having taken into the due consideration all the factors related to such transaction.

Consequently, the principle at issue exists so as to give an acceptable approximation of the cost a company would bear if it carried out a transaction with an independent and unrelated party and it serves as a reliable parameter to evaluate if the price of that transaction reflects its real value, or if it has unduly increased for tax reasons.

If, on the one hand, it is true that anti-avoidance measures are prerogatives of domestic law and that the arm's length principle is a general principle of tax treaties, it is equally true that principles belonging to international tax law have been absorbed by the domestic tax systems, which have developed their own version of those principles[44]. In this respect, it is undeniable that the arm's length

[43] In this respect, it is worth noting that tax abuse could also be present in transactions between unrelated parties, *e.g.* in value-added tax transactions, although to a lesser extent than in related-party transactions. See R.F. VAN BREDERODE, *Third Party Risks and Liabilities in Case of VAT Fraud in the EU*, in *International Tax Journal*, 2008. According to the Author "the [European Union] concept of abuse of law as well as the introduction of third party liability in case of tax fraud provide ample tools to the authorities for combating avoidance and evasion of VAT".

[44] For instance, Art. 110 and Art. 9 of the T.U.I.R. (Testo Unico delle Imposte sui Redditi) Italian Tax Code (Presidential Decree 22 December 1986, n. 917 set the general rules, for the determination of the value of transactions and identify the concept of fair value.

principle, despite deriving from the international practice, has become part of the domestic tax system[45]. In any case, its anti-abuse nature resides in its ultimate scope, which is not limited to the identification of the fair value of a transaction, but, rather, using this value as a parameter to evaluate the compliance of said transaction to the tax system's anti-abuse provisions.

In this respect, it has been pointed out that the Commentary on the OECD Model comprises a basis for the interpretation[46] of the articles of the OECD Model, as well as the OECD Guidelines, at least with reference to Article 9 of said Model.

In other words, if the Commentary is a non-binding source of interpretation and the OECD Guidelines are used as an additional tool for understanding article 9, such Guidelines cannot be considered binding too.

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[45]It is worth pointing out that the international tax law has developed its own language and its own technicalities, which are typical of this branch of law. As a consequence, the interpretation of certain international tax law concepts is not flexible and must stick to the specific wording and rules of international tax law. In this respect, see K VOGEL, *Klaus Vogel on Double Taxation Conventions*, Fourth Edition, Volume 1, Kluwer Law International, 2015. Although Article 3.2 of the OECD Model Tax Convention contains a provision on the ambulatory interpretation of tax treaties – it essentially provides flexibility in the interpretation of the meaning of terms not defined in the treaties, and stipulates the meaning of a term when the treaty is applied, not the meaning at the time of the signature, shall prevail, the purpose of this provision is not to allow for arbitrary interpretation provision practices.

[46] It is necessary to note that the BEPS Final Report on Actions 8-10 contains a revised interpretation of the arm's length principle on risk allocation, which should enable tax authorities to combat profit shifting through the transfer of risks and the associated risk premium to law-tax group companies. In a nutshell, risk allocation must be based on the activity of risk assumption and risk management – not on contractual allocation of risk. For a critical view of this interpretation, see, among all, R. HAFKENSCHEID, *The BEPS Report on Risk Allocation: Not So Functional*, in *International Transfer Pricing Journal*, 2017. In addition, the idea of an arm's length principle as an internationally recognised and well-spread principle has been criticized and it has been highlighted that "independent entity or arm's length should be replaced by a unitary principle for taxation of multinationals". In this respect, see S. PICCIOTTO, *Transfer pricing is still dead…From Independent Entity Back to the Unitary Principle*, in *Tax Notes International*, 2014.

Consequently, the value of these sources in the interpretation of the tax treaties' provisions and, thus, of Article 9 of the OECD Model Tax Convention, closely depends on the domestic tax Courts and lawmakers[47]. This implies, however, that "domestic legislation and case law could possibly include rules on adjustments of taxable income. […] The acceptance of the Commentary and, by extension, the OECD Guidelines may, however, vary among different jurisdictions, and the limitations of its use are ultimately decided in the domestic judicial system"[48].

If the general aim of the Guidelines is to provide guidance on how to determine an arm's length consideration for an intra-group transfer of intangible property and services, the objective of the Chapter regarding the CCA is to provide an additional guidance where resources and skills are pooled and the consideration received is the reasonable expectation of mutual benefits[49].

The Guidelines describe some types of CCAs, the most frequent of which entails an arrangement for the joint development of intangible property, where each of its parts receives a share of rights in the developed property.

In this case, the participants are accorded separate rights to exploit the intangible property.

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[47] For instance, the Supreme Administrative Court of Sweden has, in several cases, acknowledged the applicability of the Commentary on the OECD Model as a source of interpretation not only for tax treaties based on the Model, but also for Swedish internal tax law. See SE:SAC, RÅ, 1998 and RÅ, 2009 for application of the Commentary on Article 5, HFD, 2016 for application of the Commentary on Article 17, as well as RÅ 1991 and HFD 2016 for application of the OECD Guidelines.

[48] In this respect, see J. HAGELIN, *Retroactive Application of the OECD Transfer Pricing Guidelines for Interpretation in Transfer Pricing Issues*, in *International Transfer Pricing Journal*, 2018, p. 404.

[49] It is worth mentioning that the mutual benefit is the core concept in the analysis of whether a party can take part into a CCA, and the following cumulative conditions need to be fulfilled: 1. The person shall be assigned an interest in or right to the intangible; and 2. The person should have a reasonable expectation of benefiting from such interest or right.

In other words, once the research activity is carried out, they may use the intangible property for their own benefit and purposes, notwithstanding the necessities and the rights of the other participants. That being said, the intangibles might constitute actual legal ownership.

Although the above-described type of CCA seems to be the most frequent, cost contribution agreements are extensively in other contexts where, for instance, other types of costs and risks are shared for developing or acquiring property or for obtaining services[50].

Contributions to the CCA might be classified depending on their usage: pre-existing contributions, such as assets that constitute a basis for further development of new intangibles, differ from current contributions, like the provision of new R&D services for the purpose of I.P. development. The case of pre-existing contributions may entail that some of all the parties that join a CCA bring previously developed or created intangibles.

In this particular case, it is frequent that the party that does not already own rights in the already existing intangible buys-into[51] it before the CCA regime starts[52].

Buy-in payments[53], which may take several forms (from lump sum to periodic royalties, either fixed or decreasing)[54], then, appear to present

[50] See the OECD 2017 Transfer Pricing Guidelines, Chapter VIII, Section B.3, § 8.10, p. 348.

[51] Conversely, buy-outs are the compensation received from other or others for the transfer of historical experience, accumulated knowledge (withdrawal, relinquishing or extinction).

[52] In this respect, see R.F. REILLY – R.P. SCHWEIHS, *Valuing Intangible Assets*, 1999, ed. Mc Graw-Hill.

[53] As it was previously highlighted, the cost contribution agreements were first conceived in the US. Its legislation and the IRS documents and papers are extremely interesting and are closely and attentively studied. The buy-in payments are also required when there is a change in the participants' interests in the covered intangibles. See the US Treasury Regulation §1.482-7(g)(1). A change in the participants' interests can happen because of entry of a new participant or by any other transfer among participants.

strong issues related to their compliance with the arm's length principle. In fact, determining the amount of the buy-in payment involves difficult factual and valuation issues, that touch upon numerous and often very complex arguments and researches in fields that go from economics to the game theory. This may result in imperfect information, that could influence the decision-making process and the determination of the buy-in entity. The most evident difficulties may arise when the buy-in regards unfinished work in process R&D[55].

Also, contributions might be used solely for the purpose of the CCA activities, or they may be shared with the participants, and they might be made in cash or in kind.

Creating a CCA does not imply or require the set-up of a company or a legal entity, as the cost contribution agreement is a contractual arrangement. As it has been correctly highlighted, the OECD provisions do not specifically request a written agreement in order for a CCA to exist and be legally binding[56].

As previously mentioned, the definition of CCA, as provided by the 1995-2010 Guidelines, was amended by the most recent version of the

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[54] In this respect, see A. JOHNSON, *US Transfer Pricing Sourcebook*, 2005.

[55] See M.M. LEVEY – V.H. MIESEL – W. GAROFALO, *Buy-In and Buy-Out Requirements Present Unusual and Difficult Issues for Cost Sharing Agreements*, in *Intertax*, 2001, p. 30. After enlisting the various types of intangibles that seem to be most problematic in the context of buy-ins, the Authors describe three primary valuation models used to face the valuation challenges arising from the buy-in. Such models are: the Discounted Cash Flow (DCF) Models, pursuant to which cash flows-to-equity can be discounted at the cost of equity to determine a value of equity or cash flows to the company can be discounted at the cost of capital to arrive at the value of the company; the Relative Valuation Model, which stresses the importance of earnings of the business entity and states that only the current year's earnings are relevant in the valuation of the buy-in; the Option-Pricing Model, which estimates the value of assets that have option-like characteristics.

[56] Despite a written agreement is not a compulsory condition for the existence of a CCA, it is preferably to have an agreement which describes the contributions' valuations and the allocation of interests among the participants. Conversely, the US legislation establishes very strict contractual, timing and reporting requirements. See US Treasury Regulation § 1.482-7(k)(l)(iii).

OECD Transfer Pricing Guidelines for Multination Enterprise and Tax Administration (2017), as integrated and implemented by OECD BEPS Action Plan 8-10, which state (Chapter VIII) that "a CCA is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants".

What is interesting to point out about the aforementioned Guidelines is that the 2017 version makes it clear that "the transfer pricing issues focus on the commercial or financial relations between the participants and the contributions made by the participants that create the opportunities to achieve those outcomes".

As a consequence, the Guidelines state that "CCA participants *may* exploit their interest in the outcomes of a CCA through their individual business". Conversely, the 1995 and 2010 versions seem to be paying more attention in the "rewarding side" of the CCA, holding that "each participant in a CCA *would* be entitled to exploit its interest in the CCAs separately […]".

The Guidelines offer a useful tool that helps to put together the notion of CCA and the arm's length principle and it underlines that "for the conditions of a CCA to satisfy the arm's length principle, the value of participants' contributions must be consistent with what enterprises would have agreed to contribute under comparable circumstances"[57],

[57] See the OECD 2017 Transfer Pricing Guidelines, Chapter VIII, Section C.1, § 8.12, p. 349. In this respect, see also R. OKTEN, *A Comparative Study of Cost Contribution Arrangements: Is Active Involvement Required To Share in the Benefits of Jointly Developed Intangible Property?*, in *International Transfer Pricing Journal*, 2013.

having taken into the due consideration their proportionate share of the total anticipated benefits they expect to gain from the CCA.

The key to the interpretation of the CCA resides in the balance of the advantage and respective sacrifices among the parties. The substantive disproportion between the contribution to costs and the expected benefit serves to individualize the inadequate or unreasonable distribution of costs and benefits[58].

The advantages of a CCA are quite intuitive and easy to spot, once it is clear its purpose and characteristics. As simple as it looks, the main objective is to share the costs of the development, enhancement, maintenance, protection and exploitation (DEMPE) activities and to reduce the risks.

However, some complexities could arise in the exploitation of such a tool.

To start with, the evaluation of the parties' contributions has become way more sophisticated than it used to be, both because of the level of accuracy required by the tax administration and the very nature of certain intangibles, which is often not so easy to determine.

It follows that companies are asked to face burdensome and sometimes expensive procedures, in order to comply with the requests of the tax administration.

In addition, it is not certain that, in subsequent periods when the relevant I.P. appears to be profitable, the tax authorities would not challenge the transaction and apply the price adjustment clause for the I.P.'s valuation.

[58] See T. ROSEMBUJ, *Transfer Pricing and Cost Agreements*, in *Intertax*, 2008. The Author mentions the application of the arm's length principle to CCA, as established by the 1995-2010 Guidelines, arguing that "the [arm's length] principle is insufficient since there are non-economic elements in the contribution to the costs of the related community that, in no case, ensue from the specific and concrete economic interest, but arise from the belonging, and that force a contractual balance different from that to which an independent company can aspire in finally incomparable circumstances".

It has also been argued that some difficulties could arise in evidencing the participants' expectations and projection from the use of the I.P. In this respect, if the participants do not support the arrangement with the proper documentation, they may be faced with buy-in and balancing payments required by the tax authorities.

This drawback is related to the difference between an *ex ante* and an *ex post* basis for the comparability analysis.

According to the OECD, there are two approaches[59] to the comparability analysis from the perspective of timing. The *ex ante* (arm's length price setting) approach can be defined as an approach that rejects the application of hindsight[60].

Conversely, according to the *ex post* approach, also known as the arm's length outcome testing approach, the taxpayers assess the actual outcomes of the transactions[61].

Commentators have debated on these two approaches: in fact, some of them claim the OECD does not give preference to either of them[62], while others believe the first approach is to be considered as a general rule[63].

A final aspect of CCAs that can present flaws for MNEs is that, since such an agreement is aimed at sharing information for the creation or the development of intangibles, the level of secrecy generally expected in activities involving I.P. rights could plummet.

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[59] See the OECD 2017 Transfer Pricing Guidelines, Chapter III, Section B.2, § 3.69 and 3.70.

[60] See K VOGEL, *Klaus Vogel on Double Taxation Conventions*, supra n. 42. See also 2017 Transfer Pricing Guidelines, Chapter VIII, Section B.2, § 3,73, 3.74, Chapter VI, Section D. 4, § 6.188 and Chapter VIII, Section C.3, § 8.20.

[61] This approach is adopted by the US. See US Treasury Regulation § 1.482-1(b)(1). See also J. WITTENDORFF, *Transfer Pricing Timing Issues Revisited*, in *Tax Notes International*, 2012.

[62] See WITTENDORF, supra, n. 61.

[63] See A. BULLEN, *Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing*, Online Books IBFD, 2011.

3. The general purpose of the OECD BEPS (Base Erosion and Profit Shifting) Action Plan

The OECD BEPS Action Plan has been mentioned in the previous sections of this Chapter, which might have given a general idea of what this Action Plan consists in and what it is aimed at. Very simply, the BEPS – acronym that stands for Base Erosion and Profit Shifting – sums up and tackles (or is supposed to tackle) the most hideous problems the OECD is concerned of in the field of international tax and, more specifically, it addresses aggressive tax planning[64] and practices of tax avoidance[65]. In 2013 the G20 meeting in St. Petersburg endorsed the BEPS Action Plan, in which the OECD called for "fundamental changes to the current mechanisms and the adoption of new consensus-based approaches, including anti-abuse provisions, designed to prevent and counter base erosion and profit shifting"[66]. The OECD argues that aggressive tax planning "undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over

[64] The expression "aggressive tax planning" appears to have originated in the United States where it was used to refer to a type of tax planning characterized by the design of schemes or structures that are contrary to the spirit or purpose of fiscal regulations. See, in this respect, E. MULLIGAN – L. OATS, *The Risk Management: Evidence from the UE*, in *British Tax Review*, 2009.

[65] To give a hint on how BEPS might be disruptive, it has been estimated that – in a pre-BEPS context – anywhere between four and ten percent of corporate tax revenues are lost through profit shifting. These estimates (conservatively) suggest that between one hundred and two hundred and forty billion dollars of corporate income tax revenues are being lost annually due to BEPS. In this respect, see The G20, Australian Government Department of Foreign Affairs and Trade, https://dfat.gov.au/international-relations/international-organisations/g20/pages/the-g20.aspx [https://perma.cc/KZ86-VHQJ].

[66] G20 Leaders Declaration meeting in St. Petersburg including the Tax Annex to G20 leaders declaration. See https://www.oecd.org/g20/summits/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration,pdf.

enterprises that operate at a domestic level"[67]. These problems can seriously damage the budgets of the countries, in particular those submitted to austerity measures. As it has been correctly pointed out, double non-taxation is not desirable, because "it generates a budget loss and it is not equitable between people under a jurisdiction of a Court ("*justiciables*") […]. Double non-taxation may be used by the Contracting States, as bilateral measure to promote harmful tax competition with damaging effects on other States"[68].

The objective of the OECD is, in other terms, to create a level playing field and to minimize the distortions arising from aggressive tax planning and from the exploitation of the tax tools provided by the different tax systems[69].

In a way, this concept resembles what the EU Commission perceives as aggressive tax planning, and this common approach towards the issue has led to the pieces of legislation the EU has issued in the past few years in the field of anti-avoidance[70]. This competition-oriented – or, better yet, market-oriented – approach is made clear by the OECD

[67] See About BEPS and the inclusive framework, <ww.oecd.org/tax/beps-about.html>. Fairness is one of the tax principles the OECD formulated in its Ottawa Tax Framework, as revised in 2005 by the OECD Technical Advisory Committee.

[68] L. HINNEKENS, *La prevention de la double non-imposition dans les conventions bilatèrales suivant le modèle de l'OCDE*, Mèlanges John Kirkpatrick ed., 2004. See also A.C. DOS SANTOS – C. MOTA LOPES, *Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment*, in *EC Tax Review*, 2016.

[69] To make an example of how disruptive BEPS can be for the tax systems, it has been reported that the level of tax paid by multinationals such as Google on its non-US profits was only 2,4% in 2009, while Apple managed to achieve an effective tax rate of 2,2% in 2010 and 1,9% in 2011 on its non-US profits. In this respect, see respectively Bloomberg.com, Google 2,4% rate shows how USD 60 billion lost to tax loopholes, 21 October 2010, and C. DUHIGG – D. KOCIENIEWSKI, *How Apple sidesteps billions in taxes*, in *The New York Times*, 28 April 2012. For a diagram of the Google MNE structure, see L.A. SHEPPARD, *Reflections on the Death of Transfer Pricing*, in *Tax Notes*, 2008.

[70] The EU initiatives against tax avoidance – and, above all, the Anti-Tax Avoidance Directives 1 and 2 - will be dealt with in the following Chapter.

itself, where it states that "fair competition is harmed by the distortions induced by BEPS"[71].

The concept of aggressive tax planning is not as clear as it might look at first sight: in fact, it might be considered a pendulum that swings between tax avoidance[72] and legitimate tax planning. In other words, tax planning *per se* is allowed and strategies aimed at reducing the tax burden are not to be regarded as tax-avoidance measures, just because of their purpose.

According to the OECD report on cooperative tax compliance, included in the 2011 review of the OECD Guidelines for MNEs, "enterprises should comply with both the letter and the spirit of the tax laws and regulations of the countries in which they operate"[73].

The OECD developed fifteen Actions that address: digital economy (Action 1), hybrid mismatches (Action 2), the introduction of CFC rules (Action 3), the limitation of interest deductions (Action 4), eliminating harmful tax regimes (Action 5), tax treaty abuse (Action 6), the artificial avoidance of PE status (Action 7), transfer pricing and related issues (Actions 8-10), measurement and monitoring of BEPS (Action 11), disclosure rules (Action 12), transfer pricing documentation and Country-by-Country Reporting (Action 13), dispute resolution mechanisms (Action 14), the development of a

[71] See OECD, Action Plan on Base Erosion and Profit Shifting (2013), http://dx.doi.org/10.787/9789264241046-en.

[72] The concept of tax-avoidance, especially in relation with tax evasion, represents one of the most hideous and tricky problems commentators and Courts have dealt with. However, it is worth mentioning that statutory law has often tried to define tax-avoidance. To make an example of statutory legislation in the (grey) area of tax avoidance might be the British "Code of Practice on Taxation for Large Business". The HMRC proposal submitted by the British Government on 27 June 2015 in the Summer Budget 2015 framework tried to establish a boundary between legitimate tax planning that is acceptable within the cooperative framework and the aggressive tax planning practices that are considered unacceptable and comparable to what is classed to tax avoidance. For further details, see HMRC, *Improving Large Business Tax Compliance*, Consultation Document n. 19 and 38 (22 July 2015).

[73] With reference to this matter, see J. FREEDMAN – F. NG – J. VELLA, *HMRC's Relationship with Business*, Oxford University Centre for Business Taxation, 2014.

multilateral instrument to modify bilateral tax treaties (Action 15) [74]. The OECD has felt that "the current international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy"[75].

Very schematically, the OECD has structured BEPS Action Plan around three fundamental pillars and horizontal areas of working, meaning that these Actions are not ring-fenced and, more often than not, overlap. The three pillars are: 1. Creating coherence between the interaction of the domestic laws of the various countries (coherence); 2. Re-establishing the link between substance requirements and international taxation standards (substance); and 3. Increasing transparency and certainty for businesses and governments (transparency and certainty)[76].

Actions 2, 3, 4 and 5 are based on the first pillar. The main problem that stems from hybrid mismatch arrangements is that differences may arise in the tax treatment of an instrument or an entity under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. In other terms, hybrid mismatches arising from a lack of coordination in the two jurisdiction's laws results in non-taxed, stateless income. The Final Report of BEPS

[74] As it is possible to see from the variety of Actions proposed by the OECD, profit shifting may be carried out in different shapes. It is worth mentioning that the causes of profit shifting are deeply rooted in globalization and in the possibility that MNEs have to structure their activities differently by choosing, for instance, to centralize their strategic activities on a global or regional basis. It is not just a matter of tax burden, of course, because other relevant aspects are taken into account (*e.g.* cost of workforce, worldwide liberalization of trade, erosion of protectionist measures in many countries). In this respect, see A. DE GRAAF – P. DE HAAN – M. DE WILDE, *Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS*, in *Intertax*, 2014.

[75] See n. 66, G20 Leaders Declaration.

[76] See International Taxes Weekly Newsletter Art. 4, Volume 4, N. 1, 2015. See also, in this respect, R. STOCKER, *Potential Effects of the OECD Base Erosion and Profit Shifting Initiative on Swiss Transfer Pricing Rules and Swiss Companies*, in *Bulletin for International Taxation*, 2015.

Action 2 envisages an approach that would facilitate the convergence of national practices through changes in domestic and treaty rules that would neutralize hybrid mismatches and, thus, prevent double non-taxation.

Controlled Foreign Companies rules, tackled by Action 3, will be further dealt with in the following sub-section. It is worth mentioning, however, that the Action at issue is meant to ensure that jurisdictions that choose to implement CFC rules will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.

For what concerns Action 4, it calls for a common approach to facilitate the convergence of national rules in the area of interest deductibility and it aims at ensuring that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities and fostering increased coordination of national rules in this space.

With reference to Action 5, it expresses concerns on harmful tax practices which are primarily about preferential regimes which can be used for artificial profit shifting and about a lack of transparency in connection with certain rulings. The Final Report sets out a minimum standard based on an agreed methodology to assess whether there is substantial activity in a preferential regime.

If it were not clear enough, the Actions taken into consideration aim at leading the tax legislations of the OECD Member States to a commonly agreed standard, at least for what concerns the most controversial concepts.

The following five Actions fall under the substance pillars: Action 6, 7, 8-10.

Action 6 deals with the obnoxious practice of treaty abuse, which includes treaty shopping (that is the main source of BEPS). It includes rules that provide safeguards to prevent treaty abuse and offers a

certain degree of flexibility regarding how to do so. This Action promotes substance-over-form approaches that need to be adopted to prevent treaty shopping and principles such as the Principal Purpose Test. A more detailed analysis of this Action will be further conducted in this Chapter.

A crucial issue addressed by Action 7 is the avoidance of the concept of Permanent Establishment. The definition of Permanent Establishment included in the tax treaties plays a pivotal role as at allows to determine whether a non-resident enterprise must pay income tax in another jurisdiction. The OECD is, then, asked to review the PE definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition, such as arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors with commissionaire agreements, with a resulting shift of profits out of the country where the sales took place but without a substantive change in the functions performed in that country.

Action 8-10, that have been described before as those that redefine the concept of arm's length principle set forth by the OECD Transfer Pricing Guidelines, also address other guidance on transactions involving cross-border commodity transactions as well as on low value-adding intra-group services, and the nebulous and controversial category of Hard-to-Value-Intangibles (HTVI), which will be further explored.

Finally, Action 11, 12, 13 and 14 are grounded on the third pillar (transparency and certainty).

Very briefly, Action 11 is based on the fact that, according to the OECD, there are hundreds of empirical studies finding evidence of tax-motivated profit shifting, using different date sources and estimation strategies. Action 11 assesses currently available data and

methodologies and concludes that significant limitations severely constrain economic analyses of the scale and economic impact of BEPS and improved data and methodologies are required.

In addition, Action 12 recommends the OECD countries to introduce disclosure regimes, but it does not consist in a package of mandatory changes in the tax systems of the addressees.

Finally, Action 13 contains a three-tiered standardized approach to transfer pricing documentation, including a minimum standard on Country-by-Country-Reporting (CbCR). According to the OECD, this standard reflects a commitment to implement the common template for CbCR in a consistent manner[77].

For what concerns the horizontal approach, it involves Action 1 and 15.

Action 1, in its Final Report, concludes that the digital economy cannot be ring-fenced as it is increasingly the economy itself. According to the OECD – and, as it will be further analysed, the EU – the digital economy presents key features and fosters business models which raise related, but different, BEPS concerns and tax challenges. The horizontal aspect of Action 1 is evident once we realize that digital economy exacerbates BEPS issues for what concerns, the development of a new definition of PE in a digital context, the application of transfer pricing rules (as it pertains to intangible assets

[77] Specifically, the guidance on transfer pricing documentation requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations. It also requires that detailed transactional transfer pricing documentation be provided in a "local file" specific to each country, identifying material related-party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions. Finally, large MNEs are required to file a CbCR that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued and other indicators of economic activities.

and profit splits) or of CFC provisions (which relate to income from digital sales).

Action 15 – the last Action – explores the technical feasibility of a multilateral instrument to implement the BEPS treaty-related measures and amend bilateral tax treaties. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS is the instrument chosen by the OECD as an alternative to the current system based on bilateral tax treaties.

At international level, the treaty-related aspects of the BEPS initiative are covered by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting[78].

The initiative of the OECD and of the G20 countries has been appreciated by various parties and is to be considered as an interesting step forward from bilateralism to multilateralism[79].

If we consider the purpose of the BEPS Project, which is to prevent tax planning from threatening the market[80], some concerns may arise as to whether and to which extent this Project could be effective, in a context of harsh tax competition among the OECD countries.

If, on the one hand, each country has the power to shape its tax system in the most convenient and, if that is the case, attractive way, on the other hand, allowing aggressive tax planning[81] or practices that

[78] The treaty is open for ratification, and close to 70 countries have already signed it during the first signing round held on 7 June 2017 in Paris. This Chapter will focus on the Multilateral Convention in its final section.

[79] The multilateral inner nature of the BEPS Project does not prevent the OECD Member States from implementing the suggestions of said Project in bilateral treaties. In this respect, see L. MAURER – C. PORT – T. ROTH – J. WALKER, *A Brave New Post-BEPS World: New Double Tax Treaty Between Germany and Australia Implements BEPS Measures*, in *Intertax*, 2017.

[80] Again, it is interesting to highlight that very similar issues arise in the context of the EU: on the one hand, the problem of harmful tax competition within the market and, on the other hand, the compliance of the anti-tax avoidance tools set forth by the tax systems of the Member States with the EU principles and legislation.

[81] As defined in the Glossary of the OECD Study into the Role of Tax Intermediaries, 2008, aggressive tax planning refers to two areas of concern for

"upset" the market may result to be convenient for the country that allows them and cannot be effectively "punished" at international level.

The risk of the BEPS Action Plan, at least until every country has signed it, is that the lack of cooperation among the different jurisdictions could lead to the substantial inefficiency of the Project[82].

From a political perspective, the BEPS Project predominantly reflects a compromise between rich countries, as exemplified by the absence of measures to alter the existing balance of allocation of tax rights between residence and source countries, "though a lasting point of contention for developing countries"[83].

In addition, for what concerns the BEPS output in developing countries, it has been observed that, from the perspective of output legitimacy, the OECD and the G20 need to address this problem and

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revenue bodies: 1. Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences; 2. Taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. This definition suggests that the focus of the OECD's concern with regards to aggressive tax planning relates either to schemes or arrangements that achieve a result not foreseen by the legislators, or that rely upon an uncertain tax position. In this respect, see P. BAKER, *The BEPS Project: Disclosure of Aggressive Tax Planning Schemes*, in *Intertax*, 2015.

[82] In this respect, see A.P. DOURADO, *The Base Erosion and Profit Shifting (BEPS) Initiative under Analysis*, in *Intertax*, 2015. The Author stresses the necessity to involve also developing countries in the process of adoption of up to date and effective anti-tax avoidance tools. However, it has been observed that "international organisations and tax scholars have concerns regarding whether all BEPS Actions are relevant for developing countries, and on the feasibility of implementing BEPS Actions in developing countries". In this respect, see I. BURGERS – I. MOSQUERA, *BEPS: A Fair Slice for Developing Countries*, in *Erasmus Law Review*, 2017.

[83] M. FLORIS DE WILDE, *Taxing Multinationals Post-BEPS – What's Next?*, in *Erasmus Law Review*, 2017. It has also been stressed that "the evolution of the International Tax Regime shows a trend moving away from a system designed to protect the private interests (MNEs) and, indirectly, tax collection in the developed (OECD) world towards a model concerned with the protection of both private (avoidance of double taxation) and public (avoidance of double non-taxation) interests based on a steady movement, […] to prioritizing source taxation, which one could claim to be also the correct decision from a normative perspective". In this respect, see J.M. DE MELO RIGONI, *The International Tax Regime in the Twenty-First Century: The Emergence of a Third Stage*, in *Intertax*, 2017.

to provide solutions to the concerns these countries have raised in the implementation of the BEPS inclusive framework. Despite the response of international organizations[84] in the development of toolkits and pilot projects, it has been highlighted that "these solutions are insufficient for developing countries given the different concerns among regions"[85].

If we look at the BEPS Project from a critical point of view, we can surely appreciate the effort and the intention of the OECD to tackle the various shapes aggressive tax planning can take.

However, the Project identifies an objective without establishing new principles or new rules: what the BEPS Action Plan has mainly done is to strengthen the old principles, hoping this could be enough to stop certain harmful practices. In fact, the traditional purpose of international tax is the eradication of double taxation[86], rather than tackling episodes of double non-taxation. Insisting on those principles that have been conceived to defeat double taxation might not be the best solution in the fight against tax avoidance.

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[84] See OECD, Regional Meetings of the Inclusive Framework on BEPS, www.oecd.org/tax/beps/beps-regional-meetings.htm. An example of priorities of the developing countries is the possibility to attract investments by way of tax incentives. In this respect, see OECD, Regional Meeting of the Inclusive Framework on BEPS for Latin America & the Caribbean, Montevideo, Uruguay 21-23 September 2016. Summary available at www.oecd.org/tax/beps/beps-regional-meeting-co-chairs-summary-Iac-september-2016-montevideo.pdf.

[85] I.J. MOSQUERA VALDERRAMA, *Output Legitimacy Deficits and the Inclusive Framework of the OECD/G20 Base Erosion and Profit Shifting Initiative*, in *Bulletin for International Taxation*, 2018.

[86] The idea behind this traditional purpose is commonly referred to as the "single tax principle". Pursuant to this principle, cross-border income should be taxed once at the rate determined by the benefits principle. In other terms, cross-border income should be taxed only once at the source-country rate for active income and at the residence-country rate for passive income. The single tax principle was the idea underlying the adoption of the foreign tax credit by the United States in 1918. In this respect, see M.J. GRAETZ – M.M. O' HEAR, *The "Original Intent" of U.S. International Taxation*, in *Duke Law Journal*, 1997; J.S. EUSTICE – T. BRANTLEY, *Federal Income Taxation of Corporation and Shareholders*, 2014; R.S. AVI-YONAH, *Who Invented the Single Tax Principle?: An Essay on the History of US Treaty Policy*, in *New York Law School Law Review*, 2015; T.S. ADAMS, *Interstate and International Double Taxation*, in *Lectures on Taxation*, Roswell Magill ed., 1932.

It has been claimed that the patch-up work regarding old and new principles has produced contradictory and uncertain rules, rather than resulting in a more evolved and up to date framework[87].

The essence of this pathway chosen by the BEPS Action Plan appears clear if we consider that all the new rules of the BEPS package are still built on the notional principle of independent entity[88].

By its nature, the arm's length principle ultimately derives from the root of independent theory. In addition, many other flawed rules including weak CFC rules are also indirectly but closely linked to the independent entity principle.

In this respect, two consequences appear very likely: first, that it is hard to adopt and implement all the new rules; second, that even if the BEPS Project is implemented as outlined and conceived by the OECD, it is still possible for the creation of either new BEPS opportunities on the part of MNEs, or arbitrariness on the part of tax authorities.

In addition, the BEPS Action Plan is, *per se*, a soft-law tool, and this is evident not only if we consider the case where the Plan encourages the countries to adopt new laws or new approaches, but mainly when it does not prescribe law changes. Due to lack of agreement among all the participants, a number of reports simply take the form of analyses or recitation of best practices[89]. In this respect, however, it is

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[87] R.S. AVI-YONAH – H. XU, *Evaluating BEPS*, in *Erasmus Law Review*, 2017. See also The BEPS Monitoring Group (MBG), *Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project*, https://bepsmonitoringgroup.wordpress.com.

[88] See BEPS Action Plan 8-10.

[89] In this respect, see M. HERZFELD, *The Case against BEPS: Lessons for Tax Coordination*, in *Florida Tax Review*, 2017. In this respect, the Author mentions Action 1 on digital economy, which outlines a series of options countries could take to ensure better taxation on profits from digital transactions, or the report on controlled foreign companies (Action 3), that merely provides guidelines based on what different countries are doing as best practices.

necessary to remember the Multilateral Convention, which will be dealt with in the last section of this Chapter.

Considering the topic of this thesis and the necessity to analyse the initiatives against aggressive tax planning involving the exploitation of I.P. rights, this Chapter will focus on the BEPS Action Plans that appear to be most relevant.

In this respect, only Action 3 ("Designing Effective Controlled Foreign Company Rules"), Action 6 ("Preventing the Granting of Treaty Benefits in Inappropriate Circumstances") and Action 8-10 ("Aligning Transfer Pricing Outcomes with Value Creation", with a specific focus on Hard-to-Value-Intangibles) will be dealt with. Action 1 ("Addressing the Tax Challenges of the Digital Economy") will also be examined, since the (mis)use of digital platforms could lead to tax avoidance too. However, in the context of digital economy, the analysis will be expanded also to the EU Directive Proposals COM (147) and (148) 2018.

3.1. The BEPS Action 3 "Designing Effective Controlled Foreign Company Rules"

Controlled Foreign Company Rules[90] represent an exception in the above-described principle of single taxation and allow a State to tax profits gained by a company, resident in another State, if controlled by a company set up in the first State and if certain conditions are fulfilled. CFC rules are commonly regarded as an anti-avoidance tool,

[90] CFC rules heavily rely on U.S. international tax concepts that date back to the Subpart F provisions enacted in 1962 during the Kennedy Administration. Much of the relevant tax literature of that period addressed Treasury's objective of extending the international long arm of the IRS across the world stage, the complexity of Subpart F provisions, and the almost universal revulsion of foreign governments and their taxpayers to the U.S. rules. See, in this respect, S. SURREY, *Changes in U.S. Taxation of Business Abroad: The Possible Alternatives*, in *Journal of Taxation*, 1970; A. SICULAR, *The New Look-Through Rules: W(h)ither Subpart F*, in *Tax Notes Special Report*, 2007.

because they extend the power of a jurisdiction to impose taxes way beyond its boundaries and the common limits, and this extension is justified by the necessity to prevent abusive constructions.

In other words, CFC provisions generally serve as an anti-deferral regime to preclude taxpayers from shifting operating income to tax havens.

They act as a deterrent, as they are not primarily designed to raise tax on the income of the CFC but, rather, they are designed to protect revenue by ensuring profits remain within the tax base of the parent or, in the case of CFC regimes that also target the stripping of third countries' bases ("foreign-to-foreign stripping"), typically by preventing taxpayers from shifting income into CFCs.

In other terms, CFC regimes intend to eliminate the advantages of base stripping payments made to controlled, often low-taxed, foreign subsidiaries and they can be seen as ensuring taxation not only at the second tier (i.e. controlling shareholder), but indirectly also to ensure a minimum level of taxation of income generated at the first tier (i.e. at the level of the CFC)[91].

Considering the exceptionality of CFC rules in the tax systems, in order for the anti-avoidance measure to be triggered, the controlled company must fulfil requirements that usually regard: 1. the activity carried out by such company, or better yet, the type of income it mainly gains (*e.g.* passive income deriving from royalties, dividends, interests); and, 2. the (effective or nominal) tax rate applied by the State where the controlled company is resident for tax purposes,

[91] In this respect, see D.W. BLUM, *Controlled Foreign Companies: Selected Policy Issues – or the Missing Elements of BEPS Action 3 and the Anti-Tax Avoidance Directive*, in *Intertax*, 2018. The Author refers to the nature of CFC income as a Janus-faced, considering the above-mentioned functions, and interestingly points out that the scope of a CFC regime is extended to the indirect protection of the shareholders of the parent company. In fact, the corporate-level tax stands as an anticipation of the shareholder-level tax.

which usually must be lower than a certain amount (*e.g.* the effective tax rate of the State where the controlled company is set is 50% lower than the one applied in the State where the controlling company is resident for tax purposes).

According to the OECD, CFC provisions may interact with transfer pricing rules, which, as it was clarified before (see *supra* § 2.2), are intended to adjust the taxable profits of associated enterprises to eliminate distortions arising whenever the prices or other conditions of transactions between those enterprises differ from what they would have been, had the enterprises been unrelated. CFC regulations are, in fact, often referred to as a backstop/complementary instrument[92].

Because CFC rules address – by definition – related parties, jurisdictions often use these provisions to combat the adjusted prices charged between related parties.

Although CFC rules are not able to restore the arm's length pricing of transactions in all cases, the OECD considers that by applying the high tax rate to the low-taxed profits, "CFC rules eliminate the incentives of an MNE group to transfer profit to a tax haven or a low-tax jurisdiction"[93].

In addition, the combination of CFC rules and transfer pricing allows the parent jurisdiction to capture income earned by a foreign subsidiary that may not have been earned, had the original pricing of income-creating asset been set correctly.

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[92] In this respect, see M. MCINTYRE, *Australian Measures to Curb Tax Haven Abuses: A United States Perspective*, in *Australian Tax F.*, 1988; OECD, *The Deferral of Income Earned Through US Controlled Foreign Corporations: A Policy Study (Treasury Department Office of Tax Policy)*, 2000; HMRC, *Tackling Aggressive Tax Planning in the Global Economy: UK Priorities for the G20-OECD Project for Countering Base Erosion and Profit Shifting*, 2014; J. FLEMING – R. PERONI – S. SHAY, *Worse than Exemption*, in *Tax Law Review*, 2013; A.P. DOURADO, *The Role of CFC Rules in the BEPS Initiative and in the EU*, in *British Tax Review*, 2015.

[93] E. BURKADZE, *Interaction of Transfer Pricing Rules and CFC Provisions*, in *International Transfer Pricing*, 2016, p. 373.

In this perspective, each of the two regimes may serve as a remedy to the problems triggered either by transactions between related parties that require pricing adjustment or tax deferral (or other tax avoidance purposes) sought by a company.

It has been correctly observed that using price adjustments against tax deferral benefits is possible, but such adjustments will rather be general and keyed to the unrelated-party pricing benchmark, which has no conceptual connection to the constitutive norm for base determination.

On the other hand, if one uses CFC remedies to address pricing irregularities, this could give unexpected (and undesired) results, as it might put the related party structure in a different (and incomparable) position from the unrelated party structure[94].

While transfer pricing rules are more aimed at protecting the tax base of the source State, CFC regulations in most cases restore (or confer) the tax powers to the residence State (*id est*, the State of controlling entity).

In other terms, these two anti-avoidance tools (despite the opinion of certain commentators who do not regard the arm's length principle as an anti-avoidance measure) theoretically overlap, but they are complementary and not exclusionary, provided that they potentially lead to extraordinarily different results[95].

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[94] In this respect, see M. KANE, *Milking Versus Parking: Transfer Pricing and CFC Rules Under the Internal Revenue Code*, in *Tax Law Review*, 2013.

[95] It has been pointed out, that "TP regulations are able, to a significant extent, to replace CFC regulations when the latter regime is limited to protecting the tax base of the controlling State, both by eliminating the tax advantages of transferring to the CFC of assets generating passive income and by excluding the tax savings obtained through the CFC intermediaries, […] when important functions and economically significant risks are still being provided/incurred in the controlling person's State". In these cases, CFC regulations can be truly called as secondary measures compared to TP regulations. Conversely, when CFC regulations also cover both categories of income in relation to third countries, the TP regulations of the controlling State do not apply. In this respect, see F. MAJDOWSKI – K. BRONZEWSKA, *Revolutionary*

The Final Report on Action 3 highlights that CFC rules are not meant to protect only the base of the parent jurisdiction. Conversely, they might be used to "protect against both stripping of the parent jurisdiction's base and foreign-to-foreign stripping"[96].

CFC provisions have turned out to be an undisputed and effective anti-avoidance, albeit controversial, tool, which gives the tax administrations a powerful weapon against aggressive tax planning.

The OECD BEPS Action 3 aims to strengthen controlled foreign company rules and is based on six different blocks: 1. Rules for defining a CFC; 2. CFC exemptions and threshold requirements; 3. Definition of CFC income; 4. Rules for computing income; 5. Rules for attributing income; 6. Rules to prevent or eliminate double taxation.

The OECD warns that in designing CFC rules, a balance must be struck between taxing foreign income and the competitiveness concerns inherent in rules that tax the income of foreign subsidiaries.

Indeed, CFC rules may reduce the attractiveness of the tax jurisdiction of the parent company, especially if we consider that some countries (*e.g.* Switzerland[97]) do not have (or intend to introduce) any CFC legislation[98].

Changes to the Arm's Length Principle under the OECD BEPS Project: Have CFC Rules Become Redundant?, in *Intertax*, 2018.

[96] See *OECD BEPS Action 3 Final Report "Designing Effective Controlled Foreign Company Rules"*, 2015, p. 16.

[97] With reference to the effects of Action 3 on countries like Switzerland, see R. DANON – C. SCHELLING, *Switzerland in a Post-BEPS World*, in *Bulletin for International Taxation*, 2015. In this respect, the Authors highlight that "as a matter of principle, Switzerland agrees on the need to counter base erosion and profit shifting at a multilateral level and that the OECD is the best forum to address this issue. […] At the same time, however, Switzerland strongly believes that the BEPS Project should not interfere with national policy and that, in implementing its BEPS Action Plan, the OECD should take into consideration existing differences between the OECD member countries".

[98] Here is a criticality of the BEPS Action Plan. Despite the necessity to build up an internationally accepted framework of soft law, it is often the case that, due to the very nature of the amendments suggested, countries refuse to adopt or implement

In fact, when it comes to CFC rules, every country needs to find the right balance between protecting the domestic tax base and fostering the competitiveness of home-based multinationals[99]. This competitive disadvantage may turn into distortions, for example it may impact on where groups choose to locate their head office or increase the risk of inversion[100].

This is why a coordination among all the countries and the implementation of CFC rules, or similar anti-avoidance tools, would be essential for the effectiveness of this specific BEPS Action[101].

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the new rules or standard, this resulting in an evident fracture in the international tax context. The idea that no binding solutions can be proposed at international level, even in highly respected organizations such as the OECD gives a tangible evidence of how fragile and unstable the international community is when it comes to cooperation in the field of taxation. It is clear that flawless do not systems exist; however, it is equally clear that this lack of cooperation is the main reason why none of the solutions envisaged could really be effective in addressing BEPS o any other tax-related issue that requires efforts that go beyond soft law.

[99] In this respect, see P. JANSSENS – D. LEDURE – B. VANDEPITTE – J. LOOS, *The End of Intra-Group Financing…or Not Just Yet? – Part 2*, in *European Taxation*, 2015.

[100] A similar issue has been faced by the European Court of Justice when it had to deal with cases regarding the compatibility of anti-avoidance tools with the EU primary law and, more specifically, the freedom of establishment. In fact, the lack of harmonization in the field of direct taxation, which basically characterizes the EU, has given rise to different tax systems, each belonging to an EU Member State. The need to protect the internal market from threats or unjustified limits to the fundamental freedom has generated well-settled ECJ case law (which will be further examined in the next Chapter) on the topic. In few words, each Member State has substantially kept its tax sovereignty and the power to shape its tax system in the most convenient way. Provided that the stemming idea of the EU is the creation of a free market within its territory, generally speaking, the national provisions need to be compliant with the fundamental freedoms which guarantee and preserve the market. These freedoms do not prevent Member States from introducing tax rules that make their jurisdictions more attractive for investors or companies. The result of this situation is, in a nutshell, a sort of tax competition within the EU market. On the other hand, the introduction of anti-avoidance measures have often been regarded as in breach of EU Law, because they limited (or threatened to do so) the freedom of establishment (mainly) or other freedoms. In other terms, the introduction of anti-avoidance tools, which might be justifiable from the perspective of a tax system, might not be allowed or kept under control, depending on the circumstances, this resulting in a substantial competitive disadvantage for the country that adopts such tools.

[101] In this respect, see M.A. KANE, *The Role of Controlled Foreign Company Legislation in the OECD Base Erosion and Profit Shifting Project*, in *Bulletin for International Taxation*, 2014.

For what concerns the definition of CFCs, Action 3 recommends a broad definition, so as to include transparent entities and permanent establishments, if those entities earn income that raises BEPS concerns and those concerns are not addressed in another way.

Also, in the context of control[102], the OECD suggests that CFC rules apply a legal[103] and an economic[104] control test[105] so that satisfaction of either test results in control. Once the requirements for control have been established, it is necessary to understand how much control is enough for CFC rules to apply. Some existing rules find control when the parent company owns (directly or indirectly) exactly 50% of the foreign entity, but some others require more than 50% control. However, jurisdictions are free to lower their control threshold below 50% because owning 50% or less could still allow parent companies to exert influence in certain situations.

The second block focuses on exemptions and threshold requirements, which can be used to limit the scope of CFC rules by excluding entities that are likely to pose little or no risk of base erosion and profit shifting. In this respect, Action 3 recommends to include a tax

[102] According to some commentators, the OECD would be making an erroneous standard by relying on a control objective in determining CFC status. Instead, the OECD would be well-served by imposing a quantitative monetary test for the investment to determine CFC status. The purpose of the quantitative standard would be to preclude governments' de minimis claims. "We suggest that the OECD members determine the quantitative standard based on a shareholder's initial investment in the CFC and on its pro rata earnings pertaining to this company". In this respect, see R. FEINSHREIBER – M. KENT, *The BEPS Foreign Controlled Company Provisions Provide a Call to Action*, in *Corporate Business Taxation Monthly*, 2014.

[103] The legal control test usually looks at a resident's holding of share capital to determine the percentage of voting rights held in a subsidiary.

[104] The economic test focuses on rights to the profits, as well as capital and assets of a company in certain circumstances such as dissolution or liquidation.

[105] The *de facto* control test can look at similar factors to those considered by many countries when taking into account where a company is resident for tax purposes. For example, countries can look at who takes the top-level decisions regarding the affairs of the foreign company or who has the ability to direct or influence its day-to-day activities.

rate exemption that would allow companies that are subject to an effective tax rate that is sufficiently similar to the tax rate applied in the parent company jurisdiction not to be subject to CFC provisions.

More interestingly, the third block regards the definition of CFC income, which should ensure that income that raises BEPS concerns is attributed to controlling shareholders in the parent jurisdictions. The Action in object recognises the need for flexibility to ensure that jurisdictions can design CFC rules that are consistent with their domestic policy frameworks. As established by the OECD, jurisdictions are free to choose their rules for defining CFC income, including from among the measures set out in the explanation section below.

The OECD tries to identify the types of income that characterize CFC income and examines three different ways to classify those types of income: 1. The legal classification; 2. The relatedness of parties; and 3. The source of income.

The first way is the most straightforward and it is based on the legal definition of the types of income taken into consideration, which are: dividends; interest; insurance income; royalties and IP income; sales and services income. All these categories of income can be addressed as "passive income" and present potential risks of base erosion and profit shifting.

For what concerns the second way, the OECD points out that some jurisdictions focus on the party from whom income was earned rather than (or along with) the legal classification of the income. For instance, some jurisdictions apply a very broad related party test that includes both income from sales to a related party and income from a sale of a good originally purchased from a related party. The "related party rule" might be declined in various ways: for example, it could apply to income from goods that were developed in conjunction with a

related party (*e.g.* intellectual property that was developed with a related party or as part of a cost-sharing agreement with a related party).

Finally, the third way is based on the place where the income is earned, and it can take the form of either an anti-base stripping rule[106] or a source-country rule[107].

The Action at issue recommends rules for computing income and suggests such income should be computed on the basis of the parent jurisdiction's rules and some rules should be implemented to avoid loss compensation of a CFC with profits in the parent jurisdiction.

Action 3 contains also rules for attributing income[108] to the appropriate shareholders and rules to prevent or eliminate double taxation[109], which may arise in three different situations: 1. Situations in which the attributed CFC income is also subject to foreign corporate taxes; 2. Situations in which CFC rules in more than one jurisdiction apply to the same CFC income; and 3. Situations in which

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[106] Anti-base stripping rules treat income as CFC income if it is earned for sales to a related or unrelated party located in the parent jurisdiction or for services or investments located in the parent jurisdiction.

[107] A source-country rule excludes highly mobile income from CFC income if it was earned in the CFC jurisdiction.

[108] The income attribution process has five steps to determine: 1. Amount of income being attributed; 2. When the income should be included in taxpayer's tax returns; 4; Character of the income; 5. Applicable tax rate.

[109] The risk of economic double taxation arising from the application of CFC rules is evident if we consider that tax must be paid by the CFC's participants under CFC rules even though the income has not been received by them. The impact of economic double taxation may be seen as being even more severe and thus more harmful on international commerce than juridical double taxation stemming from actual flows of income. In this respect, see B. KUŹNIACKI, *The Need to Avoid Double Economic Taxation Triggered by CFC Rules under Tax Treaties, and the Way to Achieve It*, in *Intertax*, 2015. The Author believes the ultimate purpose of double tax treaties is not just to avoid (juridical) double taxation but, more importantly, to enhance international commerce. In this respect, see also B.J. ARNOLD – M.J. MCINTYRE, *International Tax Prime*, 2nd Ed., Kluwer Law International, 2002. With reference to the potential clash between CFC provisions and the double tax treaties based on the OECD Model Tax Convention, see J.M. HAISE, *The Conflict Between CFC Legislation and Double Tax Treaties: A New Zealand Perspective*, in *New Zealand Journal of Taxation Law and Policy*, 2008.

a CFC distributes dividends out of income that has already been attributed to the parent company under the latter's CFC rules or where such parent company disposes of the shares of a CFC.

Finally, the OECD recommendation for the first two cases basically consists in allowing a credit for foreign taxes actually paid (including CFC tax assessed on intermediate companies). Instead, for what concerns the third case scenario, the solution envisaged is to exempt dividends and gains on disposition of CFC shares from taxation if the income of the CFC has previously been subject to CFC taxation, but the precise treatment of such dividends and gains can be left to individual jurisdictions so that provisions are coherent with domestic law.

3.2 The BEPS Action 6 "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances"

If the BEPS Action 3 regards the implementation of new CFC rules and aims at tailoring broadly accepted standards for the OECD Member States, Action 6 has a less specific, but, in the opinion of the writer, more important scope, since it deals with the obnoxious practice of treaty shopping and other treaty abuse strategies.

As a preliminary statement, it is necessary to focus on the fact that in a globalized world, competition among the tax regimes of the different countries is aimed at encouraging inbound investments for the purpose of growth and trade. It is no surprise that taxpayers tend to tailor their investments taking into consideration the tax benefits offered by certain (low) tax jurisdictions.

The artificial avoidance of taxes that holding companies often pursue happens to be based on the exploitation of favourable tax provisions included in tax treaties. As it has been observed, "the main tax drivers

for the formation of holding companies are a wide range of treaty networks, favourable tax treaties, a participation exemption in respect of dividends and capital gains, no or reduced withholding tax on outbound payments, no controlled foreign corporation (CFC) rules, no thin capitalization regimes and no anti-haven legislation"[110].

The choice of a tax jurisdiction, then, does not only depend on the national tax provisions adopted by such jurisdiction, but also on the benefits included in the tax treaties signed by a given Member States.

The principal insight of the OECD BEPS project is to develop a more uniform and coordinated international tax regime. It seeks to align taxation with economic activity and ensure that taxable profits cannot be shifted. In this context, Action 6 identifies treaty abuse as a principal source of concern and offers model treaty provisions and recommendations for tax laws to prevent corporate taxpayers from accessing treaty benefits inappropriately.

In a way, Action 6 addresses the heart of all the base erosion and profit shifting sources.

Action 6 acknowledges the relevance of the problem of treaty abuse and observes that the Commentary on Article 1 of the OECD Model Tax Convention already includes a number of examples of provisions that could be used to address treaty-shopping situations[111]. In fact, in the 2003 version of the Commentary on Article 1, the OECD noted two fundamental issues involving tax treaties and anti-avoidance: whether treaty benefits must be granted when transactions constitute an abuse of the particular treaty and whether specific provisions or

[110] R. KARADKAR, *Action 6 of the OECD/G20 BEPS Initiative: The Effect of Holding Companies*, in *Bulletin for International Taxation*, 2017.

[111] The problem of treaty shopping is closely linked to the interposition of legal persons. In this respect, see P.A. HERNÀNDEZ GONZÀLEZ-BARREDA, *A Historical Analysis of the BEPS Action Plan: Old Acquaintances, New Friends and the Need for a New Approach*, in *Intertax*, 2018. See also H. AULT – W. SCHÖN – S. SHAY, *Base Erosion and Profit Shifting: A Roadmap for Reform*, in *Bulletin for International Taxation*, 2014.

jurisprudential rules of domestic law that are intended to prevent tax avoidance conflict with tax treaties[112]. Also, according to the Commentary, general anti-avoidance rules (GAARs) and judicial doctrines (substance-over-form, economic substance) are part of the basic rules for determining which facts give rise to a tax liability[113].

Despite this version of the Commentary was well received by certain scholars[114], it was not appreciated by other doctrine[115]. The fact that Action 6 moves from the 2003 Commentary and suggests some amendments could imply that even the OECD has realized that the 2003 revisions were not totally satisfactory[116].

Action 6 is divided into three different sections.

Section A preliminarily identifies two general categories of treaty abuse practices: 1. Cases where a person tries to circumvent limitations provided by the treaty itself; 2. Cases where a person tries to circumvent the provisions of domestic tax law using treaty benefits.

Section A, then, includes new treaty anti-abuse rules that provide safeguards against the abuse of treaty provisions and offer a certain degree of flexibility regarding how to do so.

Section B and Section C – which will not be further addressed in this thesis – respectively clarify that tax treaties are not meant to be used to generate double non-taxation and identify the tax policy

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[112] OECD Commentary on Article 1, §7.1, 2003-2014.

[113] OECD Commentary on Article 1, §9.2 and §22.1.

[114] In this respect, see J. SASSEVILLE, *A Tax Treaty Perspective: Special Issues, in Tax Treaties and Domestic Law* (ed. G. MAISTO), 2006.

[115] For instance, L. DE BROE, *International Tax Planning*, supra n. 20; B.J. ARNOLD – S. VAN WEEGHEL, *The Relationship between Tax Treaties and Domestic Anti-Abuse Measures, in Tax Treaties and Domestic Law* (ed. G. MAISTO), 2006; A.J. JIMÉNEZ, *The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries*, in *BIT*, 2004; B.J. ARNOLD, *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model*, in *BIT*, 2004.

[116] Even before the BEPS Action Plan, five countries (Belgium, Ireland, Luxembourg, the Netherlands and Switzerland) made observations on the Commentary on Article 1 of the OECD Model Tax Convention.

considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

With reference to the cases where a person tries to circumvent limitations provided by the treaty itself, the Action defines the arrangements through which a person who is not a resident of a Contracting State may attempt to obtain benefits that a treaty grants to a resident of that State as treaty shopping[117]. In other terms, a resident of a third State could attempt to access to benefits of a treaty between two other Contracting States.

According to Action 6, Section A, the new treaty anti-abuse rules that address treaty shopping[118] recommend different approaches: 1. A clear statement that the States that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax

[117] Treaty shopping enables taxpayers to gain access to treaty benefits in situations where the benefits were not intended. This undermines tax sovereignty and deprives States of tax revenue. Tax sovereignty refers to the ability of governments to raise revenue through taxation to support themselves, provide public goods, and protect their population from physical or economic harm. The ease in moving corporate assets (particularly intellectual property rights) and the malleability in the definition of legal home, combined with a few-tax friendly jurisdictions, makes it increasingly difficult for countries to unilaterally maintain the integrity of their corporate tax systems except in the case of purely domestic corporations. The LOB provision included in the Final BEPS Report addresses this problem specifically and introduces means through which treaty shopping and inappropriate tax avoidance can be prevented. In this respect, see T.H. LIPPERT, *OECD Base Erosion & Profit Shifting: Action Item 6*, in *J. International Law and Business*, 2017.

[118] Treaty shopping has been variously defined and it does not always have a negative connotation. It has been observed that "treaty shopping can be a legitimate form of tax planning used by taxpayers to minimize tax liabilities and may not be illegal per se […] The legitimacy of treaty shopping is a matter of debate between different States and their Courts". In this respect, see R. KARADKAR, *Action 6 of the OECD/G20 BEPS Initiative: The Effect on Holding Companies*, in *Bulletin for International Taxation*, 2017. Other Authors have defined this type of abuse as "a situation in which a person who is not entitled to the benefits of the tax treaty makes use of another (normally legal) person to obtain those treaty benefits that are not available to him directly", or as "a situation in which a person who is not entitled to the benefits of a tax treaty makes use – in the widest meaning of the word – of an individual or legal person in order to obtain those treaty benefits that are not available directly". See, respectively, L. DE BROE, *International Tax Planning*, supra n. 20; S. VAN WEEGHEL, *The Improper Use of Tax Treaties: With Particular Reference to the Netherlands and the United States*, Kluwer Law International, 1988.

avoidance (which is, however, specifically addressed in Section B); 2. The limitation-on-benefits (LOB) rule, that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model Tax Convention; 3. In order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule, a more general anti-abuse rule based on the principal purposes of transaction or arrangements (the principal purpose test or PPT rule[119]) is included in the OECD Model Tax Convention.

The Action also focuses on the combination of the LOB and the PPT rules and points out that "the LOB rule is useful as a specific anti-abuse rule aimed at treaty shopping situations that can be identified on the basis of criteria based on the legal nature, ownership in, and general activities of, certain entities"[120].

A limitation on benefits rule – the inclusion of which is the first measure the Action at issue recommends – is a provision already existing in many US tax treaties[121], which limits the entitlement to treaty benefits if the person applying the treaty does not have sufficient presence in the Contracting State in which it is a tax resident. The scope of presence is determined on the basis of various

[119] Under the PPT rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

[120] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Action 6, Final Report, Section A, §20, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015. The OECD warns that the LOB rule only focuses on treaty shopping and does not address other forms of treaty abuses, nor does it address every type of treaty shopping. In addition, a combination of a LOB rule and a PPT rule may not be appropriate or necessary for all countries.

[121] For example, see Article 26 the Netherlands-United States Income Tax Treaty (1992) and Article 24 of the Luxembourg-United States Income and Capital Tax Treaty (1996).

factors, such as nature, activities, ownership, listing of its shares on a recognized stock exchange.

Generally, LOB provisions increase the requirements to be entitled to treaty benefits and, consequently limit the number of eligible beneficiaries to a group of "qualified persons" that fulfil certain requirements[122]. In order to be entitled to treaty benefits, an entity must be considered a person within the meaning of Article 3 of the OECD Model Tax Convention (MTC), be resident pursuant to Article 4 and a "qualified person", as established by Article X (now Article 29) of the OECD MTC, as introduced by Action 6.

For the definition of qualified person, it is necessary to make a difference between companies and other persons that are deemed to have a natural connection with the treaty partner State such as individuals, the Contracting State or a person owned by the State, a non-profit organization and pension funds if more than 50% of the beneficial interest is owned by individuals in either Contracting State.

For what concerns companies, they can be considered "qualifying persons" in two cases, either where: 1. The company's principal class of shares is regularly traded on a recognized stock exchange throughout the relevant taxable period ("publicly traded company") or the company is at least 50% owned directly or indirectly by such a publicly traded company ("publicly traded test"); or, 2. The company is, on at least half of the days of the taxable period, at least 50% owned directly or indirectly by a publicly traded company or persons – such as individuals; Contracting State or person owned by the State; non-profit organization; pension funds) – and less than 50% of the company's gross income is paid or has accrued to persons other than

[122] See D. BLUM – E. PINETZ, *LOBs and Investment Funds, in Base Erosion and Profit Shifting (BEPS): The Proposals to Revise the OECD Model Convention* (ed. M. LANG et al.), 2016.

publicly traded companies or the persons enlisted above ("ownership/base erosion test")[123].

As it was previously mentioned, the LOB is not the only strategy proposed by the OECD to counter episodes of treaty shopping. The PPT rule is a more general anti-abuse clause, included in Paragraph 7 of the brand-new Article X (now Article 29, paragraph 9 of the OECD Model Tax Convention). It might be defined as a GAAR, which applies in all the circumstances where a specific anti-avoidance rule (SAAR) does not apply. As set forth in Paragraph 7, "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".

As broad as the content of Paragraph 7 can be, it sums up the essential concept of anti-abuse. The mechanics of the PPT are similar to those for domestic GAARs and, therefore, catch the situations that meet the conditions established by Article 29, paragraph 7. In fact, every type of abuse dealt with in Action 6 and in any other BEPS Action is based on the same element: the undue benefits the taxpayer would like to

[123] For a detailed analysis of the tests, see P. JANSSENS – J. LOS – B. VANDEPITTE – D. LEDURE, *The End of Intra-Group Financing…or Not Just Yet? – Part 1*, in *European Taxation*, 2015. For a deeper knowledge on the effects of Action 6 on developing countries, see also L. WAGENAAR, *The Effect of the OECD Base Erosion and Profit Shifting Action Plan on Developing Countries*, in *Bulletin for International Taxation*, 2015. The Commentary on Article X included in the Final Report of BEPS Action 6 contains a more detailed version of the cases where a limitation-on-benefits rule apply.

gain through a certain transaction or arrangement. The PPT rule[124], as enshrined in Paragraph 7 of Article X, does not look too far from the concept of wholly artificial arrangement developed by the European Court of Justice in its case law, at least at first sight [125].

The very existence of a PPT rule in Action 6 represents a compromise between the insistence on an LOB provision and the concern that this model, shaped on the U.S. system, is too complicated.

As it was expected, the decision to introduce the PPT rule generated a variety of controversies and concerns. In fact, the U.S. feared that the combination of the LOB provision with the PPT[126] would "cause uncertainty, discourage cross-border investment, undermine the purpose of tax treaties, and reverse much of the work that the OECD has done to reduce trade barriers"[127]. This reaction coming from US commentators might be caused by the fact that the "LOB clause is typical for U.S.-style legislation, which adopts a rule-based approach"[128]. In addition, it has been pointed out that the advantages of a clear set of objectives, mechanical tests like those offered under a U.S.-style LOB provision would be completely undone by a main purpose clause.

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[124] It is necessary to anticipate that the EU has included its version of the PPT rule in the Anti-Tax Avoidance Directive 1.

[125] See, for example, Case C-164/96 Imperial Chemical Industries (ICI v. Kenneth Hall Colmer; Case C-234/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt; Case C-446/03 Marks & Spencer plc v. Halsey (Her Majesty's Inspector of Taxes). The ECJ case law in the field of direct taxation and anti-avoidance measures will be more deeply analysed in the following Chapter. The concept of wholly artificial arrangement, however, is not as strict as the one tailored by the OECD.

[126] For a deeper analysis of the interaction between LOB and PPT rules, see E. KOKOLIA – E. CHATZIIOAKEIMIDOU, *BEPS Impact on EU Law: Hybrid Payments and Abusive Tax Behaviour*, in *European Taxation*, 2015.

[127] K.A. PARILLO, *U.S. Views on Treaty LOB and Main Purpose Test Draw Scepticism*, in *Tax Notes*, 2014.

[128] In this respect, see F. DEBELVA – D. SCORNOS – J. VAN DEN BERGHEN – P. VAN BRABAND, *LOB Clauses and EU-Law Compatibility: A Debate Revived by BEPS?*, in *EC Tax Review*, 2015. The Authors point out that the contiguous introduction of a PPT rule and an LOB clause demonstrates that the provision was probably the result of diverging views of the drafters.

For what concerns the effectiveness of LOB rules within the EU, and the introduction of such clauses in the tax systems of the Member States, it is interesting to highlight that, according to the aforementioned ECJ case law, the loss of revenue is not, *per se*, allowed as a justification to restrict fundamental freedoms. This topic will be deepened in the following Chapter, but it is worth mentioning that the very existence of a super-national organization such as the EU, with its own set of values and rules, could be – as strange as it may seem! – an obstacle in the pursue of tax harmonization in the international framework[129].

If we go back to the analysis of the PPT rule and to paragraph 7 of Article X, it is possible to see two tests in order to determine whether the benefit of the treaty should be granted in a specific case: a subjective test – which answer to the question as to whether obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit – and an objective test (i.e. was the granting of the benefit in accordance with the object and purpose of the relevant treaty provision?).

[129] In the view of the writer, the paradox of the EU is that one of its purposes is the harmonization of the internal market (despite it does not have an immediate competence in the field of direct taxation) but its primary law principles (i.e. the fundamental freedoms) might create a loophole at international level, since they do not always allow the application of anti-avoidance measures, and be an obstacle in creating that level playing field at international level, sought for by the OECD. Preventing the EU Member States from applying their anti-avoidance measures would, in the one hand, protect the internal market from unacceptable breaches of its founding principles but, on the other hand, result in the failure of the OECD BEPS Action Plan, since taxpayers that wish to gain undue tax benefits could use the EU as a tool to unhinge the international anti-avoidance system that is being set up. The only solution to this crumbling and unpromising scenario is the correct implementation of the ATAD 1, which will be discussed in the following Chapter. With reference to the compatibility of the BEPS Action 6 and EU Law, see D. DE WOLF, *BEPS Case Study: Treaty Abuse*, in *International Tax Journal*, 2017. In this respect, see also 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.

Commentators have been debating on the term "benefit": some of them claim it refers to the taxation of one Contracting State, while others believe it refers to the overall tax burden in both Contracting States combined[130]. The benefit to which the PPT rule refers must be provided "under this Convention".

In this respect, commentators have pointed out that the PPT may not be used to deny a benefit stemming exclusively from domestic law or another tax treaty. Similarly, a lower domestic corporate income tax in the residence State is not a covered benefit for the purpose of the PPT rule.

For what concerns the subjective test, the wording in paragraph 7 is extremely important, because the taxpayer can enjoy the benefit they aim to gain only if "*it is reasonable to conclude*" that such benefit is not one of the principal purposes of any arrangement or transaction.

Such a vague phrase is used so that a taxpayer cannot avoid application of the PPT by "merely asserting that the arrangement of transaction was not undertaken or arranged to obtain the benefits of the Convention"[131]. It must be pointed out that it is very hard to prove a taxpayer's intentions, even if all circumstances and relevant facts of the specific case are taken into account. Objective facts may give only indications as to the "motives behind certain behaviour but proving a

[130] L. DE BROE, *Tax Treaty and EU Law aspects of the LOB and PPT provision proposed by BEPS action 6*, in *Institute for Tax Law*, Kluwer/Schulthess, 2017. It has also been said that the "term benefit exclusively covers the reduction of domestic taxation that the State applying the tax treaty must accept under the applicable distributive rule". In this respect, see R.J. DANON, *Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups*, in *Bulletin for International Taxation*, 2018.

[131] R. KOK, *The Principal Purpose Test in Tax Treaties under BEPS 6*, in *Intertax*, 2016. The Author considers Article X, paragraph 7 as the codification of the concept of "fraus conventionis".

certain motivation or that a certain motivation did not exist is hardly possible" [132].

In addition, the OECD refers to the "principle purpose", not to the "sole purpose", making it relatively easy for the tax authorities to establish that the subjective test is met.

However, in certain circumstances it is hard to determine which purpose prevails over another one and, thus, if the substantive condition is met or not, this resulting in an uncertain application of the PPT rule[133].

In fact, the taxpayer could not prevent the application of the PPT by arguing that its arrangement or transaction was inspired by significant or principal tax benefits arising from another legal basis or, more importantly, by significant or principal non-tax motives[134].

Conversely, it has been stated that the problem of the subjective test is not that it is impossible to prove an intention as far as this intention might be always deducted on the basis of external facts. The real problem is that "subjective purposes, intentions or motives are, or at least should be, totally alien to material tax consequences"[135].

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[132] E. PINETZ, *Final Report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse*, in *Bulletin for International Taxation*, 2016.

[133] The application of the PPT rule might be quite controversial in certain circumstances, especially when other purposes, as important as the tax purpose, are involved in the decision-making process of the taxpayer. The 2017 updated OECD Commentaries state that if, for any reason, a person sells a property but, before the sale, becomes a resident of one of the Contracting States, and one of the principal purposes for doing so is to obtain a benefit under a tax treaty, the PPT rule could apply notwithstanding the fact that there may also be other principal purposes for changing the residence, such as facilitating the sale of property or the reinvestment of the proceeds of the alienation. In this respect, see Action 6 Final Report, at 58 and OECD Model: Commentary on Article 29, §180, 2017.

[134] In this respect, see L. DE BROE – J. LUTS, *BEPS Action 6: Tax Treaty Abuse*, in *Intertax*, 2015. See also M. LANG, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, in *Tax Notes*, 2014.

[135] In this respect, see A.B. MORENO, *GAARs and Treaties: From the Guiding Principle to the Principal Purpose Test. What Have We Gained from BEPS Action 6?*, in *Intertax*, 2017. As correctly pointed out by some commentators (see L. DE BROE, *International Tax Planning*, supra n. 20) it is conceptually intolerable to deny

In any case, whether it is possible or not for the taxpayer to prove their intention in carrying out certain transactions or arrangements, the interpretation of the PPT rule leads to an inevitably strict result and, in the opinion of the writer, a breach of his rights[136].

In fact, as reported by note 131 of this Chapter, the taxpayer may have other relevant motives, apart from the tax benefits, that convince him to choose to carry out certain transactions or arrangements. Leaving aside the economically irrelevant, albeit intimate, personal motives, other reasons may justify the behaviour of the taxpayer, but it is clearly impossible to demonstrate which reason prevails. If we were to accept the extremely narrow perspective of the OECD, only those arrangements where the tax benefit has little or no impact on the decisions of the taxpayer can be accepted. But here is the nonsense: the application of the PPT rule prevents the taxpayer from taking advantage of the tax benefit.

However, if a certain transaction or arrangement is found to be not in breach with the PPT rule, the taxpayer, whose aim was not to get the benefit, would be entitled to receive it.

Apart from this contradictory case, the range of the PPT rule is too wide, and, considering the burden of proof on the taxpayer, it is likely to be applied also on transactions and arrangements that do have a real economic scope and content, but also pursue a tax-related objective.

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treaty benefits to a taxpayer for the mere reason that obtaining such benefits is one of the principal reasons, if the taxpayer is able to prove they have other economic reasons that appear as relevant.

[136] The soft law essence of the BEPS Action Plan is evident also in Action 6. In fact, if a country is not able to accept the PPT rule as suggested, in order to effectively address treaty shopping the country may need to adopt domestic general anti-avoidance rules so as to allow third-country residents to take advantage of treaties. In this respect, see Action 6 Final Report, Section A, p. 64 §15. See also P. CARMAN, *Comparison of the Proposed Changes to the OECD and US Model Conventions*, in *Derivatives & Financial Instruments*, 2015; S. MORRI – S. GUARINO, *The Principal Purpose Test and the Principle of Good Faith: Two Sides of the Same Coin?*, in *European Taxation*, 2018.

The concept of "wholly artificial arrangement" (*supra*, page 53) developed by the ECJ, then, appears much more balanced and, in the opinion of the writer, it better responds to the necessity to correctly assess if a transaction/arrangement leads to tax avoidance or not.

Luckily, the Report also provides States with an optional provision that can be included in tax treaties as paragraph 8 of Article X (Article 29, last paragraph of the OECD MTC). This additional provision provides a taxpayer, who has been denied a treaty benefit, with the possibility of filing a request with the tax authorities to receive that benefit, with the possibility of filing a request with the tax authorities to receive that benefit. In other words, tax authorities can allow a taxpayer to enjoy a tax treaty benefit.

Finally, it has been noted that, given the legal nature of such rule, its implementation might not be as flexible as the implementation of GAARs

In this respect, if domestic GAARs are required to be amended to widen their scope or to remedy "damage" brought about by the courts, the relevant domestic legislative procedures should be complied with. Conversely, with reference to the PPT rule, an additional layer of coordination and negotiations is required at an international level to implement the changes[137].

.3 The BEPS Actions 8-10 "Aligning Transfer Pricing Outcomes with Value Creation": the concept of Hard-to-Value-Intangibles (HTVI)

The BEPS Actions 8-10 have already been mentioned in this Chapter, since they amend the OECD TP Guidelines and deal with the CCAs. In this context, the Actions at issue will be examined with reference to

[137] In this respect, see V. KOLOSOV, *Guidance on the Application of the Principal Purpose Test in Tax Treaties*, in *Bulletin for International Taxation*, 2017.

the concept of Hard-to-Value-Intangibles (HTVI). This is due to the fact that the focus of the whole thesis is not the BEPS Action Plan itself but, rather, the analysis of how the international community is trying to respond to the problem of aggressive tax planning and, more broadly, tax avoidance, involving the exploitation of I.P.

In this respect, identifying certain types of intangibles plays a pivotal role. Even the acronym used by the OECD – HTVI – gives an idea of how "dark" this grey area is.

As observed by the OECD in BEPS Action 8, "a tax administration may find it difficult to establish or verify what developments or events might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, and the extent to which the occurrence of such developments or events, or the direction they take, might have been foresee or reasonably foreseeable at the time the transaction was entered into"[138].

In those situations involving the transfer of intangibles or of rights in intangibles *ex post* outcomes can provide a pointer to tax administrations about the arm's length nature of the *ex ante* pricing arrangement agreed upon by the associated enterprises, and the existence of uncertainties at the time of the transaction.

The problem is that any difference between the *ex ante* projections and the *ex post* results, which is not due to unforeseeable developments or events, may give an indication that the pricing arrangement agreed upon by the associated enterprises at the time the transaction was entered into may not have adequately taken into account the relevant developments or events that might have been expected to affect the value of the intangible and the pricing arrangements adopted.

[138] Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 Reports, OECD, 2015.

The uncertainties related to the pricing of the intangibles might be due to the fact that the intangibles at issue are "hard-to-value-intangibles".

This term covers, according to the OECD, intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, "(i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer"[139].

Action 8 also enlists of the characteristics transactions involving the transfer or the use of HTVI may exhibit.

These may include, for example the case where the intangible is only partially developed at the time of the transfer, or it is not expected to be exploited commercially until several years following the transaction, or even the case where the intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.

It has been claimed that many intangibles are likely to be classified as HTVI, especially as digitalization continues and value chains are changing more rapidly than ever before[140].

More simply, HTVIs are often created in early in the process of development for new commodities and may require significant

[139] Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 Reports, OECD, 2015, p. 110 §6.189.

[140] In this respect, see A. RIEDL – K. SCHWINGER, *How to Deal with Risks in the Context of Two-Sided IP Valuations after BEPS?*, in *International Transfer Pricing Journal*, 2018.

additional research and funding before the true value may be determined[141].

One of the problems with HTVIs is the lack of comparables, that makes it more challenging to determine their correct value and represents one of the aspects that define those intangibles. However, the implementation of Action 8 has not always taken into the due consideration the absence of comparables, or, better yet, has put the stress on different criteria, such as the uniqueness of the intangible or its value[142].

For the intangibles at issue, information asymmetry between taxpayer and tax administration may be acute and may increase the difficulties faced by tax administrations in verifying how and on which basis the pricing was determined. More specifically, the tax administration may find it hard to: perform a risk assessment for transfer pricing purposes; evaluate the reliability of the information on which pricing has been based; consider whether the intangible or rights in intangibles have been transferred under or over value compared with the arm's-length price[143].

In these cases, according to the OECD, the tax administrations can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements. In other words, tax administrations are given a new special tool to examine transfer prices set in relation to the transfer or the use of HTVIs.

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[141] In this respect, see G. PUN, *Base Erosion and Profit Shifting: How Corporations Use Transfer Pricing to Avoid Taxation*, in *Boston College International and Comparative Law Review*, 2017.

[142] In this respect, see J. HAGELIN – S. MUTO, *The OECD/G20 Base Erosion and Profit Shifting Initiative and the 2019 Tax Reform in Japan: Revisions to the Earnings Stripping Rules and the Introduction of Hard-to-Value Intangibles into Transfer Pricing*, in *Bulletin for International Taxation*, 2019.

[143] In this respect, see I. VERLINDEN – L. DE PRETER – A. KATZ – H. PENA – I. DYKES – J. VAN DE GUCHT – M. KARAYANNIS – P. SKEWES-COX – R. COLLIER – P. OLSON – S, VAN WEEGHEL – D. ERNICK – P. GREENFIELD, *OECD Guidance on Hard-to-Value-Intangibles*, in *Journal of International Taxation*, 2015.

The consideration of *ex post* evidence should be based on a determination that such evidence is necessary to be taken into account to assess the reliability of the information on which *ex ante* pricing has been based.

Where the administrations are able to confirm the reliability of the information on which *ex ante* pricing has been based, notwithstanding the approach described in this section, then adjustments based on *ex post* profit levels should not be made.

In evaluating the *ex ante* pricing arrangements, the tax administrations are entitled to use the *ex post* evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction.

In other terms, *ex post* evidence is to be used only in situations when the difference between *ex ante* projections and *ex post* outcomes is significant, and when such a difference is due to events that were foreseeable at the time of the transaction[144].

There are a few exceptions to this approach, which occur if either the of the following conditions are fulfilled: i) if the taxpayer provides 1. Details of the *ex ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price, and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and, 2. Reliable evidence that any significant difference between the financial projections and actual outcomes is due to: a. unforeseeable developments or events occurring after the determination of the price

[144] In this respect, see E. SPORKEN – P. VISSER, *Intangibles in a BEPS World and How the Netherlands Is Complying with OECD Rules*, in *International Pricing Journal*, 2016.

that could not have been anticipated by the associated enterprises at the time of the transaction; or b. the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction; ii) the transfer of the HTVI is covered by a bilateral or multilateral advance pricing arrangement in effect for the period in question between the countries of the transferee and the transferor; iii) any significant difference between the financial projections and actual outcomes mentioned in i)2 above does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction; iv) a commercialisation period of five years has passed following the year in which the HTVI first generated unrelated party revenues for the transferee and in which commercialisation period any significant difference between the financial projections and actual outcomes mentioned in i)2 above was not greater than 20% of the projections for that period.

Apart from the Section on HTVI included in Action 8 and copied and pasted in the TP Guidelines, in June 2018 the OECD released additional guidance on the HTVI approach[145], aimed at clarifying the use of *ex post* evidence from the perspective of tax administrations. The new guidance specifically contains principles that should underlie an application of the HTVI approach. Such principles include a "probability criterion to take into account regarding whether the information related to an outcome reasonably could or should have been known and considered by the taxpayer […], the use of different

[145] OECD Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value-Intangibles, Inclusive Framework on BEPS: Action 8, 2018. This additional guidance is also incorporated as an annex to Chapter VI of the OECD Guidelines.

price-setting mechanisms other than those agreed upon by the taxpayer"[146].

Also, the additional guidance provides two basic examples of how the HTVI approach may be applied by tax administrations: 1. A change in the anticipated timeline of the commercialization of a product and a following increased income over the life of a HTVI, although an otherwise correct original valuation was made; 2. The underestimation of the projected sales compared to the *ex post* outcome.

The HTVI approach is considered by the OECD to be compatible with the arm's length principle. It is partly motivated by not allowing the use of taking *ex post* results for tax assessment purposes without considering what could or should have been known by the taxpayer. However, it has been suggested that the HTVI is not compatible with such principle[147].

An application of the HTVI approach entails an apparent risk that beneficial outcomes that would normally occur between independent parties from time to time are interpreted in hindsight as evidence of the lack of an arm's length arrangement at the time of the transaction, although the business terms and price may have been at arm's length.

.4 Expanding the focus: profit shifting through digital economy. From BEPS Action 1 "Addressing the Tax Challenges of the Digital Economy" to EU Directive Proposals COM (2018) 147 and COM (2018) 148

The final BEPS Action that is going to be examined in this Chapter is Action 1, "Addressing the Tax Challenges of the Digital Economy",

[146] J. HAGELIN, *Ex Post Facto Considerations in Transfer Pricing of Hard-to-Value Intangibles: Practical and Methodical Issues with the HTVI Approach*, in *International Transfer Pricing Journal*, 2018.

[147] In this respect, see O. FEDUSIV, *Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?*, in *International Transfer Pricing Journal*, 2016.

which deals with aggressive tax planning based on the (mis)use of digital platforms[148].

For what concerns the previously mentioned (see *supra*, §3) horizontal approach of Action 1[149], it must be pointed out that such Action has had an influence in reshaping the concept of permanent establishment[150], based on the business models that have been developed to avoid the application of P.E. rules[151].

Action 1 encouraged the OECD Member States to rapidly follow its suggestions[152].

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[148] As it was pointed out by the Final Report of the BEPS Action Plan 1, in the field of VAT, p. 82, "under certain conditions opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to (i) remote digital supplies to exempt businesses and (ii) remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (MLE) that are engaged in exempt activities".

[149] In this respect, see P. SAINT-AMANS – R. RUSSO, *The BEPS Package: Promise Kept*, in *Bulletin for International Taxation*, 2016.

[150] In this respect see, among all, W. HELLERSTEIN, *Jurisdiction to Tax in the Digital Economy: Permanent Establishment and Other Establishments*, in *Bulletin for International Taxation*, 2014; O. SALVINI, *La strategia anti-BEPS nell'economia digitale: la revision del criterio di collegamento*, in *Rassegna Tributaria*, 2017. The OECD approach has been criticized by C.H. PANAYI, *International Tax Law Following the OECD/G20 Base Erosion and Profit Shifting Project*, in *Bulletin for International Taxation*, 2016. According to the Author: "[…] while obviously the recommendations should be read in the context of the other recommendations under the Action Plan, arguably, the undertone of these recommendations is one of slight indecisiveness and deference to the future. Effectively, the Final Report encourages countries to deal with digital base erosion and profit shifting challenges unilaterally with some very "soft" guidance, most of which is still forthcoming, from the OECD. This is likely to result in general uncertainty and inconsistency. A cursory review of the recommendations under the Final Report on Action 1 suggests that it has not adequately addressed the tax challenges arising from the digital economy".

[151] Before the BEPS Project, some business models were elaborated so as to avoid the application of the P.E. status. Such models were, for instance, the online retailer model, or the online advertiser model. For a deeper analysis of these business models, see M. OLBERT – C. SPENGEL, *International Taxation in the Digital Economy: Challenge Accepted?*, in *World Tax Journal*, 2017.

[152] The OECD underlines the necessity to establish reliable and certain criteria for the allocation of the income deriving from digital transactions. Also, the OECD identifies three lines of action the governments should follow: "**Nexus**: The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate. **Data**: The growth in sophistication of information

The initiative of the OECD has given a decisive impulse to the EU Commission and the other EU Institution to deal with the problems arising from digital economy and to issue a package of measures aimed at ruling a *Fair and Efficient Tax System in the European Union for the Digital Single Market*, which led to a first Communication of the Commission to the Parliament (21 September 2017)*[153]*. In its Communication, the EU Commission felt the urge for an action against aggressive tax planning through digital means[154] and it underlined which and how important the development of digital economy would be in the future[155].

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technologies has permitted companies in the digital economy to gather and use information across borders to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterise for tax purposes a person or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction, or some other way. **Characterisation**: The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing".

[153] On 21 September 2017, the Commission sent a Communication to the Parliament and the Council claiming the necessity to understand and provide solutions for the distortive effect that aggressive tax planning of certain MNEs in the context of digital economy might have in the common market. According to the Commission, "the Digital Single Market (DSM) is one of the 10 political priorities of the European Commission. The DSM strategy aims to open up digital opportunities for people and businesses in a market of over 500 million EU consumers. Completing the Digital Single Market could contribute to EUR 415 billion per year to Europe's economy, create jobs and transform our public services". This was followed by the conclusions adopted on October 19th, 2017 (European Council meeting – Conclusions EUCO 14/27).

[154] The Commission mirrors the content of the OECD Action 1 and feels the necessity to tax income in the place where it is gained. In this context, the recipient EU Institutions have given rise to two doubts: 1. Where to tax this income and how to protect the tax sovereignty of the States where the companies provide digital services, without having any physical presence; 2. What to tax and how to attribute profits in relation to new business models based on the exploitation of intangibles.

[155] As observed by the EU Commission: "The Digital Single Market (DSM) is one of the 10 political priorities of the European Commission. The DSM strategy aims to open up digital opportunities for people and businesses in a market of over 500 million EU consumers. Completing the Digital Single Market could contribute to EUR 415 billion per year to Europe's economy, create jobs and transform our public services".

The "package" of measures regarding the digital economy is completed by the EU Commission Directive Proposal, approved by the Council, regarding the application of VAT to e-commerce[156] and the Directive Proposal for the adoption of a Common Consolidated Corporate Tax Base (CCCTB), relaunched on 25 October 2016[157].

These pieces of legislation are meant to be the pillars of a new tax system that, as far as the Commission is concerned, should prevent, or contribute to considerably reduce, the level of tax avoidance within the internal market and, thus, could create a level playing field.

On 5 December 2017, the ECOFIN Council looked forward to appropriate Commission proposals by early 2018, taking into account relevant developments in the ongoing discussions at the OECD. Eventually, on 21 March 2018, the Commission published two proposals, which are supposed to introduce an interim solution[158] and a long-term solution[159], and two respective Communications, as well as an Impact Assessment Report.

Even though the EU Institutions pushed hard and encouraged the adoption of the required measures, they were aware of the difficulties

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[156] Proposal for a Council Directive COM (2016) 757. This proposal is part of a broader plan of reform of the VAT. On 7 April 2016, the Commission adopted a Plan of Action for the VAT that identified some immediate and urgent measures to adopt the European system on VAT to digital economy and to the needs of SMEs. In this respect, see the Communication of the EU Commission COM (2016) 148, that sums up the short-term and long-term objectives of this Plan. In this respect, see also B. WESTBERG, *Taxation of the Digital Economy – an EU Perspective*, in *European Taxation*, 2014. According to the Author "[…] if the European Union is to take a leadership role in respect of the digital economy, a broad range of VAT initiatives should be undertaken with haste. Legal certainty, however, must be observed, which necessitates a time-consuming process for the introduction of new or amended tax laws.

[157] Proposal for a Council Directive COM (2016) 683.

[158] Proposal for a Council Directive COM (2018) 148: Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services.

[159] Proposal for a Council Directive COM (2018) 147: Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence.

and that it was not possible to introduce effective fast and long-lasting tax tools in a short period of time[160]. Consequently, the strategy the EU has decided to carry on implies the introduction of an interim solution[161] (the digital services tax Directive Proposal), as part of a huge and far more complex plan (see *supra* the VAT Directive on e-commerce[162] and the CCCTB Proposal[163]).

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[160] Some commentators have underlined that, despite the action of the whole EU and of its Institutions could improve the cohesion and the harmonization of the internal market, this would essentially keep the international scenario unchanged. Consequently, a global approach would be recommended. According to M. F. DE WILDE, *Taxation of Multinational Enterprises in a Global Market: Moving to Corporate Tax 2.0?*, in *Bulletin for International Taxation*, 2016, p. 182, "the OECD/G20's package addresses the various issues through a series of specific action points; however, it leaves the existing international corporate taxation framework essentially intact. The same is basically true for the approaches currently being taken within an EU context (at least at present), given that the Commission has recognized the need for a long-term solution for the European Union in its proposals for the Common Consolidated Corporate Tax Base (CCCTB). Although the long-term EU solutions envisaged take matters a step further than the OECD(G20 has done, at least analytically , any EU-wide solution, regardless of its merits, will be subject to geographical limitations that would allow base erosion and profit shifting issues to continue to arise beyond the water's edge, i.e. in respect of economic activities beyond the European Union's outer geographical borders".

[161] Conversely, Action Plan 1 of the BEPS Project criticizes the adoption of interim solutions. The Final Report of Action Plan 1 states that "[…] none of the other three options analysed by the TFDE [(Tax Force on the Digital Economy)] were recommended at this stage. This is because, among other reasons, it is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy, that certain BEPS measures will mitigate some aspects of the broader tax challenges, and that consumption taxes will be levied effectively in the market country".

[162] The necessity to introduce specific provisions that address e-commerce in the field of VAT has been felt since 1997, when the Commission issued a Directive Proposal , that was then approve on 8 December 1999 (Directive 2000/31/EC). In this respect see, among all, L. HINNEKENS, *New Age International Taxation in the Digital Economy of Global Society*, in *Intertax*, 1997; G. MELIS, *Economia digitale e imposizione indiretta: problem di fondo e prospettive*, in *Diritto e Pratica Tributaria Internazionale*, 2016.

[163] It is not the first time that the EU tries to introduce a CCCTB. In fact, on 16 March 2011, the Commission issued a Directive Proposal. The main idea the CCCTB is grounded on is the need to create a tool to harmonize the internal market. The new version of the CCCTB, such as the previous one, might be considered as the "natural heir" of the Neumark Report (1962), or the Tempel Report (1970), or the Ruding Report (1992), which proposed to reach the harmonization of the common market. For more details on the Ruding Report, see, for example, K. NIGHTINGALE, *Taxation: Theory and Practice*, Harlow, Fourth Edition, 2002; H.J.I. PANAYI, *European Union Corporate Tax Law*, New York, 2013; J. MARTENS-

The above-mentioned Directive Proposal on the digital service tax (DST) is not the first solution elaborated by Commission[164] to tackle the tax issues arising from digital economy, as on 21 September 2017, it proposed three alternative measures: an equalisation levy on the turnover of digital companies, a withholding tax on digital transactions[165] and a levy on revenues generated from the provision of digital services or advertising activities. These measures were suggested by the OECD BEPS Action 1 in the first place[166].

WEINER, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU*, New York, 2006; R.H. FOLSOM – R.B. LAKE – V.P. NANDA, *European Union Law after Maastricht: A Practical Guide for Lawyers Outside the Common Market*, The Hague, 1996; M. LANG – J. SCHUCH – C. STARINGER, *Introduction to European Tax Law: Direct Taxation*, Third Edition, Wien, 2003. Before the CCCTB, alternative proposals had been suggested, such as the Home State Taxation (HST) or the EU Corporate Income Tax (EUCIT). In this respect, M. HELMINEN, *EU Tax Law – Direct Taxation*, 2017, Online IBFD Books.

[164] The Commission adopts a market-oriented approach towards the problem of taxation of digital economy, that is not the scope but the means to protect the EU internal market. The Commission, thus, affirms that "[…] the appropriate level of action is the EU. Only a coordinated EU approach will ensure that the solution is fit for the Digital Single Market and can deliver on [the] objective of fairness, competitiveness and sustainability". The objectives of the EU in building up the Digital Single Market are as follows: ensuring that profits are taxed where they are gained (fairness); creating a correct and well-structured tax system, that may allow start-ups to flourish in the EU (competitiveness); converging to a common solution to avoid unilateral measures (integrity of the single market); ensuring a long-term sustainable tax system for business enterprises (sustainability). However, it has been observed that the supranational action promoted by the EU Commission might be going beyond its competences. In this respect, see C. H.J.I. PANAYI, *The Compatibility of the OECD/G20 Base Erosion and Profit Shifting Proposal with EU Law*, in *Bulletin for International Taxation*, 2016. The Author points out that "[…] the European Union cannot interfere with how a Member State exercises its taxing rights with regard to other countries".

[165] In this respect see L.U. CAVELTI – C. JAAG – T.F. ROHNER, *Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD's Actions against Base Erosion and Profit Shifting*, in *World Tax Journal*, 2017.The Authors state that "the OECD argues that a new withholding tax would enable source countries to enforce income taxation, especially in situations where foreign corporations have no physical nexus to the country of source and where it is therefore difficult to enforce tax laws".

[166] Action 1 presents more risks and concerns than it could be expected at first sight. In fact, reaching a high degree of agreement among the OECD (and non-OECD) countries is not easy, provided that certain countries appear to be "running at a faster pace in the digital race" and to be more interested in attracting investors in this field rather than in the traditional "brick and mortar" economic sectors. Some countries

Even though the Commission has not reproduced all these solutions at EU level, it might be interesting to summarize the main aspects of such measures.

The equalisation levy (or equalisation tax) was meant to tax the turnover of digital companies, that is to say the gross revenue of those entrepreneurial (either B2B or B2C) activities carried out on the Internet[167].

The second solution initially suggested was the introduction of a withholding tax on digital transactions, that was supposed to be applied as a global withholding tax on all the payments made to non-resident subjects[168].

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could argue that there is a need to review the importance of intangibles and of digital goods or services when assessing the right to tax. Others, like India or China, are likely to argue that intangibles should not be perceived to receive as much remuneration for tax purposes as today since value is created at destination. In this respect, see K. ANDERSSON, *Should We Use Value Creation or Destination as a Basis for Taxing Digital Businesses? – Kristen Andersson's Comments on the 2018 Klaus Vogel Lecture Given by Professor Michael Devereux*, in *Bulletin for International Taxation*, 2018. The Author reports and comments that "[…] without a physical presence, it would, however, be hard to allocate taxation rights even if the risk-return assessment is changed. Any change of the rules is, therefore, more likely to affect traditional businesses and the large […] firms without a physical presence in the consumer countries would continue to be taxable […]".

[167] It is not the first tax of this kind, or the first time there is an attempt to tax an MNE that does not have a physical presence or a P.E. in a country. In this respect, it is worth mentioning the Diverted Profit Tax introduced by the UK Finance Act in 2015. See L. CERIONI, *The New "Google Tax": The "Beginning of the End" for Tax Residence as a Connecting Factor for Tax Jurisdiction?*, in *European Taxation*, 2015; D. ROXBURGH, *Finance Act 2015*, in *European Taxation*, 2015; O. POPA, *Taxation of the Digital Economy in Selected Countries – Early Echoes of BEPS and EU Initiatives*, in *European Taxation*, 2015. Also, an equalisation levy, such as the one envisaged by the OECD, had already been introduced in India. For more details on the Indian version of the equalisation tax, see S. BASAK, *Equalisation Levy: A New Perspective of E-commerce Taxation*, in *Intertax*, 2016; S. VARANASI– M. NAGAPPAN, *Financial Budget for 2016-2017: Has India put Its BEPS Foot Forward?*, in *Intertax*, 2016; M. K. SINGH, *Taxation of Digital Economy: And Indian Perspective*, in *Intertax*, 2016.

[168] This type of tax was encouraged by part of the commentators. More in details, Y. BRAUNER – P. PISTONE, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union, in Bulletin for International Taxation*, 2017, claimed that "the withholding tax solution would be a flexible, immediate solution to the most acute challenges of the digital economy. It is a solution that would avoid critical technical problems and would work in the

Finally, the third solution was a levy on revenues generated from the provision of digital services, that was conceived to take into consideration all the transactions carried out remotely in case the providing company were to have a significant economic presence in the country where the service is provided.

What the Commission ended up with is a Directive proposal, the scope of which is "to put forward a measure that targets the revenues stemming from the supply of certain digital services and that is easy to implement and helps to level the playing field in the interim period until a comprehensive solution is in place"[169] . This Directive Proposal appears to operate as a sort of "backup" in case the long-term solution cannot be applied[170].

The Commission points out that the introduction of the Digital Services Tax (DST) is in line with the general objectives of the proposal, whose aim is: to protect the integrity of the Single Market and to ensure its proper functioning; to make sure that the public finances within the Union are sustainable and that the national tax bases are not eroded; to ensure that social fairness is preserved and

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direction of better cooperation between states to arrive at collaborative solutions, even if, at present, such a solution has not yet presented itself. It could also become an implementation mechanism for a virtual PE solution, of one were to be agreed on by a sufficient number of the Member States". See also Y. BRAUNER – A. BAEZ, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenge of the Digital Economy*, in *IBFD White Paper*, 2015. The Authors claim the application of a withholding tax such as the one at issue would better address the problems deriving from digital taxation. In this respect, they point out that "[…] the difficulty of simply attributing profits to a non-physical PE and the opposition of the OECD to formulary taxation (which is, again, taken as a given, leaving its assessment to another occasion), may require a remedial tool, such as a withholding tax to adequately implement the nexus-based approach in the digital economy". Also, the Authors suggest the application of a 10% tax rate and different tax treatments depending on the nature of the subjects involved in the transactions, that is to say, if the withholding tax is applied to B2B or B2C transactions.

[169] Proposal for a Council Directive COM (2018) 148, p. 3.

[170] For a comprehensive analysis of the two Directive Proposals, see L. A. SHEPPARD, *Digital Permanent Establishment and Digital Equalization Taxes*, in *Bulletin for International Taxation*, 2018.

that there is a level playing field for all businesses operating in the Union and; to fight against aggressive tax planning and to close the gaps that currently exist in the international rules which makes it possible for some digital companies to escape taxation in countries where they operate and create value[171].

If, on the one hand, this competition-oriented approach can be appreciated, since it represents the essence of the activity of the Commission and, more broadly, of the EU in general, it might be claimed that the introduction of pieces of legislation that limit the legislative power of the Member States in tax matters could be beyond the competence of the EU, even though according to the Commission, the Directive proposal is based on Article 113 of the TFEU.

This provision enables the EU Institutions, with a special legislative procedure, to adopt provisions for the harmonisation of Member States' legislation concerning other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.

The Commission states that an action at EU level is needed in order to mitigate the fragmentation of the internal market and the creation of distortions of competition within the Union due to the adoption of divergent unilateral actions at national level.

After these preliminary remarks on the steps followed by the EU Institutions to adopt the piece of legislation at issue, it is possible do briefly examine the main provisions of the Directive Proposal.

[171] Again, it is worth noting that the EU Commission puts the stress on the competition issues deriving from nowadays digitalized economy and considered tax measures as tools to create a homogeneous and – as much as possible – harmonized market.

In a nutshell, the Digital Service Tax is going to levy on revenues from the supply of certain digital services, as defined and qualified by Article 3 of the proposed Directive[172].

Taxable revenues should be those resulting from the provision of the following services: (i) the placing on a digital interface of advertising targeted at users of that interface; (ii) the making of multi-sided digital interfaces which allow users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users (sometimes referred to as "intermediation" services); and (iii) the transmission of data collected about users and generated from such users' activities on digital interfaces.

Consequently, if no revenues are obtained from the supply of such services, there should be no DST liability.

Article 3, paragraph 3, specifies that point (i) shall apply whether or not the digital interface is owned by the entity responsible for placing the advertising on it and that where the entity placing the advertising does not own the digital interface, that entity, and not the owner of the interface, shall be considered to be providing a service falling within point (i), whereas paragraph 4 underlines that point (ii) shall not

[172] According to Article 3, "the services falling within the scope of DST are those where the participation of a user in a digital activity constitutes an essential input for the business carrying out that activity and which enable that business to obtain revenues therefrom. […] These services can be provided remotely, without the provider of the services necessarily being physically established in the jurisdiction where the users are and value is created. Therefore, such businesses models are responsible for the greatest difference between where profits are taxed and where value is created. However, what is subject to taxation are the revenues obtained from the monetisation of the user input, not the user participation in itself". User participation can contribute to the value of a business in various ways. For example, digital businesses can derive data about users' activities on digital interfaces, which is typically used to target advertising at such users, or which can be transmitted to third parties for consideration. Another way is through the active and sustained engagement of users in multi-sided digital interfaces, which build on network effects where, broadly speaking, the value of the service increases with the number of users using the interface.

include: a) the making available of a digital interface where the sole or main purpose of making the interface available is for the entity making it available to supply digital content to users or to supply communication services to users or to supply payment services to users; b) the supply by a trading venue or a systematic internaliser of some services referred to in Annex I to Directive 2014/65/EU; (c) the supply by regulated crowdfunding service provider of any of the services referred to in Annex I to Directive 2014/65/EU, or a service consisting in the facilitation of the granting of loans. Point (iii) shall not include the transmission of data by a trading venue, systematic internaliser or regulated crowdfunding service provider.

Article 4 establishes when a subject might be deemed a taxable person in the context of the DST and it sets forth the following conditions: (i) the total amount of worldwide revenues reported by the entity for the relevant financial year exceeds EUR 750.000.000; (ii) the total amount of taxable revenues obtained by the entity within the Union during the relevant financial year exceeds EUR 50.000.000.

Article 5 identifies the place of taxation by determining which proportion of the taxable revenues obtained by an entity has to be treated as obtained in a Member State for the purposes of this tax. In other words, it establishes that DST is due in the Member State or Member States where the users are located.

Paragraph 2 provides that "with respect to a taxable service: a user shall be deemed to be located in a Member State in a tax period if: (a) in the case of a service falling within Article 3(1)(a), the advertising in question appears on the user's device at a time when the device is being used in that Member State in that tax period to access a digital interface; (b) in the case of a service falling within Article 3(1)(b): (i) if the service involves a multi-sided digital interface that facilitates the provision of underlying supplies of goods or services directly between

users, the user uses a device in that Member State in that tax period to access the digital interface and concludes an underlying transaction on that interface in that tax period; (ii) if the service involves a multi-sided digital interface of a kind not covered by point (i), the user has an account for all or part of that tax period allowing the user to access the digital interface and that account was opened using a device in that Member State; (c) in the case of a service falling within Article 3(1)(c), data generated from the user having used a device in that Member State to access a digital interface, whether during that tax period or any previous one, is transmitted in that tax period.

The Directive Proposal appears somewhat vague about how revenue from an activity must be allocated. However, the press release of 21 March 2018 offered more clarity: in the case of taxable event A (*e.g.* advertising), it concerns revenue from the sale of online advertising space. In the event of taxable event B (*e.g.* making digital interface available), it concerns revenue from making the interface at issue available. In the case of taxable event C (*e.g.* data transmission), it concerns revenue from the sale of that data.

The tax base, then, consists in gross revenues from the aforementioned activities, net of VAT and other similar taxes.

Paragraph 3, then describes the ways the proportion of an entity's total taxable revenues that is treated under paragraph 1 as obtained in a Member State shall be determined. The DST tax rate shall be 3% (Article 8).

The DST is meant to take effect on 1 January 2020 and is expected to generate an estimated EUR 5 billion per annum for EU Member States.

The main concern regarding the introduction of the DST is the protection of the tax sovereignty of the other countries. In fact, it is indisputable that digital economy is based on intangible and virtual

value creation, but it is debatable if such value is created in the territory of the EU. This problem mainly regards the case of online advertising and the case of the making available a multi-sided interface. In fact, the last case, which concerns data transmission, has its core value in the creation of data and this data usually refers to the users, who are the nexus that allow the EU Member States to apply the DST[173].

And this is because data appears to be valuable insofar as it is processed and is in the hand of someone who can use this data.

Despite the need to intervene with strong and deeply impacting measures, it is a shared view that the Directive Proposals at issue are premature or, at least, do not give an effective response to the issues related to digital economy. Unilateral digital turnover taxes, in order to act quickly, are not the answer to address the impact of globalized business models on corporate tax systems[174].

The long-term solution issued by the Commission regards the concept of permanent establishment and, more in details, the definition of significant digital presence, as suggested by the OECD. Although Action 7 of the BEPS Action Plan provides some solutions to the avoidance of the status of permanent establishment[175], Action 1 deals

[173] In this respect, see F. VAN HORZEN – A. VAN ESDONK, *Proposed 3% Digital Services Tax*, in *International Transfer Pricing Journal*, 2018. For what concerns the identification of the users as taxing nexus, see R. PETRUZZI – V. KOUKOULIOTI, *The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment*, in *European Taxation*, 2018.

[174] In this respect, see the the *OECD Interim Report on Tax Challenges Arising from Digitalisation* (2015), which states that "there is no consensus on the need for, or merit of, interim measures, with a number of countries opposed to such measures on the basis that they will give rise to risks and adverse consequences".

[175] Action 7 of the BEPS Action Plan addresses several issues, such as: the artificial avoidance of PE status by the use of commissionaire arrangements; the abuse of the "independent agent" exception in Article 5(6) of the OECD Model and instances in which such an agent could be closes related to the principal; the artificial avoidance of PE status by way of the specific activity exception in Article 5(4); the related concern with regard to enterprises misusing the exceptions in Article 5(4) by

with the digital permanent establishment more specifically[176]. In this respect, the Commission adopted the suggestion of the OECD and issued a Directive which is going to redefine the concept of permanent establishment.

Essentially, the proposal, after having identified its scope (Article 2)[177] and having defined the various concepts for applying the provisions in the Directive (*e.g.* digital services, digital interface, revenues, entity, user and tax period) in Article 3, describes what significant digital presence in Article 4 and warns that it should be regarded as an addition to the existing permanent establishment

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fragmenting activities; and the abuse of the exception in Article 5(3) by splitting of contracts.

[176] Action 1 basically identifies the importance of the digital economy and sets out its features and typical business models. It also raises the question of redefining the nexus for taxation in the source state and suggests, as a solution, the introduction of the significant economic presence (SEP) nexus. See B. LARKING, *A Review of Comments on the Tax Challenges of the Digital Economy*, in *Bulletin for International Taxation*, 2018: "Allocation of profits to a SEP is the next tricky issue and the OECD considers both the possibility of adapting traditional profit allocation principles […] as well as alternative methods such as formulary (fractional) apportionment or deemed profit-based methods". The Author believes the SEP would not work, as problems would arise regarding both threshold and profit allocation. Other commentators put the stress on the threshold. See Y. BRAUNER- P. PISTONE, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union*: "[…] in order to avoid an excessive fragmentation of the taxable base, we envisage that the application of the virtual PE should take place along the lines of a de minimis threshold. This could operate with a similar function to that which a construction PE has in Article 5(3) of the OECD Model. With reference to an intervention on this topic at EU level, the Authors believe that "the introduction of a virtual PE concept into EU law would be a constructive step forward and an effective global action to bring international tax categories and concept back into line with the business models. It would also represent a friendly development in cooperation with the OECD, as it would essentially preserve the OECD PE standard and facilitate OECD action to realize a possible expansion of this solution at a later time. Finally, it would not prevent the European Union from applying this solution in a context of formulary apportionment, provided, of course, that the factors along which the formula applies were amended in a way that would take into account the different features of the new business models connected with the digital economy".

[177] Under this Directive, the scope of taxable services is considerably wider compared to the DST Directive. The rationale behind it is not very clear, since it is hard to draw a line between taxable and non-taxable services. In this respect, see M. NIEMINEN, *The Scope of the Commission's Digital Tax Proposals*, in *Bulletin for International Taxation*, 2018.

concept, and enlists the profits attributable to the significant digital presence in Article 5.

According to Article 4, a permanent establishment shall be deemed to exist if a significant digital presence through which a business is wholly or partially carried on exists.

Paragraph 3 provides that a SDP shall be considered to exist in a Member State in a tax period if the business carried on through it consists of digital services through a digital interface and one or more of the following conditions is met with respect to the supply of those services by the entity carrying on that business, taken together with the supply of any such services through a digital interface by each of that entity's associated enterprises in aggregate: (a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7.000.000; (b) the number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100.000; (c) the number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3.000. The provision establishes, thus, three different thresholds which allow to identify when a significant digital presence occurs and, consequently, if there is a (virtual) permanent establishment. Paragraph 4 underlines that a user shall be deemed to be located in a Member State in a tax period if the user uses a device in that Member State in that tax period to access the digital interface through which the digital services are supplied, while paragraph 7 establishes that the proportion of total revenues referred to in paragraph 3 (a) shall be determined in proportion to the number of times that devices are used in that tax period by users located anywhere in the world to access the digital interface through which the digital services are supplied.

Briefly, Article 5 states that the profits that are attributable to or in respect of a significant digital presence in a Member State shall be taxable within the corporate tax framework of that Member State only. While paragraph 2 identifies the type of profits attributable as those that the digital presence would have earned if it had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed, through a digital interface, paragraph 3 describes the way such profits are determined[178], and paragraph 5 enlists the economically significant activities.

This proposal is essentially based on the reshaping of the concept of P.E. and on giving relevance to the virtual presence or digital presence for those cases that involve the provision of virtual goods or services or through digital/virtual means.

In this respect, it has been noted that in today's world, "the notion of a fixed place of business hardly ever applies in the digital economy"[179]. This statement gives a clear idea of how urgent the introduction of some measures that deal with the digital economy is.

The problem of value creation[180] is felt also in respect to this Directive Proposal, because the profit attribution rules must be linked to the

[178] For the purposes of paragraph 2 the determination of profits attributable to or in respect of the significant digital presence shall be based on a functional analysis. In order to determine the functions of and attribute the economic ownership of assets and risks to, the significant digital presence, the economically significant activities performed by such presence through a digital interface shall be taken into account. For this purpose, activities undertaken by the enterprise through a digital interface related to data or users shall be considered economically significant activities of the significant digital presence which attribute risks and the economic ownership of assets to such presence.

[179] P. COLLIN – N. COLIN, *Task Force on taxation of the digital economy*. (Ministère de l'économie et des finance); P. HONGLER – P. PISTONE, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, *White Papers IBFD*, 2015.

[180] For what concerns the problem of value creation, se A.S. SAMARI, *Digital Economy and Profit Allocation: The Application of the Profit Split Method to the*

place where the taxed value is created. The BEPS Action 8.10 have not defined the concept of value creation, nor has the BEPS Action 1. However, the aforementioned OECD Interim Report, which is an update of the Action 1 Final Report, classifies the value creation process in the digital economy in three categories: 1. The value chain[181]; 2. The value network[182]; 3. The value shop[183].

The EU is of the opinion that the most ideal approach would be a global solution to the taxation of the digital economy. However, the EU "has also seen this proposal as an opportunity to create enthusiasm for the implementation of a common consolidated corporate tax base (CCCTB), in which the virtual PE proposal could be included"[184].

4. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. Effectiveness of the Convention: between soft law and *ius cogens*. The problem of unilateral approaches

Once the most relevant BEPS Actions have been described and analysed, it is possible to conclude this first Chapter with some observations regarding the Multilateral Convention to Implement Tax Treaty Related Measure to Prevent BEPS.

Value Created by a "Significant Digital Presence", in *International Transfer Pricing Journal*, 2019.

[181] This theory suggests that inputs are converted into outputs via interrelated, sequential activities. The key critique on the value chain is that it is not able to measure value creation for services-oriented enterprises, such as digital business models.

[182] It is useful for business models that rely on mediating technology, for instance multisided platforms. See, in this respect, A. HAGIU, *Strategic Decisions for Multisided Platforms*, in *MIT Sloan Management Review*, 2014; A. BAL, *United Kingdom/European Union – Managing EU VAT Risks for Platform Business Models*, in *Bulletin for International Taxation*, 2018.

[183] It does not depend on network relationships and operates in single-sided markets and generally makes use of an intensive technology to solve a specific customer problem of demand, for example medical technology used for purposes of diagnosis.

[184] W. NEUVEL – S. DE JONG – À. UCEDA, *Profit Attribution Challenges in a Digital Economy – A Transfer Pricing Analysis of the EU Virtual Permanent Establishment Concept*, in *International Transfer Pricing Journal*, 2018.

The Multilateral Convention (also known as Multilateral Instrument, MLI) represents an innovative measure the OECD has decided to adopt in order to give faster implementation to the amendments to the tax treaties set forth by the BEPS Action Plan. The idea of this new instrument the OECD has decided to experiment is to speed up the implementing procedure, since the Multilateral Convention allows a simultaneous introduction of some Actions.

For what matters in this context, the MLI automatically enriches the double tax treaties with provisions regarding treaty abuse, that is to say, Action 6 recommendations regarding the LOB and the PPT rule.

In a way, the experiment of the Multilateral Convention is an interesting answer to the increasingly pressing requests for a higher degree of international cooperation in the field of double taxation.

In fact, disagreement among nations about the extent of cooperation in tax matters is often deemed as surrender of sovereignty[185]. If, on the one hand, tax sovereignty is the most powerful tool a country has to shape its policies, on the other hand, the lack of cooperation has given rise to those phenomena the BEPS Action Plan has tried to tackle. Tax avoidance might be regarded as the product of different factors, which involve the lack of cooperation among countries that has resulted in harmful tax competition.

Paradoxically, it has been observed that giving up a certain amount of tax sovereignty could turn out to be the only choice countries might have to preserve a certain amount of sovereignty as a whole[186].

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[185] In this respect, see Y. BRAUNER, *McBEPS: The MLI – The First Multilateral Tax Treaty that Has Never Been*, in *Intertax*, 2018. See also S.A. ROCHA – A. CHRISTIANS (edited by), *Tax Sovereignty in the BEPS Era*, ed. Wolter Kluwers, 2017. The Authors focus on sovereignty-based claims against international tax cooperation.

[186] Conversely, it has been pointed out that sovereign nations tend to attract major corporations to their tax base and, although their abilities to freely adapt laws to do so may be constrained by their existing obligations in treaties, or subjected to international pressures, countries will always want to compete in this regards. In this

This paradox, however, is quite convincing if we consider the evolution international tax law has had in the last years with the BEPS Action Plan and the level of involvement and interest achieved among the Member States.

The EU could represent an additional – and an even bigger one – paradox. As it will be explained with further details in the next Chapter and as it is commonly known, the EU is based on a set of values, some of which protect the internal market from any obstacles or distortions that might threaten it. The very existence of these principles and the market-oriented approach the EU Institutions have always had when they were called to deal with tax issues, have always made it more difficult for the EU Member States to build up effective anti-avoidance measures, which were subject to a case-by-case analysis in order to assess their compliance with the above-mentioned values. As a result, tax-avoidance practices have sometimes been regarded as a sort of collateral damage in the pursuit of an obstacles-free internal market.

To sum up, then, while the OECD considers tax avoidance a threat to international competition and episodes of double non-taxation as damaging as double taxation, and welcomes anti-avoidance measures as powerful tools to establish a level playing field, the EU has often seen the problem of tax avoidance from a specular and opposite perspective. Things have somehow changed since the ATAD Directives that were introduced as a response to the OECD BEPS Action Plan.

Back to the main topic of the final section of this Chapter, it is necessary to point out that the MLI was initially and primarily devised to preserve the conservative evolution of the international tax regime,

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respect, see R. A. AGRESTA, *International Tax Planning as a Business Driver*, in *Penn State Journal of Law & International Affairs*, 2017.

based on mutual recognition, reciprocity and competition, but it turned out to be a revolutionary instrument that is expected to break with the orthodoxy of the international tax regime[187]. Being the Multilateral Convention in its early stages, its full evaluation certainly requires more time.

In addition, it might be worth to stress that the Multilateral Convention does not purport to create supranational law or obligation, leaving the traditional Vienna Convention on the Law of Treaties norms to apply to the still predominantly bilateral tax treaties.

As it has been convincingly observed, the core principle of the BEPS Action Plan is that countries cannot adopt completely independent tax policies due to the interdependence of their economies. As a result, "the existence of the international tax regime is questionable as a system, because, unsurprisingly, it has remained soft law without an established international or supranational forum"[188].

Thus, the reason behind the Multilateral Convention is the necessity to turn this soft law system into something that resembles a hard law system. In other terms, the automatic integration of the existing bilateral tax treaties with the provisions included in the Multilateral Convention looks like an interesting step forward in the direction of the cohesion of the international tax law general framework.

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[187] In this respect, see A. DELLA CARITÀ – L. BONFANTI, *Riserve, opzioni e algebra booleana nella Convenzione multilaterale BEPS*, in *Corriere Tributario*, 2017; P. BONARELLI, *La Convenzione Multilaterale per l'attuazione delle misure BEPS*, in *Fiscalità e Commercio Internazionale*, 2017.

[188] M.L. GOMES, *International Taxation and the Challenges for Multilateralism in the Contex of the OECD Multilateral Instrument*, in *Bulletin for International Taxation*, 2018. In this respect, see also Y. BRAUNER, *An International Tax Regime in Crystallization*, in *Tax Law Review*, 2002; H.D. ROSENBLOOM, *Where's the Pony? Reflections on the Making of International Tax Policy*, in *Bulletin for International Taxation*, 2009.

The MLI is self-standing and operates alongside existing tax treaties. In the meantime, it proposed to modify those tax treaties in a swift, coordinated, harmonic and consistent manner.

The global acceptance of the Multilateral Convention is important, given the way in which it was developed, as the substantive content results of the OECD/G20 BEPS initiative emerge from the OECD. The aim of the OECD/G20 was to include non-OECD countries, non-G20 countries and developing countries in the implementation of the BEPS Action Plan suggestions. To be fair, this same approach had been adopted also in the previous step, that is to say, while the BEPS Actions were developed.

Despite the revolutionary approach that has given birth to the MLI, it might be said that the primary limitation of this initiative is the use of an old approach. In fact, as well as what happened with the BEPS Action Plan, the general context has not changed. In fact, also the Multilateral Convention consists in a mere "patching-up" of the current rules could well be insufficient to strengthen the new principles and rules adopted following the OECD/G20 initiative[189].

To sum up, the most critical aspects of the MLI, which reflect the criticalities of most of the current international tax tools are: its soft law nature and non-binding nature; the fact that it moves in the traditional track and works as a patch-up tool, instead of an entirely innovative tool.

In the opinion of the writer, the main issue is represented by its soft law nature. If we consider the fact that the OECD is not able to create hard law measure, the adoption of its suggestions must be on a volunteer basis. If, on the one hand, it is true that economies are

[189] In this respect, see the *OECD Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, 24 November 2016, OECD.

interdependent, it is equally true that some countries or some institutions may have their set of values or their interests to protect, which do not necessarily go alongside with what the OECD expects the countries to do for everyone's sake.

In other terms, relying on the good will of the countries and on the diplomacy and on "peer pressure" is part of the old approach the OECD did not manage to overtake.

If the EU has promoted an anti-avoidance policy that substantially reflects the OECD's, and has introduced binding provisions in this respect – although the compatibility of such provisions with the EU system is still under investigation – the U.S. have not signed the Multilateral Convention. It has been claimed that the fact the U.S. have not signed the MLI yet is due to the fact that the U.S. tax treaties already have robust anti-avoidance measures. However, it is necessary to bear in mind the above-mentioned U.S. concerns on the PPT rule[190].

The next Chapter, then, will focus on the EU approach towards the problem of tax avoidance, with a special focus on the I.P. Companies, that, as it was previously described, take advantage of the current provisions for aggressive tax planning purposes and give rise to base erosion and profit shifting concerns. The final Chapter, instead, will analyse the U.S. approach, which is based on a more protectionist measure, such as the introduction of an instrument named GILTI (Global Intangible Low-Taxed Income), that strengthens the previous CFC rules. In few words, the 2017 U.S. Tax Cut and Job Act adopts its own anti-avoidance tools, that are aimed at protecting the U.S. market from delocalization and profit shifting, making it more convenient to invest in the United States rather than overseas.

[190] See *supra* notes n. 125-126.

GILTI is, in fact, intended to reduce the incentive for U.S. corporations to relocate CFCs to low-taxed jurisdictions, as any tax savings achieved by the CFCs may be partially offset by an increase in current taxes at the U.S. shareholder level.

Even at first sight, the U.S. tax reform seems to be going in the opposite direction: while the OECD and (as it will be described in the following Chapter) the EU have adopted internationally shared measures[191], based on market-related reasons (either at international or EU level), the U.S. have decided to find their own solution[192], which will be further described in the third and last Chapter.

[191] For what concerns the EU approach, it is clear that the binding nature and the strength of the Directives inspired by the BEPS Action Plan is intrinsic in the instruments chosen by the EU. In addition, while the ATAD 1 and 2 are legally binding for all the EU countries (once they have been implemented) the EU Member States were not forced to sign the MLI. What is more, the ECJ well-settled case law has stated the primacy of EU Law over double tax treaties. In this respect see *inter alia*, Case C-265/04 [2006] ECR I-923 (ECJ) *Bouanich v Skatteverket*; Case C-379/05 [2010] BTC 563 *Amurta SGPS v Inspecteur van de Belastingdienst*. See also J. SCHWARZ, *Schwarz on Tax Treaties*, 2015, Wolters Kluwer.

[192] In this respect, see C. P. GAUTRIN, *U.S. Tax Cuts and Jobst Act: Part 1 – Global Intangible Low-Taxed Income (GILTI)*, in *Bulletin for International Taxation*, 2018. The Author reports the words of the U.S. Congress, stating that "the Congress characterized GILTI as the all-American adaptation of international anti-avoidance standards intended to dissuade MNEs from the pernicious practice of sheltering profits in low-taxed jurisdictions".

CHAPTER II

BEPS AND THE EU ANTI-TAX AVOIDANCE DIRECTIVES (ATAD 1 AND 2)

Table of contents: 1. EU principles and the anti-tax avoidance national provisions. The role of the ECJ in the protection of the internal market and the notion of abuse in the EU case law; 1.1 Is the arm's length principle compliant with the fundamental freedoms?; 2. Tax harmonization within the internal market: the anti-abuse provisions of the "Corporate Tax Directives"; 2.1 The EU Council Directive 2016/1164 (Anti-Tax Avoidance Directive 1) and the EU Council Directive 2017/952 (Anti-Tax Avoidance Directive 2), An overview; 2.2 General Anti-abuse rule (GAAR) (Art. 6); 2.2.1. A first step into the "new world": the US General Anti-abuse rule; 2.3. Controlled Foreign Company rule (art. 7 and 8).

1. EU principles and the anti-tax avoidance national provisions. The role of the ECJ in the protection of the internal market and the notion of abuse in the EU case law

As a preliminary remark, it must be stated that the present Chapter is not meant to be either a comprehensive description or a deep analysis of any of the principles or the pieces of legislation that are going to be explored therein.

Rather, the first part of this Chapter will try to give an understanding of the core EU law principles that constitute a limit against anti-tax avoidance.

This part will also touch the dispute on the arm's length principle and its compliance with the EU internal market.

The thesis, however, will not deal with the, albeit very interesting, issues regarding the intricate relationship between the Advanced Price Agreements and the tax rulings and EU competition law.

In the following sections, the Chapter will focus on the anti-avoidance provisions set forth in some pieces of secondary legislation, that might be regarded as the very first steps the EU has taken in the direction of anti-tax avoidance. The Chapter will, then, examine the Anti-Tax Avoidance Directives (1 and 2), that are a direct consequence of the OECD BEPS Action Plan and represent the EU response against some of the aggressive tax planning practices addressed by the Action Plan.

In principle, direct taxation falls within the competence of the EU Member States and, therefore, the EU should not have any competence in this field.

However, taxes are intrinsic in the market and, as the EU is mainly focused on the market, they seem to be an issue that cannot be ignored by the EU itself. In this respect, it must be noted that at the time the Treaty of Rome was signed (1957) direct taxes were not included in the scope of the EC Treaty. However, in the absence of a specific provision regarding direct taxes, Article 115 of the Treaty on the Functioning of the European Union (TFEU) provides for the Council to issue directives for the approximation of such laws, regulations or administrative provisions of the Member States that directly affect the establishment or functioning of the internal market.

In addition, Article 352 TFEU requires the Council, acting unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament, to take appropriate measures to attain one of the objectives set out in the Treaties if those Treaties have not provided the necessary powers. In any case, whether or not secondary EU legislation existed, Member States' tax systems and tax treaties must in any event respect the fundamental Treaty principles of

the free movement of workers, services and capital and the freedom of establishment (Article 45, 49, 56 and 63 TFEU) as well as the principle of non-discrimination (as expressed by Art. 18 TFEU).

The idea of a common internal market could not survive if it were not supported by those strong principles that allow business enterprises to carry out their activities in the whole market and, thus, create a level playing field.

Provided that the EU Member States legislation must comply with the EU legislation[193], these principles set forth by the TFEU appear to be binding also when Member States deal with direct taxation. In other words, Member States must exercise their competence in the field of direct taxation consistently with EU Law and avoid any discrimination on grounds of nationality[194].

Therefore, the role of the European Court of Justice in this context is crucial[195]: direct tax issues before the Court do not concern interpretation of national tax law as such, but the assessment of its compatibility with EU law principles, like, for example, market access, market equality, market distortions, subsidiarity, proportionality, non-discrimination, non-restriction, etc.

The fundamental freedoms are the pillars that support the internal market and the principles expressed therein guide the ECJ in its interpretative activity. They are: (i) the free movement of goods, (ii) the free movement of workers, (iii) the freedom to establish and to provide services and (iv) the free movement of capital. The last three of these freedoms more frequently have an impact on direct taxation, while for indirect taxation (*e.g.* VAT) the free movement of goods

[193] Case C-6/64 *Costa v Enel* [1964] ECR 585 ECJ. In this judgment, the ECJ held that "the law stemming from the Treaty […] could not […] be overridden by domestic legal provisions […]".

[194] In this respect, see Case C-270/83 *Commission v France (Avoir Fiscal),* [1986].

[195] For further reference on the role of the ECJ, see P. PISTONE, *The Impact of ECJ Case Law on National Taxation*, in *Bulletin for International Taxation*, 2010.

seems to be the most important. It must be stated, however, that in few cases the European Court of Justice held that the free movement of goods could affect the national direct tax provisions[196].

Also, Art. 110 TFEU prohibits discriminatory and protective product taxation, but it does not itself affect national tax sovereignty. It allows product taxation as part of a general domestic consumption tax applied on foreign and national products. Art. 110 TFEU requires a comparison between domestic goods and similar foreign goods, in order to assess whether the national fiscal provision might be regarded as in breach of Art. 110 TFEU or not[197].

If it were not clear enough, the fundamental freedoms are not just mere and vague principles, but they are directly applicable within the internal market. To put it simply, if the national legislation of any Member State infringed any of the fundamental freedoms, that Member State would be prohibited to apply the legislation found to be in breach of any of such freedoms.

Such prohibition is competence of the ECJ.

The application of the fundamental freedoms and the interpretation of the domestic provisions of the Member States in the light of such principles is far more complex than it may appear at first sight. In fact, the Court follows a three-step legal procedure when asked to evaluate the compatibility of national measures with the fundamental freedoms.

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[196] See Case C-18/84 *Commission v France* [1985] EU:C: 1985:175, or Case C-69/88 *H. Krantz Gmb H & Co. v Ontvanger der directe belastingen* [1990] EU:C:1990:97.

[197] See Case C-26/67 *Firma Fink-Frucht GmbH Frankfurt-am-Main v Hauptzollamt München-Landsbergerstrasse*, where the Court stated the EU Member States have to ensure normal conditions of competition and to remove all restrictions of a fiscal nature capable of hindering the free movement of goods within the Common Market. For further reference on Art. 110 TFEU see also Case C-112/84 *Michel Humblot v Directeur des services fiscaux* [1985] EU:C: 1985:185, or Case C-265/99 *Commission v France* [2001] EU:C:2001:169.

The first step is that the ECJ has to verify if the measure (*e.g.* national tax provisions) deemed to be in breach of any fundamental freedom makes any distinction between domestic investment/establishment/work and cross-border and the domestic case which might explain the difference in the tax treatment[198].

The second step follows the case where the domestic and the cross-border situations were found to be comparable, the Court would have to analyse if the measure at issue is justified by a requirement of public interest[199].

Finally, the third step: even though a certain measure might be considered in breach of the fundamental freedoms, it could still be accepted if a proportionality test is satisfied. In other terms, if a national (tax) provision set forth by a Member State is effective and does not restrict the free movements beyond what is necessary to reach its scope, it is not considered as in breach of the EU internal market and, thus, it can still be applied by the Member State[200].

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[198] This comparability test was used in various cases such as, for instance, Case C-388/14 *Timac Agro Deutschland GmbH* [2014] EU:C:2015:829 ECJ, Case C-459/17 *Société de Gestion Industrielle (SGI)*, EU:C:2010:26.

[199] Examples of requirements of public interest are given in Case C-120/78 *Reve Zentrale AG v Bundesmonopolverwaltung für Branntwein* (more commonly known as *Cassis de Dijon*) [1979] EU:C:1979:42 or Case C-250/95 *Futura Participations SA and Singer* [1997] EU:C:1997:239 I-2471, where the Court accepted the need for effective fiscal supervision, Case C-204/90 *Bachmann v Belgium* [1992] EU:C:1992:35 I-249, where the ECJ gave relevance to the need to protect fiscal (territorial) cohesion.

[200] The proportionality test and the importance of the balance between the public interest of a Member State and the fundamental freedoms are well shown in Case C-446/03 *Marks & Spencer* [2005] I-10866, where the ECJ explained that a restriction to the freedom of establishment is permissible only as long as it meets two conditions: it must pursue a legitimate objective compatible with the Treaty and be justified by overriding reasons in the public interest; it must also be apt to ensure the attainment of the objective in question and not go beyond what is necessary to attain that objective. (In the case at issue, the European Court of Justice held that it is contrary to freedom of establishment to preclude the possibility to deduct from taxable profits in that Member State the losses incurred by its non-resident subsidiary. The case at issue regarded the possibility that a Company, resident in a Member State, had to deduct losses occurred by one of its subsidiaries, resident in another Member States and the ECJ held that the deductibility of such losses could

After this general introduction regarding the importance of the fundamental freedoms to create a basic frame of principles and the precious role of the ECJ as a proper rule-maker, it is possible to highlight the main aspects of the fundamental freedoms that appear relevant in this context.

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be allowed only as long as those losses were "definitive", that is to say, the subsidiary could not deduct them itself, even potentially. This rule, known as "the Marks & Spencer exception", has often been challenged before the ECJ. In this respect, see Case C-650/16 *Bevola* or the very recent Case C-405/18 *AURES Holding a.s.*, where Advocate General Juliane Kokott insisted on the concept of "definitive losses and opted for a restrictive interpretation of the exception at issue It was not the first time Advocate General Kokott expressed an opinion against the "Marks & Spencer exception". In Case C-172/13 she held that "the abandonment of the Marks & Spencer Exception is the most balanced solution because it preserves that principle of case-law and […] no less onerous means are available in this regard" See Opinion of Advocate General Kokott, ECLI:EU:C:2014:2321 Case C-172/13. With reference to the proportionality test, see also Case C-168/01 *Bosal Holding BV* [2003] EU:C:2003:479 and Case C-231/05 *Oy AA* [2007] EU:C:2007:439 I-6393. The same type of legal reasoning can be found in the Case C-18/11 *Philips Electronics* [2012], where the ECJ. See also Case C-337/08 *X Holding* [2010] ECR I-1215, where the ECJ accepted the need to safeguard the balanced allocation of the power to impose taxes as justification. More specifically, the European Court of Justice decided that EU law does not prevent national legislation of Member States that disallows the formation of a cross-border tax group. See Z. M. REIJN - N. VAN DE VOORDE - F.M. VAN DER ZEIJDEN - *Tax Grouping in an EU Context: All Roads Lead to Brussels*, in *European Taxation*, 2018. For a deeper analysis of the principle of proportionality as applied by the ECJ, see D. FREYER, *The Proportionality Principle under EU Tax Law: General and Practical Problems Caused by Its Extensive Application – Part 1*, in *European Taxation*, 2017. It is worth noticing the proportionality test represents, in a way, the difficult relationship between the sovereignty of the Member States and the EU fundamental freedoms. In this respect, see G. MEUSSEN, *Thin Capitalization Rules and Corresponding Tax Exemptions: All or Nothing*, in *European Taxation*, 2017. The Author, in his analysis of Case C-593/14 *Masco Denmark ApS and Damixa ApS v Skatteministeriet*, 2016, points out that "this case is a perfect example of the tension between the principle of autonomy […] and the treaty freedoms […]. Member States are free to shape their tax legislation in the way the feel fit and are not […] dependent upon the direct tax legislation of another Member State". The independence of Member States tax system is due to the lack of harmonization at EU level in the field of direct taxation. It has also been pointed out that when analysing the ECJ case law the Court often eludes qualifying a given measures as discriminatory but simply analyses whether it can be justified or not on the grounds of the general interest. In this respect, see V. RUIZ AMENDRAL, *Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?*, in *Intertax*, 2005. With reference to the qualification of abusive measures as such, see also D. CANÈ, *Indebito Vantaggio Fiscale e Abuso del Diritto. Profili di Diritto Comunitario e Internazionale*, in *Diritto e Pratica Tributaria Internazionale*, 2016.

It must be borne in mind, in fact, that the main topic of this thesis is not the thorough analysis of all the fundamental freedoms but, rather, the effectiveness of the current (and future) provisions in tackling phenomena of aggressive tax planning[201] and tax avoidance involving I.P. Companies.

As it was previously mentioned, however, the unique status of the EU makes it more difficult for the EU Member States to apply anti-avoidance provisions, since those Member States must comply with a framework of EU law (which does not consist only of statutory law, but also case law).

Consequently, the only fundamental freedoms that will be dealt with in this Chapter are the freedom of establishment and the free movement of capital.

The freedom of establishment is guaranteed by Art. 49 et seq. TFEU and it protects the right of individuals to take up and carry out activities as a self-employed person in another Member State as well as the right to set up and manage undertakings in another Member State. Furthermore, this fundamental freedom applies to companies and grants them the right to set up agencies, branches or subsidiaries in another Member State. The freedom of establishment has been widely interpreted by the ECJ: for instance, the ECJ once decided that a holding in the capital of a company established in another Member

[201] The expression "aggressive tax planning" is quite recent and its introduction follows the sudden changes of the international economic and financial environment. In particular, the interaction amongst tax treatments provided for by different jurisdictions gives rise not only to the undesired overlapping of taxation rights, but also to unforeseen loopholes. Aggressive tax planning "consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability". In this respect, see EU Commission recommendation of 6 December 2012 on aggressive tax planning, point 2 of the Preamble OJ L338/41. With reference to the way aggressive tax planning occurs in the EU, see F. CACHIA, *Aggressive Tax Planning: An Analysis from an EU Perspective*, in *EC Tax Review*, 2017; A.P. DOURADO, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, in *Intertax*, 2015.

State which gives the shareholder a definite influence over the company's decisions and allows him to determine its activities, exercises his right of establishment[202]. In another judgment[203], the European Court of Justice held that a legislation which makes a tax advantage in the form of a consortium relief available solely to companies which control, wholly or mainly, subsidiaries whose seat is in the national territory, which applies the test of the subsidiaries' seat to establish differential tax treatment of consortium companies established in that Member State, is not justified in terms of a need to ensure the cohesion of the national tax system arising from the fact that the revenue lost through the granting of tax relief on losses incurred by resident subsidiaries cannot be offset by taxing the profits of non-resident subsidiaries, since there is no direct link between the consortium relief granted for losses incurred by a resident subsidiary and the taxation of profits made by non-resident subsidiaries.

It is indisputable that the tax tools the EU Member States have issued have challenged this freedom in various circumstances[204].

Art. 63 et seq., prohibit all restrictions on the movement of capital and payments between either Member States or Member States and third countries. It is the only fundamental freedom that is not applied only within the EU.

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[202] Case C-251/98 *Baars* I-2805, 1998.

[203] Case C-164/96 *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*. For further reference, see also E. ROBERT – D. TOF, *The Substance Requirement and the Future of Domestic Anti-Abuse Rules in the Internal Market*, in *European Taxation*, 2011.

[204] See, for example, Case C-418/07 *Société Papillon v Ministère du Budget, des Comptes publics et de la Fonction Publique*, 2008, where the ECJ ruled that the French tax legislation that did not allow French parent companies to include in their tax group lower-tier subsidiary held indirectly by a subsidiary established in another EU Member State was in breach of the freedom of establishment, even though the French Government claimed that the aim of this provision was to prevent episodes of double tax deduction. See also Case C-293/06 *Deutsche Shell GmbH v Finanzamt für Grossunternehment in Hamburg*, 2008, where the ECJ held that non-deductibility of currency losses from foreign exempt permanent establishment restricts the freedom of establishment.

The Treaty does not define movement of capital, but "in general terms, any right concerning movable or immovable assets is capital for purposes of the TFEU, and movement of capital is the transfer of rights concerning assets"[205].

Just to make an example of how wide the concept of movement of capital is, the ECJ stated the opening of securities account within the concept of movement of capital[206].

It is essential to analyse also the relationship between the free movement of capital and the freedom of establishment. In fact, the possible overlapping between these two fundamental freedoms is relevant once we consider that the former applies also in cases where also third countries are involved whilst the latter remains applicable only within the internal market.

The ECJ case law in this matter has not always been univocal. In fact, at first the European Court of Justice applied the so-called "principal purpose test" to identify the "main purpose of national measure" and verify whether the free movement of capital or the freedom of establishment were to be applied[207]. Put simply, "to ascertain whether national legislation, in third State situations, must be judged under one or the other Treaty freedom, the purpose of the legislation at issue is decisive. National provisions aimed at holdings in companies giving the holder effective control of the company […] come under the

[205] P.J. WATTEL, *General EU Law Concepts and Tax Law*, in P.J. WATTEL, B. TERRA, (ed), *Fiscale Handboeken European Tax Law*, Volume 1 (Seventh Edition, Wolters Kluwer), 2018.

[206] See Case C- 317/15 *X v Staatssecretaris*, 2017 EU:C:2017:119.

[207] Such an approach was adopted by the ECJ in judgments such as Case C-452/04 *Fidium Finanz*, 2006, EU:C:2006:631, Case C-524/04 *Test Claimants in the Thin Cap GLO*, 2007, EU:C:2007:161, Case C-492/04 *Lasertec*, 2007 EU:C:2007:273, Case C-102/05 *Skatteverket v A and B*, 2007, EU:C:2007:275, Case C-157/05 *Holböck*, 2007, EU:C:2007:297.

freedom of establishment"[208]. Conversely, measures not aimed at definite influence are to be seen under the freedom of capital.

This type of approach was applied until the FII GLO 2 judgment[209], when the Court's Grand Chamber radically changed its perspective and adopted the "market access criterion". In few words, if the national measure regulates market access or its principal purpose relates to majority interests in companies, or situation of definite influence in the management, the freedom of establishment applies. In all the other cases where the two freedoms may overlap, the free movement of capital should prevail[210].

The distinction between the aforementioned two fundamental freedoms is extremely useful when it comes to decide whether national measures issued by third countries fall within the scope of the Treaty or not.

As it is possible to understand from the above-mentioned cases, the ECJ has played a pivotal role in shaping what we might call "EU Tax Law". The ECJ case law, in fact, establishes principles that rule the relationship between EU law and the national tax provisions of the Member States, limiting the provisions that turn out to be in breach of EU law.

As it was previously pointed out, the ECJ has sometimes accepted breaches of EU Law, in cases where such breaches were justified and were proportional to the scope of the national provision. Of course, not every justification is acceptable in the view of the ECJ.

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[208] A.P. DOURADO – P. WATTEL, *Third States and External Tax Relations*, in P.J. WATTEL, B. TERRA, (ed), *Fiscale Handboeken European Tax Law*, Volume 1 (Seventh Edition, Wolters Kluwer), 2018.

[209] Case C-35/11 *Test Claimants in the FII GLO 2*, 2012, EU:C: 2012:707.

[210] Case C-35/11 *Test Claimants in the FII GLO 2*, 2012, para. 100 introduces the concept of "access of a company from a Member State to the market of a third country" and vice versa.

For instance, the ECJ does not accept the argument according to which different measures are necessary for persons exercising their fundamental rights under the TFEU in order to take account of differences between the tax systems of the EU Member States. With this argument, the EU Member States have tried to justify discriminatory measures.

However, the Court did not accept this argument, holding that even in the absence of harmonization, Member States are not allowed to apply measures to foreign nationals exercising their fundamental rights that differ from those which apply to their own nationals, unless these measures are justified and proportionate.

Also, in a number of cases, a Member State tried to justify a discriminatory provision with the argument that difficulties in obtaining information exist. In those cases, the ECJ denied this justification by referring to Directive 77/99/EEC[211] (mutual assistance in the exchange of information).

Even though the Member States argued that this instrument was not effective, because obtaining information was too difficult, the Court held that it was up to the Member States to make this tool effective[212].

In many cases in which Member States apply discriminatory national provisions, the Member States do so in order to avoid a loss in their own tax revenue. However, the ECJ has never accepted the loss of revenue as a justification for discriminatory national provisions.

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[211] Council Directive 77/99/EEC was first amended by Council Directive 2011/16/EU. The latter was amended by Council Directive 2014/107/EU and, finally, by Council Directive 2018/822/EU of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, which extends the Common Reporting Standard and should help the Tax Administrations of the EU Member States to prevent aggressive tax-planning.

[212] See Case C-386/04 *Stauffer*, 2006 ECR I-8203, para. 48; Case C-233/09 *Dijkman*, 2010, ECR I-6649, para. 43.

In fact, it seems that the Court accepts the fact that, within the internal market, one Member State's tax revenue is reduced in a cross-border situation[213].

Although the loss of tax revenue is not accepted *per* se as a justification, it is worth noticing that the EU Member States are interested in exercising their tax sovereignty and the justifications they commonly use represent the means to reach their scope, that is to say, not giving up their tax sovereignty.

In other terms, the justifications the ECJ accepts are those that EU law itself considers worth to be accepted and to serve as a balance against the fundamental freedoms.

In this respect, even though the ultimate objective of the Member States is to impose taxes, the reason they base their justifications on must be compliant with EU law or, at least, purport to protect some values shared by the EU.

For example, the ECJ has accepted reasons such as the promotion of national education and training[214] (not the promotion of national research and development)[215], the balanced allocation of taxing rights[216] and, more importantly for the purpose of this thesis, anti-abuse reasons.

The effects of non-harmonization in the EU in the field of direct taxation are reflected by the ECJ case law regarding the compliance of national anti-abuse provisions with the fundamental freedoms and, more specifically, with the freedom of establishment.

Since the EU Member States have kept their tax sovereignty, they can shape their tax systems the way they prefer, as long as it is compliant with EU law. In this respect, creating a set of tax provisions that

[213] In this respect, see Case C-319/02 *Manninen*, 2004 ECR I-7477.
[214] See Case C-10/10 *Commission v Austria*, 2011, ECR I-05389, para. 38
[215] See Case C-39/04 *Laboratoires Fournier*, 2005, ECR I-2057, para. 23
[216] See Case C-337/08 *X Holding*, 2010, ECR I-1215, paras. 31 et seq.

makes it more attractive to invest in a Member State, is certainly compliant with the fundamental freedoms.

Consequently, arrangements or transactions that imply the exploitation of the tax tools that some EU Member States make available is allowed under EU and, at least in principles, any national tax provisions other Member States may issue to prevent this phenomenon might be considered to be in breach of the freedom of establishment, since it could limit this type of freedom[217].

Therefore, it might be said that the Treaty guarantees, to a certain extent, free movement of tax avoiders.

The interpretation of the ECJ has regarded the application of anti-tax avoidance national provisions such as, for example, CFC rules.

As it is commonly known, the purpose of this type of measure is to prevent taxpayers from setting up controlled companies in low tax jurisdiction to obtain undue tax benefits.

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[217] The freedom of establishment has often been challenged by the national tax provisions, probably because the fundamental freedom at issue has a very pervasive nature and the interpretation of the ECJ could either expand or restrict the tax sovereignty of the EU Member States, depending on the freedom of establishment. See, *inter alia*, Case C-418/07 *Société Papillon v Ministère du Budget, des Comptes publics et de la Fonction Publique*, 2008, where the ECJ ruled that the French tax legislation that did not allow French parent companies to include in their tax group lower-tier subsidiary held indirectly by a subsidiary established in another EU Member State was in breach of the freedom of establishment, even though the French Government claimed that the aim of this provision was to prevent episodes of double tax deduction. See also Case C-293/06 *Deutsche Shell GmbH v Finanzamt für Grossunternehment in Hamburg*, 2008, where the ECJ held that non-deductibility of currency losses from foreign exempt permanent establishment restricts the freedom of establishment. Case C-294/97 *Eurowings Luftverkehrs AG*, 1999, ECR I-7447, showed that the Member States may not penalize the use of low tax regimes in other jurisdictions if the economic activity in that jurisdiction is genuine. *Eurowings* concerned the German *Gewerbesteur* (a regional tax on business yield and assets). To prevent double taxation, relief was available if assets had been leased from another undertaking which was subject to the same tax. Consequently, German companies leasing assets from a foreign lessor (not subject to the German regional tax) were not eligible for relief. *Eurowings Luftverkehrs* leased its aircraft from a lessor established in Ireland and subject there to a special low tax regime (10% rate). The ECJ saw refusal of the relief as a restriction of the freedom to provide services, as leasing from foreign providers was made less attractive

The application of this kind of provision implies that the income generated in the low tax jurisdiction is considered as if it had been earned by the taxpayer, resident for tax purposes in the high tax jurisdiction, and it would be, thus, taxed therein.

For what concerns the compliance of CFC rules and the principles that govern the EU internal market, it is worth considering Case C-19/6/04 *Cadbury Schweppes*[218].

In such case, the ECJ held British CFC provisions were in breach of the freedom of establishment or the free movement of capitals. In the case at issue, the British CFC rules required that the following conditions were to be fulfilled: 1. The parent company, resident for tax purposes in the UK, held more than 50% of the shares of the controlled company, 2. The income of the controlled company was subject to a tax rate lower than 75% of the tax rate that would have been applied, had the controlled company be resident for tax purposes in the UK. In addition, the UK tax system provided a set of exceptions to the application of the CFC rules, such as, for example, the possibility to prove that shifting profits from the parent company to the controlled company was not the main purpose, or one of the main purposes for the very existence of the controlled company.

Very briefly, the ECJ had to make a balance between the reasons of public interest the UK meant to protect with its CFC provisions and the freedom of establishment, and held that such provisions are

[218] In Case C-196/04 *Cadbury Schweppes*, 2006, I-8031, the ECJ held that the freedom of establishment prohibits the Member State of origin from hindering the establishment in another Member State of one of its nationals or a company incorporated under its legislation. See G.T.K. MEUSSEN, *Cadbury Schweppes: the ECJ Significantly Limits the Application of CFC Rules in the Member States*, in *European Taxation*, 2007, where the Author points out "the ECJ […] argued that the application of UK CFC legislation entails a disadvantage for the resident company. It was not so much that the resident company paid more tax than without this legislation, but, […] it was the difference in tax treatment by means of this "look-through approach"".

justified, at least in principle, but only as long as they are aimed at and able to prevent the whole artificial arrangements, that is to say, contractual arrangements carried out by the companies with the only purpose of avoiding the application of the taxes that would have been applied if such an arrangement had not taken place[219]. In addition, such burden of proof must not be so heavy that the taxpayer cannot effectively prove that the controlled company carries out a real and substantial economic activity[220].

The legal reasoning of the ECJ in the *Cadbury Schweppes* case is essentially reflects the proportionality test[221] and, interestingly, it has

[219] See Case C-196/04 *Cadbury Schweppes*,2006, I-8031, par. 57.

[220] In this respect, see S. LAMPERT, J.N. BITTERMANN, B. HARMS, *The CFC Regime in Germany*, in *European Tax Studies*, 2013, p. 20. See also G.T.K. MEUSSEN, *Cadbury Schweppes: the ECJ Significantly Limits the Application of CFC Rules in the Member States*, who claims that: "In contemplating the ECJ's ruling in the Cadbury Schweppes case, the direction that the Court has taken is clearly indicated. As corporate income tax rates are not harmonized in the European Union and the Commission is not opposed to tax competition, there is little room for the application of CFC rules. In this respect, the ECJ's ruling could be interpreted as a political hint or implicit advice to EU politicians, i.e. if they want to counter low-tax jurisdictions within the European Union, the only proper way to do this is to reach some form of understanding regarding minimum corporate income tax rates and, in general, CFC rules are inadequate to counter low-tax jurisdictions".

[221] See, *inter alia*, Case C-264/96 *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*. In this judgment, the ECJ held that general exclusion of all or an entire category of cross-border cases for a (remote) possibility of abuse is disproportional or even unsuitable to attain the goal of prevention of abuse (see para. 26).

been followed also in non-tax case[222] which, however, regarded the abuse of rights[223].

The artificiality the court appeared to contemplate was in the exercise of the fundamental freedom (in that case the right of establishment in art. 49). This is to be identified by reference to objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment has not been achieved.

That objective is to allow nationals to set up in another Member State to carry on activities there, and thus assist economic and social interpretation within the Community in the sphere of activities as self-employed persons. Freedom of establishment is intended to carry on genuine economic activities and is ascertainable by third parties with regard, in particular, to the extent to which the establishment physically exists in terms of premises, staff and equipment.

In order to find that there is such an artificial arrangement, there must also be the subjective element mentioned in the last note. This must go beyond any advantage of low taxation resulting from establishment in a particular Member State and intend to escape the tax normally due

[222] There is a long list of consistent ECJ case law in non-tax cases, that shows that economic operators may be denied recourse to EU law where that recourse is frivolous, where the connecting factors to EU law, especially the cross-border aspect, is artificially created and lacks real economic substance. In this respect, see Case 33/74 *Van Binsbergen*, 1974, ECR 1299; Case 115/78 *Knoors*, 1979, ECR 399; Case 229/83 *Leclerc v Au blé vert*, 1985; Case 79/85 *Segers*, 1986 ECR 2375; Case 39/86 *Sylvie Lair*, 1988 ECR 3161; Case 292/86 *Claude Gullung*; Case C-221/89 *Factortame II*, 1991, ECR I-3905; Case C-375/89 *Raulin*, 1992 ECR I-1027; Case C-370/90 *Surinder Singh*, 1992 ECR I-4265; Case C-23/93 *TV 10*, 1994 ECR I-4795; Case-212/97 *Centros*, 1999 ECR I-1459; Case C-367/96 *Kefalas*, 1998 ECR I-2843.

[223] In this respect, see Case C-110/99 *Emsland Stärke*, 2000, ECR I-11569. In this judgment (para- 52-53), the ECJ held that: "a finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved. It requires, second, a subjective element consisting in the intention to obtain an advantage from the Community […]".

on the profits generated by activities carried out on national territory of the home Member State.

The test applied by the ECJ in the case at issue has been adopted in the field of indirect taxation[224] and, then, also in the field of harmonized direct taxation.

In fact, in Case C-126/10[225] and subsequent cases concerning the anti-abuse provisions in the Merger and the Parent-Subsidiary Directives, the Court reiterated that the anti-abuse provisions reflect a general principle of EU law prohibiting abuse of rights, and that fiscal motives are not necessarily fatal, as long as they are not "predominant"[226].

In these cases the ECJ held that the anti-abuse rules in the Merger Directive and in the Parent-Subsidiary Directive reflect the general EU law principle that abuse of rights[227] is prohibited and that EU law cannot be relied on for abusive or fraudulent ends.

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[224] See, for example, Case C-255/02 *Halifax a.o.*, 2006 ECR I-1751.

[225] Case C-126/10 *FOGGIA-Sociedade*; Case C-321/05 *Kofoed*, 2007 ECR I-5795; Case C-6/16 *Eqiom SAS/Enka former Holcim France SAS*, 2017; Case C-39/16 *Argenta Spaarbank NV H*, 2017; Case C-14/16 *Euro Park*, 2017. The interpretation the ECJ has given to the anti-abuse provisions of the Corporate Tax Directives has raised the question of whether such provisions serve any purpose next to autonomous and general principle of EU law that abuse of rights is prohibited. This issue will be further addressed in the following sections, that will analyse the content and the nature of the anti-abuse provisions included in the "Corporate Tax Directives".

[226] See also Joined Cases C-50/16 and C-613/16 *Deister Holding AG and Juhler Holding A/S*, where the ECJ sums up its present views regarding the permissible restriction of free movement rights for anti-abuse reasons. For more details on the cases at issue, see J. BUNDGAARD – P- KOERVER SCHMIDT – M. TELL – A. NØRGAARD LAURSEN – L. BO AARUP, *When Are Domestic Anti-Avoidance Rules in Breach of Primary and Secondary EU Law? Comments Based on Recent ECJ Decisions*, in *European Taxation*, 2016.

[227] In this respect, however, it has been observed that "while Member States are entitled to enact laws to prevent avoidance, no general principle exists in EU law which might entail an obligation of Member States to combat abusive practices in the field of direct taxation, either under the principle of the prohibition of abuse of rights, or Art. 4(3) TFEU which requires that Member States take all appropriate measures to ensure fulfilment of the obligations arising out of the EU treaties and refrain from any measure which could jeopardise the attainment of the EU's objective". See J. SCHWARZ, *Schwarz on Tax Treaties*, 2015. The Author mentions also Case C-417/10 *Ministero dell'Economia e delle Finanze v 3M Italia S.p.A.*, 2012.

The above-mentioned judgments have made it clear that the abusive intent might exist even in cases not involving taxation and when no anti-abuse measures are set up by the Member States.

However, the abuse of rights (more specifically, the abuse of tax-related measures) is more evident when anti-tax avoidance tools are involved.

Another example of anti-avoidance national tax provision is the thin capitalization rule, that introduces a tax limit based on the amount of debt financing and aims to counter situations in which a company is financed with excessive intra-group debt where, under similar facts and circumstances, the debt would not have been granted by a third-party creditor[228].

Finally, the anti-avoidance purpose is intrinsic in exit tax provisions, that is to say, in those protectionist measures that consist in the application of a tax on accrued income of companies that transfer their tax residence from a Member State to another and, as such, might

[228] See, T.J.C. DONGEN, *Thin Capitalization Legislation and the EU Corporate Tax Directives*, 2012, in *European Taxation*. Case C-415/93 *Lankhorst-Hohorst*, 2002, concerns German thin capitalization rules denying deduction of interest paid on a loan taken out by a German subsidiary with its Netherlands parent company, financing the subsidiary's German losses. This debt-financing exceeded the German statutory debt/equity ratio for controlling shareholder loans, which applied only to non-resident shareholder loans. The excess interest was treated as a covert dividend. The Court held the denial of deduction to be incompatible with the right of establishment because in domestic cases the interest would have been deductible. See also Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, 2007, ECR I-2157. Under the UK thin cap rules, a domestic group company's risk of being denied interest deduction depended on the place of residence of its group creditor. Even though the UK claimed there was no real restriction, because the real position of the group was neutral, as the UK's reclassification of the interest into a non-deductible profit distribution would be followed, pursuant to Article 9 of the OECD Model Tax Convention, by a corresponding adjustment in the creditor company state, the ECJ found this measure to be in breach of the freedom of establishment and it reiterated (if it were necessary) that anti-abuse measures, in order to be acceptable, must be targeted to catch only wholly artificial arrangements which do not reflect economic reality. For further reference, see also ERIC ROBERT - DRISS TOF, *The Substance Requirement and the Future of Domestic Anti-Abuse Rules in the Internal Market*, in *European Taxation*, 2011.

constitute an access restriction to the internal market and might hinder the establishment in another Member State[229].

As it will be further discussed in this Chapter, the EU legal order must move in one direction: towards greater sovereignty or toward greater integration. This is a political decision that the EU as a whole needs to make. If this choice is made, Member States could build on the core weakness of the EU legal order and unilaterally nullify ECJ anti-avoidance rulings by refusing both to enforce them domestically and to refer any future anti-avoidance cases for preliminary rulings. Although domestic courts have shown themselves willing to enforce ECJ rulings, even when these ruling push Member States toward greater integration at the expense of sovereignty, the effectiveness of EU Law ultimately depends on the willingness of domestic courts to enforce it. If one or more Member States determine that the wholly artificial arrangements doctrine and the limits it imposes on Member State sovereignty are unbearable, those Member States can simply refuse to enforce relevant ECJ rulings. No matter how many cases are brought against those Member States, whether by other Member States or the Commission, enforcement ultimately rests in the hands of domestic courts[230].

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[229] Case C-371/10 *National Grid Indus*, 2011 made clear the tax consequences of corporate mobility. To sum up, the ECJ stated that: the origin Member State does not have to take into account post-emigration decreases in value; a security for later payment of the tax may be required if there is a risk of non-recovery of the exit tax which increases with the passage of time; the company itself may choose between immediate payment or an interest-bearing trailing tax. It must be noted that Article 5 of the recently introduced Council Directive 2016/1164/EU of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1 (Anti-Tax Avoidance Directive 1) contains an option for deferred payment of the exit tax, which directly flows from the National Grid Indus judgment. This piece of legislation is going to be described in the following sections of this Chapter.

[230] In this respect, see S. DILLON, *The Mirage of EC Environmental Federalism in a Reluctant Member State Jurisdiction*, in *N.Y.U. Envtl. Law Journal*, 1999.

The one response that would address the fundamental issue of the ECJ's encroachment on Member State sovereignty over direct taxation would be to restrict the Court's jurisdiction by preventing it from considering anti-avoidance cases – or direct tax cases entirely. Although drastic, this solution was considered during negotiations over the proposed Reform Treaty[231]. With limited jurisdiction, the ECJ would not have the opportunity to develop or apply the wholly artificial arrangements doctrine, and Member States would be free to retain anti-avoidance rules that violated freedom of movement.

In exchange for retained sovereignty over direct taxation, however, the Member States would create a roadblock to greater integration and a gaping consistency in EU Law. The ECJ currently has jurisdiction that has allowed the ECJ to push forward integration by invalidating Member State measures that limit the freedom of movement. One of the fundamental principles of EU Law is the principle of supremacy, pursuant to which EU Law is granted primacy over any contradictory domestic law [232].

Were the ECJ no longer permitted to rule on questions regarding the interpretation of EU Law that involved direct taxation, integration would stall and the principle of supremacy, now so fundamental to EU Law, would not apply in all cases. Furthermore, carving direct taxation cases out of the Court's jurisdiction creates a clear incentive for Member States and EU Institutions to claim that challenged measures that would otherwise fall under the court's jurisdiction in fact relate to direct taxation.

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[231] In this respect, see J. MINTZ – J. M. WEINER, *Some Open Negotiation Issues Involving a Common Consolidated Corporate Tax Base in the European*, in *Tax Law Review*, 2008.

[232] In this respect, R. R. LUDWIKOWSKI, *Supreme Law or Basic Law? The Decline of the Concept of Constitutional Supremacy*, in *Cardozo Journal Int'l & Comp. L.*, 2001.

Logistically, restricting the court's jurisdiction would require amendment of the Treaty and would again require the unanimous support of the Member States[233].

As it will be explained in § 2.1.1 of this Chapter, the EU and its Member States have opted for a higher grade of integration in the field of direct taxation.

1.1 Is the arm's length principle compliant with the fundamental freedoms?

The first Chapter dealt with the arm's length principle and made it clear that such principle stems from the international tax law framework but has become part of the national tax systems.

From an EU law-related point of view, it is legitimate to wonder if such a principle, that belongs both to the international tax tradition and the tax systems of the EU Member States, is compliant with the fundamental freedoms.

In other terms, is establishing a principle that realigns the price of certain transactions to the market value in breach of EU law[234]?

In the context of the EU, the interpretation of the arm's length principle must be in light of the fundamental freedoms.

In fact, domestic rules regarding the application of the principle at issue has been held to lead to "unequal treatment in cases involving domestic and foreign transactions since, in a case involving purely domestic transactions, no corrections of income would be made in

[233] In this respect, see L. V. FAULHABER, *Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance*, in *Columbus Journal of Transactional Law*, 2010.

[234] Another interesting and very current topic regards the compliance of the arm's length principle with the competition-related EU provisions and, more specifically, with EU State aid law (Art. 107 TFEU and seq.). Despite the relevance of this issue, it would be impossible to address it properly in this context, as it would broaden the discussion on EU law too much.

order to reflects the presumed amount of the remuneration for guarantees granted to subsidiaries"[235].

The ECJ does not compare cross-border uncontrolled transactions with cross-border controlled transactions, but rather domestic and cross-border controlled transactions, which – in light of the territoriality principle – are incomparable. Instead, the Court asserts that territoriality and symmetry do not relate to the comparability of situations, but rather to the justifications derived from territoriality and the need to preserve rights of the Member States.

The *Hornbach-Baumarkt* case concerned Hornbach-Baumarkt AG, a public limited company established in Germany which provided comfort letters to a bank. Those comfort letters contained a guarantee statement, so that its Dutch subsidiaries Hornbach Real Estate Groningen BV and Hornbach Real Estate Wateringen BV had negative equity capital and needed those loans in order to continue their business operations. Hornbach-Baumarkt AG provided the comfort letters for no consideration.

The German tax authorities argued that unrelated third parties under the same or similar circumstances, would have agreed on remuneration in exchange for granting such guarantees, and accordingly increased the amount of taxable income of Hornbach-Baumarkt AG. The German referring Tax Court agreed with the tax authorities' correction of the taxpayer's taxable income, taking into account the comparability test and the associated risk[236]. However, the referring Tax Court was unsure whether that correction infringed the EU freedom of establishment, which led to the referral to the ECJ.

[235] See Case C-382/16 *Hornbach-Baumarkt AG v Finanzamt Landau*, 2018, para. 13.

[236] Case C-382/16 *Hornbach-Baumarkt*, para. 16.

In *Hornbach-Baumarkt AG*, according to the ECJ, restrictions on the freedom of establishment caused by adjustments under the arm's length standard, may be justified because they "pursue legitimate objectives concerning the need to maintain the balanced allocation of the power to tax between the Member States and that of preventing tax avoidance"[237].

Generally speaking, the justification would be a commercial justification presented as evidence to explain why a transaction had been concluded on non-arm's length terms.

If such evidence is not provided, the adjustment by the tax authorities must "be confined to the part which exceeds what would have been agreed between the companies in question under market conditions"[238].

This means that, in absence of comparable (market) conditions, the correction by tax authorities may not be based on the arm's length standard, but only on abusive behaviour as interpreted by the ECJ.

However, in the case at issue, the comparability test with transactions between uncontrolled entities was possible and had been carried out by the German tax authorities.

The ECJ proceeded in the assessment of the proportionality principle, by moving away from the arm's length standard. The ECJ "restricted the arm's length standard by abandoning its historical meaning, as it had been asserted by the German authorities (to achieve free competition between related and unrelated entities)"[239].

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[237] Case C-382/16 *Hornbach-Baumarkt*, para. 20. In this context, it is surely worth to mention the debate around the anti-avoidance essence of the arm's length principle, that was previously described in the first Chapter. See, in this respect, *infra* Chapter 1 §2.2 notes N. 42 and seq.

[238] In this respect, see Case C-311/08 *Société de Gestion Industrielle (SGI) v Belgian State*, 2010, paras. 71 & 72; Case C-382/16 *Hornbach-Baumarkt*, para. 49.

[239] A.P. DOURADO, *Profit Splitting and the Aspirational Arm's Length Standard*, in *Intertax*, 2018.

In fact, the ECJ added that there might be commercial reasons for a parent company to agree to provide capital on non-arm's length terms. Those commercial reasons could be linked to the purpose of continuation and expansion of the business operations of those foreign companies; to the financial success of the foreign group companies, as well as by a certain responsibility of Hornbach-Baumarkt AG to finance its subsidiaries.

As it is possible to notice from the above-described case, the arm's length principle, which – we remind – is not an EU-derived principle, was used by the Member State as an anti-avoidance tool and triggered the doubt on whether the application of such principle could be in breach of EU law. In that specific case, the ECJ held that the breach of the freedom of establishment could be justified by legitimate reasons, such as the correct allocation of taxing rights or to prevent tax-avoidance.

The ECJ gave relevance also to commercial reasons in assessing whether the price of the transaction had to be realigned or not. In other terms, the ECJ undermined the anti-avoidance purpose of the arm's length principle, as applied by the German tax authorities, establishing that only in those cases where there are no commercial reasons the arm's length principle can be applied, as long as the breach of EU law complies with the proportionality test.

The mismatches in the application of this principle could certainly be avoided if the ECJ interpreted it in a way that is consistent with its purpose and, more importantly, if a higher level of harmonization in the field of direct taxation is reached.

2. Tax harmonization within the internal market: the anti-abuse provisions of the "Corporate Tax Directives"

As it was previously mentioned, the EU does not only rely on primary law and the longed objective of the harmonization within the market is reached also through secondary law.

In the field of direct taxation, the most relevant pieces of secondary legislation are the so-called "Corporate Tax Directives", that is to say, a group of Directives issued to minimize the risks of breach of fundamental freedoms in cross-border transactions or arrangements.

This section is not meant to analyse the Directives at issue in detail but, rather, to give an overview of such Directives and to focus more on their anti-abuse measures.

As a preliminary remark, the exploitation of the benefits provided by the Directives is often referred to as "Directive shopping". Examples of Directive shopping typically consist in avoidance of withholding tax through the use of an intermediate holding company in a Member State for a tax-free profit distribution to an ultimate shareholder not eligible to the benefits of the PSD (*e.g.* a parent in a third country: outbound profit transfers).

Another type of Directive shopping is the use of an artificial intermediate holding company for a tax-free inbound profit transfer. This type of Directive shopping abuses the participation exemption in the Member State of the artificial intermediate holding company, and therefore the adequate response would be the denial of that exemption in the Member State of the parent company, rather than the withholding source tax in the Member State of the artificial intermediate holding company when It redistributes the third State dividend received.

As it was observed in the first Chapter, the Double Irish with a Dutch Sandwich takes advantage of the fundamental freedoms and certain pieces of secondary legislation that provide tax benefits.

To better understand the phenomenon of Directive shopping which, in other terms, is a sort of tax avoidance that exploits Corporate Tax Directives, it is necessary to introduce these pieces of legislation and, more importantly, their anti-abuse content.

One of the main Directives is certainly the so-called Parent-Subsidiary Directive[240], which establishes that: intragroup cross-border payments of dividends must be exempted from withholding tax by the Member State of the subsidiary. Consequently, the Member State of the recipient must either refrain from taxing the incoming dividend altogether, unless the profit is deducted by the subsidiary (exemption method), or tax it, but in that case credit, against the parent's corporation tax, the corporation tax already paid by the subsidiary in its Member State, or by the subsidiary of that subsidiary in a third Member State, etc.

To be eligible for the tax benefits of the Directive, the taxpayer must either be a company of a Member State and must be part of a group (either a parent company or a subsidiary). In order for the Directive to be applied, Art. 2 provides that the company needs to fulfil three conditions: it must take one of the specific forms listed in Annex I, Part A, of the Directive ("legal form"); it must be considered to be resident in a Member State for tax purposes, according to the tax laws of that Member State ("fiscal residence"[241]); it is subject to one of the

[240] Council Directive EU/2011/96 of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States OJ L 345/8. This Directive is a recast of Council Directive EEC/90/435 of 23 July 1990 OJ L 225/6. The Parent-Subsidiary Directive has been amended twice, by Council Directive EU/2014/86 of 8 July 2014 OJ L 219/40 and by Council Directive EU/2015/121 of 27 January 2015 OJ L 21/1.

[241] As a consequence, the company may not, according to a tax Treaty with a non-Member State, be resident for tax purposes outside the Union.

taxes listed in Annex I, Part B, of the Directive ("subject to tax requirements"[242]).

In addition, Art. 3, paragraph 1 (a) establishes a "minimum holding requirement": the status of parent and subsidiary is to be guaranteed by the Member States in all the cases where the parent company holds at least 10% of the capital of the other company. However, Art. 3, paragraph 2 allows Member States to replace, through bilateral agreements, the minimum shareholding requirement by a corresponding voting rights requirement. Also, according to Art. 3, paragraph 2 (b), Member States may deny parent or subsidiary status to companies which are not affiliated by a qualifying shareholding for an uninterrupted period of at least two years.

It is also necessary to point out, that Art. 1, paragraph 2, sets forth a general anti-abuse provision. Before the amendment introduced in 2015[243], the anti-abuse provision authorized but did not require Member States to apply existing anti-abuse provisions within the scope of the Directive. Art. 1, paragraph 2, established that "Member States are not allowed to establish conditions other than those enlisted in Art. 2 and 3, unless domestic or agreement-based provisions required for the prevention of fraud or abuse"[244].

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[242] This requirement is said to define the subjective and also the objective scope of application of the Directive. In this respect, see P. ARGINELLI, *The Subject-to-Tax Requirement in the EU Parent-Subsidiary Directive (2011/96)*, in *European Taxation*, 2017. See also G. MAISTO, *Il regime tributario dei dividendi nei rapporti tra società madri e società figlie*, (Giuffrè, 1996).

[243] Council Directive EU/2015/121.

[244] See E. PICQ, *"Abuse" of EU Holding Companies: Fundamental Freedoms, EC Parent-Subsidiary Directive and the French Constitution*, in *European Taxation*, 2009. The Author analyses the former Parent-Subsidiary Directive (Council Directive EEC/90/435), where there was the same anti-abuse provision as the one previously established in Art. 1, paragraph, 2, and he claims "it can be inferred […] that the fraud or abuse referred to in Art. 1 (2) can only arise if an EU holding structure is used to benefit third country residents […] or if the structure does not facilitate the grouping together of companies from different Member States".

The current version of Art. 1, paragraph 2, seems far more detailed and concrete than the previous one and it appears to be in line with the current anti-avoidance concerns that have led the EU to introduce an Anti-Tax Avoidance Directive. It might be argued, also, that the 2015 amendment of the Parent-Subsidiary Directive, together with the ATAD and other Directives (or proposed Directives), which will be described later, represents a convincing attempt of the EU to attain a higher level of harmonization within the market in the field of direct taxation.

The new Art. 1, paragraph 2, prevents Member States from granting the benefits of the Parent-Subsidiary Directive to those 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 the purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part".

It must be noted that the wording of the new version of Article 1, paragraph 2, strengthens and makes more explicit the obligation to refuse the Directive benefits.

Pursuant to the following paragraph, "an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality"[245].

[245] The concept of "not genuine" arrangements sounds like the concept of "wholly artificial arrangements", as expressed in Case C-524/04 Test Claimants in the Thin Cap Group Litigation. For comments on the anti-abuse provision of the Parent-Subsidiary Directive, see F. DEBELVA – J. LUTS, *The General Anti-Abuse Rule of the Parent-Subsidiary Directive*, in *European Taxation*, 2015. See also E. KOKOLIA – E. CHATZIIOAKEIMIDOU, *BEPS Impact on EU Law: Hybrid Payments and Abusive Tax Behaviour*. The Authors evaluate the concept of "genuine arrangements" and describe it as compliant with the ECJ case law and substantially in line with the concept of "wholly artificial arrangements".

Finally, paragraph 4 states that "this Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse".

Pursuant to the relevant provision of the Parent-Subsidiary Directive, the "subjective test" is met if the main purpose (or one of the main purposes) of the transaction/arrangement is obtaining a tax advantage. This type of wording seems to imply that the condition under the subjective test is met in a wide range of cases, that is to say, where at least one of the main purposes a given transaction/arrangement is obtaining a tax advantage.

If we consider this wording, it certainly looks closer to the OECD-derived PPT rule, as it was described in the first Chapter, than to the concept of abuse as developed by the ECJ. It is certainly influenced by the international concern on the topic of tax avoidance.

In the opinion of the writer, if the aim of this anti-abuse provision was to take a step ahead towards tax harmonization and to define the concept of tax abuse in the context of the Parent-Subsidiary relationship, such an objective was not fully attained.

If, on the one hand, the provision at issue defines what abuse means[246], unlike its predecessor, on the other hand it is not as balanced as the former ECJ case law was.

In fact, the case law in the field of tax avoidance strived to obtain a balance between the fundamental freedoms and the right to tax of the Member States.

[246] According to some commentators, this type of abuse is just a *species* of the *genus* "abuse of rights", as applied by the ECJ, and it shall be interpreted as such by the ECJ. In this respect, see A. LENAERTS, *The General Principle of the Prohibition of Abuse of Rights: A Critical Position on Its Role in a Codified European Contract Law*, in *European Review of Private Law*, 2010; *supra* § note N. 49, F. DEBELVA – J. LUTS, *The General Anti-Abuse Rule of the Parent-Subsidiary Directive*.

In a way, it allowed tax avoidance as a sort of collateral damage, but it was still able to guarantee that "wholly artificial arrangements" would not be allowed in the internal market.

This provision seems to suffocate (or, at the very least, to sensitively reduce) the freedom of establishment in favour of the right to tax of the Member States. In fact, it does not allow arrangements that have, as one of their main purposes, the attainment of tax advantages, if the subjective test is met.

In this respect, it is necessary to remind that an arrangement/transaction might be carried out for purposes other than tax advantages, being the latter purpose a reason that "convinces" the taxpayer to carry out such transactions/arrangements or that such transactions/arrangements are more convenient than others that are theoretically possible.

Article 1, paragraph 3, requires that the arrangement needs to be artificial, not genuine, this implying that it is not put in place for valid commercial reasons which reflect economic reality.

The original proposal contained a list of examples that the Member States needed to take into account when assessing artificiality (such as where the arrangement is carried out in a manner which would not ordinarily be used in a reasonable business conduct, and where the transactions concluded are circular in nature)[247].

The only guidance provided by the adopted provision is that one must have regard to all relevant facts and circumstances when assessing whether an arrangement is put into place for valid commercial reasons which reflect economic reality.

[247] Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 25 November 2013, COM(2013)814.

The presence of the objective test might mitigate the range of applicability of the anti-abuse provision in object.

However, the question that needs to be answered is: to which extent can an activity be considered genuine? In other terms, which relevance is given to the "other commercial reasons" that may lead to an assessment in a way or another?

Considering the wording of the provision and the concept of tax avoidance itself, there are various scales of grey in evaluating the substance of an arrangement or a transaction and its genuine essence.

And, more importantly, unless it is evident that the commercial reasons invoked by the taxpayer are artificial, some borderline cases where there could be relevant commercial reasons, but not as relevant as the tax advantage the taxpayer would want to obtain, how could it be assessed if a given arrangement/transaction is genuine or not?

If we consider both these tests as a whole, we realize that the aim of the EU Institutions was certainly to find the most appropriate way to effectively address tax avoidance schemes.

However, the result cannot be fully satisfactory.

If we combine the fact that even one of the purposes might be obtaining a tax advantage and the fact that the lack of economic substance required by the provision it might look, at least at first sight, as an effective provision. If we go more in depth, however, the anti-abuse provision could potentially refuse the benefits of the Directive to a series of arrangements that could have commercial reasons other than the tax benefit.

After having pointed out these essential elements, it is possible to say that the Parent-Subsidiary Directive represents a manifestation of the freedom of establishment. And this is made particularly clear in case

Denkavit[248]. The case regarded dividends distributed by two French companies to their Dutch holding (Denkavit Internationaal BV) in a period where the former Parent-Subsidiary Directive did not apply yet. Basically, the French tax system provided a different treatment for resident (that were granted exemption for dividends) and non-resident parent companies (which were taxed for such dividends). In the case at issue, the ECJ found the French tax legislation at issue to be in breach of the freedom of establishment (former Art. 43 EC), because it was discriminatory, and it reached such a conclusion through the above described three-step procedure and, more specifically, through the comparability test[249].

The Parent-Subsidiary Directive is not the only piece of secondary legislation where one of the fundamental freedoms is protected. In fact, the freedom of establishment is involved also in two other relevant Directives regarding the field of direct taxation, that is to say, the Merger Directive[250] and the Interest and Royalties Directive[251]. The objective of the former is to set forth a deferral of tax liability at

[248] Case C-170/05 *Denkavit Internationaal BV*. Despite its importance, this case is not the first one. See also Case C-283/94.

[249] See T. PONS, *The Denkavit Internationaal Case and Its Consequences: The Limit between Distortion and Discrimination?*, in *European Taxation*, 2007.

[250] Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchange of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States OJ L 310/34. This Directive codifies the former Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable mergers, divisions, transfer of assets and exchanges of shares concerning companies of different Member States OJ L 225 of 20 August 1990 and the following amendments contained in Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States OJ L 58 of 4 March 2005. For further reference on the relationship between the freedom of establishment and the Merger Directive, see M. DEN TOOM, H. VAN DEN BROEK, *The Freedom of Establishment and Recapture of PE Losses under the Merger Directive*, in *European Taxation*, 2018.

[251] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States OJ L 157/49.

the time of one of the operations covered by the Directive to the moment of realization, and this is made possible by a carry-over of the tax value of either the assets and liabilities transferred, or the shares exchanged.

Briefly, the Merger Directive applies only to certain operations, as provided by Art. 2, such as mergers (where one or more companies transfer all of their assets and liabilities to another company and the transferring companies are dissolved), divisions (where an existing company transfers all of its assets and liabilities to two or more newly incorporated or existing companies, which become its legal successors), partial divisions (in case the existing company is not dissolved), transfers of assets[252] (where a company transfers one or more branches of its activity to another existing or newly incorporated company), exchanges of shares (where a company acquires a holding in another existing company and obtains a voting majority in it), transfers of Registered Offices of an SE (European Society) or SCE (European Cooperative Society). The benefits deriving from the Directive are to be granted also in cases where "the assets transferred in a merger, a division, a partial division or a transfer of assets include a permanent establishment of the transferring company" (Art. 10, paragraph 1)[253]. The Tax Merger Directive is said to have a limited scope, even after the 2005 amendment, since it only deals with immediate tax problems or mergers and divisions of companies of different Member States[254].

[252] In Case C-43/00 *Andersen og Jensen ApS v Skatteministeriet*, 2002 I-379 the ECJ held that a branch transfer does not qualify if the transfer is not actually against shares but against cash.

[253] For further reference on the transfer of permanent establishment, see H. VAN DEN BROEK, M. DEN TOOM, *Transfer of a PE under the Merger Directive (2009/133): Capital Gains Taxation and the Freedom of Establishment*, in *European Taxation*, 2018.

[254] See F. BOULOGNE, *The Tax Merger Directive*, in *Fiscale Handboeken European Tax Law Volume 1*.

Art. 3 of the Directive establishes that the companies that qualify for the benefits of the Tax Merger Directive are only those that comply with the following conditions: (i) they must have one of the legal forms listed in Annex I, Part A, to the Directive; (ii) they must be resident for tax purposes in a Member State; and (iii) they must be subject to National Corporation Tax. For what concerns this last requirement, it must be pointed out that such a condition is not to be applied to shareholders. However, it might be claimed that third State shareholders may be taxed on their unrealized capital gains in a share exchange[255]. Since the wording of Article 8, paragraph 1, does not make any reference to the residence of the shareholders, it is hard to understand the meaning of the statement of the Council, unless it implies that only in case the shareholders are resident in a Member State, they can take advantage of the benefits of the Directive[256].

As much as the Parent-Subsidiary Directive, also the Merger Directive contains an anti-abuse provision. Art. 15 sets forth a general anti-abuse reservation, according to which a Member State may refuse to apply or withdraw the benefit of all or any part of the provisions of the Directive "where it appears that one of the operations referred to in Article 1: (a) is mainly or solely aimed at tax evasion or tax avoidance and is not carried out for valid commercial reasons; (b) "results in a company, whether participating in the operation or not, no longer fulfilling the necessary conditions for the representation of employees on company organs according to the arrangements which were in

[255] Such a doubt may emerge from a statement of the Council regarding the 2005 amendments, which held "that the Council and the Commission agree that Article 8 of Directive 90/434/EEC does not deprive shareholders resident in Member States of the benefits of the directive in a case where the majority holding is acquired from Community residents and from residents of third countries".

[256] The ECJ, however, has not taken into consideration this view in its decisions. See, for example, Case C-299/02 *Commission v Netherlands*, 2004, I-9761.

force prior to that operation"[257]. As it has been correctly pointed out, "abusive intent does not place a taxpayer outside the scope of the reasons for the Directive […]. Article 15 is a carve-out: transactions which in principle objectively qualify are in the end carved out by Article 15 if and because they represent abuse of the directive rights"[258].

The anti-abuse clause in the Merger Directive differs from the one in the Parent-Subsidiary Directive in that it also addresses a perceived non-fiscal abuse and contains a negative specification of abuse. It is very unlikely that the difference in framing between the two Directives will lead to material differences in the application by the ECJ.

If the Merger Directive regards the tax effects of the above described operations and the Parent-Subsidiary Directive is aimed at eliminating double taxation of intra-group cross-border dividend payments, the key principle behind the Interest and Royalties Directive is the need to ensure the freedom of establishment through the elimination of double taxation and cash-flows disadvantages of cross-border intra-group interest and royalty payments, mainly caused by withholding taxes. Simultaneously, the Directive should ensure that interest and royalties are taxed at least once in a Member State.

After having defined interests[259] (Art. 2 (a)) and royalties[260] (Art. 2 (b)), the Directive establishes the conditions a company needs to meet

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[257] The application of the anti-abuse provision has been explained by the ECJ in some cases, such as Case C-28/95 *Leur-Bloem v Inspecteur*, 1997, I-4161, or Case C-352/08 *Zwijenburg*, 2010 I-4303. For a definition of the concept of abuse in the context of the Merger Directive, see K. PETROSOVICH, *Abuse under the Merger Directive*, in *European Taxation*, 2010.

[258] See note N. 254.

[259] The term 'interest' 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 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.

to qualify for its benefits (Art. 3 (a)): (i) it must be incorporated as a legal entity included in Annex I of the Directive; (ii) it must be subject to tax in the Member State where it is incorporated; (iii) it must be resident for tax purposes in a Member State. Since the Interest and Royalties Directive covers upstream (from a subsidiary to a parent company), downstream (from a parent to a subsidiary company) and side stream (between sister companies) payments, the Directive also establishes that the companies must be associated (Art. 3 (b))[261] .

Even the Interest and Royalties Directive has an anti-abuse provision, set forth by Art. 5, which, unlike the other examples of anti-abuse rules previously described, does not contain a definition of abuse and simply (and quite broadly) establishes that "(1) this Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. (2) Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of this Directive or refuse to apply this Directive".

It might be claimed that the width of the concept of abuse of rights and the correspondent applicability of the anti-abuse provisions of the Merger Directive and the Interest and Royalties Directive might

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[260] The term 'royalties' means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films and software, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; payments for the use of, or the right to use, industrial, commercial or scientific equipment shall be regarded as royalties.

[261] A company is an 'associated company' of a second company if, at least: (i) the first company has a direct minimum holding of 25 % in the capital of the second company, or (ii) the second company has a direct minimum holding of 25 % in the capital of the first company, or (iii) a third company has a direct minimum holding of 25 % both in the capital of the first company and in the capital of the second company. Holdings must involve only companies resident in Community territory. However, Member States shall have the option of replacing the criterion of a minimum holding in the capital with that of a minimum holding of voting rights.

depend on the wording of the Articles, but the ECJ case law[262] has considered all of them "as 'reservations of competence' which – therefore – switch off the rights extended by the directives where abuse is present. This implies that the exercise of that reserved competence is not governed by the directive at issue […] but by primary EU law, notably the free movement rights"[263]. Instead, the Article 1, paragraph 4, of the Parent-Subsidiary Directive contains an obligation to refuse the Directive Benefits.

Again, it might be claimed that the Parent-Subsidiary Directive takes a decisive step ahead in the intricate pathway of tax harmonization, but, in the opinion of the writer, it does not guarantee the freedom of establishment as much as the ECJ case law in the field of tax avoidance has done.

The reason behind this decision of the EU Institutions might be political and, to a certain extent, comprehensible and acceptable, considering the need to tackle repeated phenomena of tax avoidance in the internal market and given the internationally-felt urge to intervene with efficient measures.

Although the current measures adopted at EU level in the field of tax avoidance somehow reflect the necessities of the Member States, that have always tried to protect their taxing rights, the adoption of Directives that influence the Member States' tax systems so pervasively appears to clash against the sovereignty of the Member States.

In this respect, the problem seems to be more political than juridical and the most logical and straightforward way to solve it would be for

[262] See Case C-6/16 *Eqiom SAS/ENKA* EU:C:2017:641, point 64, or Case C-14/16 *Euro Park Service* EU:C:2017:177, point 69.
[263] See note N. 58.

the Member States, to give up what remains of their sovereignty and to hand it over to the EU, which is quite unlikely at the moment.

In fact, tax avoidance could be better tackled if the EU could rule the tax systems of the Member States without limiting its competence to the harmonization of the tax systems in the view of a better shaped internal market and, consequently, no issues regarding the competence clash between the EU and the Member States could arise. In other terms, the problem of tax avoidance would not be considered under the paradigm of the respect of the internal market but, rather, as a problem itself and even the loss of tax revenue would be considered as a reasonable justification by the ECJ.

Conversely, the current legislative framework preserves the tax sovereignty of the EU Member States and gives rise to issues regarding the compatibility of the anti-tax avoidance rules set forth by the EU Member States and the fundamental freedoms.

In this context, it has been claimed that the anti-abuse provisions in the Corporate Tax Directives are superfluous. First, tax frauds may fall outside the scope of EU law benefits altogether. Secondly, as regards tax avoidance, a long list of consistent case law of the ECJ (as discussed before) shows that economic operators may be denied recourse to EU law where that recourse is frivolous, even in cases where there no statutory anti-avoidance rules apply. In this respect, Corporate Tax Directives' anti-abuse provisions are to be regarded as a specification of the general anti-abuse principle.

Unlike the Corporate Tax Directive, the Anti-Tax Avoidance Directive(s) does not stem from an original initiative of the EU but, rather, from the impulse of the OECD, and is based on different legal and political grounds. Since its core objective is to redesign and reshape, not to mention to harmonize, certain concepts concerning tax avoidance, the presence of variously crafted specific anti-abuse

provisions and of a general anti-abuse provision is nothing but justified by the very scope and essence of the Directive.

2.1 The EU Council Directive 2016/1164 (Anti-Tax Avoidance Directive 1) and the EU Council Directive 2017/952 (Anti-Tax Avoidance Directive 2). An overview

The OECD suggestions included in the BEPS Action Plan did not remain unheard and were welcomed by the EU Institutions that, in 2016, adopted the Anti-Tax Avoidance Directive 1[264], followed by the Anti-Tax Avoidance Directive 2, that partially amended the former.

These pieces of legislation will not be examined article by article but, rather, with a sort of "cherry-picking" approach, since not all the provisions included therein are relevant to the object of this piece of writing.

What matters the most in this context is the policy aspects of the ATAD and its compatibility with the EU law framework.

The ATAD 1[265] sets forth provisions that go from the deductibility of interests to the application of the exit tax, from the introduction of a general anti-abuse rule (GAAR) to controlled foreign company (CFC)

[264] In October 2016, the Commission released two proposals for the phased introduction of a harmonized European Corporate Income Tax regime, the so-called Common Corporate Tax Base (CCTB) and the Common Consolidated Corporate Tax Base (CCCTB). This regime would introduce one single European Corporate Tax language spoken in all EU Member States. In the view of the European Commission, this should deal with many international mismatches in a more effective and comprehensive way. The introduction of the ATAD would thus constitute only a first step within a broader three-step approach (ATAD, CCTB, CCCTB) towards harmonization in the field of corporate taxation within the Union. For a detailed description of the origins and the genesis of the ATAD, see A. RIGAUT, *Anti-Tax Avoidance Directive (2016/1164): New EU Policy Horizons*, in *European Taxation*, 2016.

[265] The EU issued the ATAD1 under Article 115 of the Treaty on the Functioning of the EU (TFEU), taking the position that the balance between fiscal autonomy on direct taxation and the functioning of the internal market should be mitigated in favour of the latter. Since the EU has no exclusive competence in the area of direct taxation, a proposed directive should meet the subsidiarity and proportionality tests.

rules and from a switch-over clause to a framework to tackle hybrid mismatches[266].

What appears to be more interesting and controversial is the spirit that has motivated the EU to introduce those very rules which were deemed to be in breach of EU law when they were introduced by the EU Member States.

In other words, the EU has radically changed its point of view in respect to tax avoidance, considering the threats it brings with it, and has eventually acknowledged that tax avoidance practices affect the functioning of the internal market.

The ATAD differs in its perspective from the so-called Corporate Tax Directives, aimed to eliminate obstacles in the EU Member States' domestic local income and dividend tax laws.

Under these Directives *bona fide* taxpayers executing certain transactions are the principle actors when relying on the Directive, while tax authorities will check whether a given transaction may qualify for the benefits provided therein.

In addition, where the Corporate Tax Directives were aimed at eliminating domestic obstacles potentially violating the EU fundamental freedoms, notably the freedom of establishment and the free movement of capital, the ATAD imposes measures based on a consensus reached by the Council of the EU in adopting the OECD BEPS Action Plan's recommendations.

BEPS policies as adopted by the EU focus on the intra-EU mobility of tax bases, but the main method to address this problem Is the CCCTB, which would eliminate mismatches between national systems and remove the possibility of using preferential regimes for profit shifting or to manipulate transfer pricing because intra-group transactions

[266] This last provision was amended by the ATAD2.

would be ignored and the consolidated group profits would be attributed to Member States by a formula. The CCCTB could also be a useful instrument to address the debt bias[267].

The ATAD has an inverse set-up compared with implemented Directives.

First, it addresses only one, albeit quite broad topic, such as tax-avoidance in cross-border transactions/arrangements.

The ATAD measures intervene in the working of the internal market and reverse the outcome for specific transactions or for actors on the internal market which primarily take advantage of the differences in income tax rates.

Secondly, the ATAD aims to ensure within the EU that income tax is paid where profits and value are generated, it is a correction on the existing status quo.

Since domestic tax provisions may unintendedly adversely affect the functioning of the internal market, this Directive addresses an internal market deemed functioning too good to be in accordance with primary EU law.

This is a novel and far-reaching concept in direct taxation, likely subject to challenge and if upheld could provide the EU Institutions with more power in the area of direct taxation. However, it can be questioned whether under Article 5 TEU EU Member States have conferred such competences to the EU in the area of direct income taxation.

It might be claimed that the ATAD seems to be based, essentially, on the assessment of the functioning of the EU internal market by the Council of the EU and/or EU Commission.[268]

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[267] In this respect, see C. GARBARINO, *Harmonization and Coordination of Corporate Taxes in the European Union*, in *EC Tax Review*, 2016.

As outlined by the Commission[269] "the Anti-Tax Avoidance Directive is one of the constituent parts of the Commission's Anti-Tax Avoidance Package, which addresses a number of important new developments and political priorities in corporate taxation that require quick reaction at the level of the EU".

The Directive, which sets out legally binding rules to enable Member States to effectively tackle corporate tax avoidance, is aimed at balancing the taxing power of the Member States with the Treaty Freedoms and EU Law in general.

As it was previously mentioned, it represents the effort EU Institutions have decided to make to give a strong response to the OECD BEPS initiative. The key that makes this piece of legislation – at least in principle – more effective than the OECD BEPS Action Plan is the binding nature of the tool that the EU has used.

Obvious as it may seem, this is what makes the difference between an international organization and the intrinsic flaws of systems based on soft law and a supranational organization such as the EU.

The ATAD1 (as well as the amending ATAD2) is just part of a wider strategy the EU has recently started to enact in order to attain the long longed objective of tax harmonization, which includes also the introduction of a Common Consolidated Corporate Tax Base (CCCTB).

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[268] In this respect, see A. DE GRAAF – K.J. VISSER, *ATA Directive: Some Observations Regarding Formal Aspects*, in *EC Tax Review*, 2016.

[269] Explanatory Memorandum of the Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market COM(2016) 26, 2016/0011 28 January 2016. The political necessity to introduce anti-avoidance provision evidenced by the OECD and the EU is enhanced by the fact that "budget deficits forced countries to look for new money. Where the focus was for a long time on tax competition, now the focus is much more on tax coordination". In this respect, see E.C.C.M. KEMMERMEN, *Where is EU Law in the OECD BEPS Discussion?*, in *EC Tax Review*, 2014.

As pointed out by the EU Commission in the same Explanatory Memorandum, "the Directive aims to achieve a balance between the need for certain degree of uniformity in implementing the BEP outputs across the EU and Member States' needs to accommodate the special features of their tax systems within these new rules".

In other terms, what the EU is trying to obtain with such Directive is a minimum level of harmonization, some primary principles that should serve as pillars for the implementation of the BEPS Action Plan.

The implementation of this theory of a "minimum level of protection" raises many questions as to how to assess whether a domestic system safeguards a sufficiently high level of protection of domestic corporate tax bases[270].

In the opinion of the writer, this approach is more intriguing and controversial than it may look at first sight.

From one perspective, it represents a sort of awakening of consciousness of the EU, which has realized how crucial it is for the survival of the internal market to defeat or, at the very least, to tackle tax avoidance and to prevent certain practices that have been allowed by some EU Member States.

From the opposite perspective, the necessity to introduce a piece of statutory legislation such as the one in object would incontrovertibly go against the previous ECJ case law on this issue, which has often regarded national anti-abuse or anti-avoidance measures as in breach of EU Law.

[270] In this respect, see D. GUTMANN – A. PERDELWITZ – E. RAINGEARD DE LA BLÉTIÈRE – R. OFFERMANNS – M. SCHELLEKENS – G. GALLO – A. GRANT HAP – M. OLEJNICKA, *The Impact of the ATAD on Domestic Systems: A Comparative Survey*, in *European Taxation*, 2017. The Authors wonder if the level of protection must be assessed generally or on a "provision-by-provision" basis.

It might be pointed out that an EU approach towards[271] this matter would deal with the problems regarding the compatibility of national provisions with the fundamental freedoms in a consistent manner.

On the other hand, there still is a sort of mismatch between the previous ECJ case law and the current legislative framework.

It is true that the ECJ has always insisted on the application of the principle of proportionality in cases involving the compliance of national anti-avoidance measures with EU law, and such approach has been adopted also by the ATAD1.

Another interesting issue regards the application of the principle of proportionality.

In fact, such principle has been applied by the ECJ in order to keep a balance between the integrity of the internal market and the need to ensure the protection of the taxing rights of the Member States. Once the EU has introduced the ATAD as a tool to tackle tax avoidance and to protect the common market from abusive practices, the ECJ will be asked to balance EU primary law with this piece of EU secondary law, or- better yet – with the pieces of legislation the EU Member States will adopt to implement it.

This could result in a different application of the principle of proportionality: while it used to represent the extent to which the Member States' legislation could "legitimately" restrict the fundamental freedoms, it will now be regarded as the extent to which a certain EU law principle (*e.g.* the fundamental freedoms) prevails

[271] With reference to the necessity, felt at EU level, to intervene in the area of direct taxation to tackle episodes of tax avoidance, it has been observed that "an understanding between Member States and the EU Institutions (more than simple tax coordination and less than full tax harmonization) is necessary to turn the situation into a clear benefit for all […]. Soft harmonization would not harm competitiveness and economic growth in the European Union, as only an approximation of the 27 tax systems can eradicate harmful tax competition". In this respect, see P. LAMPREAVE, *Fiscal Competitiveness versus Harmful Tax Competition in the European Union*, in *Bulletin for International Taxation*, 2011.

over another principle (*e.g.* the general principle of prohibitions of the abuse of rights).

In any case, the EU appears to be more inclined to the introduction of anti-avoidance rules than it used to be in the past, possibly because, in this case, the EU Member States are asked to implement EU law, instead of shaping their own tax systems[272]. What is clear is that the EU has never felt so impellent the urge to vehemently intervene in the field of direct taxation[273].

Shifting the adoption of anti-avoidance measures from a Member States level to a EU level will have a significant impact[274] on the level

[272] As it is possible to see, the discussion around the implementation of anti-avoidance measures is highly politicized: on the one hand, the EU approach is preferable, especially if we consider the integration of the EU internal market as a medium to long-term objective; on the other hand, direct taxation falls within the competence of the EU Member States, that should be able to shape their tax systems at their best convenience, which includes, also, the adoption of anti-avoidance measures. In the opinion of the writer, the first approach seems more farsighted since every EU Member State could benefit from a package of shared values, even in the field of tax avoidance. The twist of the EU and the sudden awakening of consciousness, that was previously mentioned, is what raises more doubts, provided that the adoption of anti-abuse measures, as envisaged by the ATAD, seems to be an acceptable restriction of the fundamental freedoms, just because the EU has realized how a big threat to the common market tax avoidance is. Again, the competition-oriented approach that characterizes the policy of the EU in the field of direct taxation differs from the budget-related interests of the EU Member States and, thus, does not consider the raise of revenue as a legitimate objective the Member States could pursue under the EU law framework.

[273] In this respect, see M. FLORIS DE WILDE, *The European Commission's Anti-Tax Avoidance Package: A Stop along the Route or the Final Destination?*, in *EU Law and the Building of Global Supranational Tax Law: EU BEPS and State Aid – Online Book*, 2016.

[274] It could be observed that the application of the concept of tax avoidance and the approach of the ECJ towards this issue is different from the approach adopted by the national tax systems. In fact, while the objective of countering tax avoidance in national tax systems consists of eliminating non-taxation or reduction in taxation in one single system where the legislator has complete control over the tax base and taxpayers, EU Law does not have the same objective. In fact, the role of the ECJ is limited to eliminating the abuse of EU Law, including abuse of E Law to circumvent the national tax rules of the Member States. However, if a taxpayer effectively exercises the fundamental freedoms, there can be no abuse of EU Law. In this respect, see F. VANISTENDAEL, *Is Tax Avoidance the Same Thing Under the OECD Base Erosion and Profit Shifting Action Plan, National Tax Law and EU Law?*, in *Bulletin for International Taxation*, 2016. In the opinion of the writer – which has been expressed also in few other parts of this Chapter – the ATAD unduly expands

of complexity of the legal reasoning of the ECJ, because evaluating the compatibility of national provisions with EU law is far easier than assessing which piece of EU legislation should prevail, unless we identify the ATAD as a stand-alone piece of legislation and not as the expression of the prohibition of abuse of rights. But, if this were the case, the principle of proportionality could never be applied, because the fundamental freedoms should always prevail over a piece of secondary legislation.

From a formal, rather than political, point of view, it has been observed that the ATAD "gives Member States numerous choices in the way they wish to implement the ATAD provisions. Essentially, the ATAD has the characteristics of a menu of options"[275].

This has led to the conclusion that the ATAD does not seem to be properly consistent with its purposes since it establishes only a minimum level of protection and multiple options for the Member States that can jeopardize its application[276].

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the power of the EU in the field of direct taxation. As a result, the purpose of the EU on its fight against tax avoidance radically changes: tax avoidance turns out to be the main focus of the EU and of its Institutions (ECJ included), and is felt as disruptive for the integrity and the cohesion of the internal market. In other terms, the ECJ has now become competent to give a final answer to questions on what tax abuse is. It is, in a nutshell, a competence creep of the EU in tax matters, in an area of formerly national sovereignty. With reference to the use of tax sovereignty, see T. DAGAN, *International Tax and Global Justice*, in *Law, Theoretical Inquiries in Law*, 2017, where the Author points out that tax sovereignty could be regarded as protectionist, when it seeks to protect the raise of revenue and, more broadly, the welfare state, or as aggressive, as it is aimed at attracting foreign investors.

[275] D. SMIT, *The Anti-Tax Avoidance Directive (ATAD)*, in P.J. WATTEL, B. TERRA, (ed), *Fiscale Handboeken European Tax Law*, Volume 1 (Seventh Edition, Wolters Kluwer), 2018, p. 489.

[276] In this respect, see G. BIZIOLI, *Taking EU Fundamental Freedoms Seriously: Does the Anti-Tax Avoidance Directive Take Precedence over the Single Market?*, in *EC Tax Review*, 2017. The Author also suggests that the "as far as the fundamental freedoms are concerned, the main issues of compatibility concern the general anti-abuse provision, with particular regard to […] the CFC legislation […]", which will be discussed in § 2.1.2.

2.2 General Anti-abuse rule (GAAR) (Art. 6)

The first provision that needs to be examined is Art. 6, which sets forth a General Anti-abuse rule (GAAR), in contrast with the other specific anti-abuse rules established by the ATAD.

The GAAR might be regarded as either a general legal principle or a general rule. According to Dworkin[277], there are two main differences between rules and principles. First, rules are all-or-nothing norms, while principles may allow some degree of optimization in their application and enforceability. In other terms, while rules either apply or do not apply, principles need to be balanced with and take into account other competing principles. Secondly, principles have a dimension of weight and importance that is lacking in rules[278]. That being said, it is important to understand the concept and implications of general principles of EU Law.

In this context, general principles of EU Law can be defined as fundamental propositions of law of some importance from which concrete rules derive[279] and their functions is basically threefold: 1. A gap-filling function to ensure the autonomy and coherence of the EU legal system; 2. An aid to interpretation of EU Law and national law falling within the scope of EU Law; 3. A grounds for judicial review of the legality of secondary EU Law and the compatibility of national law transposing secondary EU Law[280].

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[277] R. DWORKIN, *Taking Rights Seriously*, in *Harvard University Press*, 1977.

[278] In this respect, see J. DÀCIO ROLIM, *The General Anti-Avoidance Rule: Its Expanding Role in International Taxation*, in *Intertax*, 2016.

[279] In this respect see A. ZALASIŃSKI, *The Principle of Prevention of (Direct Tax) Abuse: Scope and Legal Nature – Remarks on the 3 M Italia Case*, in *European Taxation*, 2012. Case C-417/10 *3 M Italia* shows that no general obligation for the Member States obtains to avoid abuse under domestic tax laws.

[280] In this respect, see T. TRIDIMAS, *The General Principles EU Law 1*, Oxford University Press, 2006.

In this respect, it is controversial as to whether a GAAR should be regarded as a principle.

In fact, considering the way it is shaped and designed, its level of abstraction and its degree of importance it might be claimed that it serves as a general principle, a pillar of the entire system which guarantees the reliability of the tax rules introduced by the ATAD.

More importantly, while the other rules specifically address certain abusive practices and somehow reflect some primary law principles, the GAAR itself is a stand-alone principle and, despite it is set forth by a piece of secondary legislation, it has a "constitutional value" that goes beyond the piece of legislation at issue.

Conversely, it could be argued that in a context such as the one represented by the EU, however, with a specific set of values and the ECJ case law that has often regarded anti-avoidance measures as in breach of the fundamental freedoms, portraying the General Anti-Avoidance Rule as a general principle could be considered as a dangerous and extremely restrictive tool the tax administrations could use because its indeterminacy could result in its extensive interpretation and, thus, in a restriction of the taxpayers' rights.

More realistically, it is reasonable to state that the GAAR merely specifies a wider, deeper and even more indefinite concept, such as the abuse of law, which better suits as a general principle.

Also, as suggested by the ATAD's preamble, the "inclusion of the GAAR aims to fill gaps"[281]. As it was previously underlined, this may lead to the conclusion that the GAAR is a general principle.

In this respect, it is uncertain if this implies that it should not affect the applicability of specific anti-abuse rules or, conversely, if it would

[281] D. SMIT, *The Anti-Tax Avoidance Directive (ATAD)*, in P.J. WATTEL, B. TERRA, (ed), *Fiscale Handboeken European Tax Law*, Volume 1 (Seventh Edition, Wolters Kluwer), 2018, p. 530.

apply only in those cases where other SAARs apply. In other terms, there seems to be room to apply the GAAR even if a SAAR specifically deals with a certain from of tax avoidance, but still leaves a loophole in that area[282].

In the opinion of the writer, the "filling gaps clause" is not meant to allow the simultaneous application of the GAAR and the SAARs but, rather, to apply the GAAR in those circumstances where a SAAR is not directly applicable.

It seems clear, however, that Article 6 of the ATAD is not intended to apply to the situations addressed by the anti-abuse rules included in other directives, since the first phrase of that Article is: "for the purposes of calculating the corporate tax liability […]".

In the opinion of the writer, however, the fact that the provision in object is not meant to replace the anti-abuse provisions of the so-called Corporate Directives and is not to be considered as a general principle of EU Law does not diminish its importance, nor does it reduce the risks of over-restricting the rights of the taxpayers, which remains in the hands of the ECJ, which will be asked, time after time, to give its authentic interpretation of the EU GAAR and to carefully apply the principle of proportionality.

Having a closer look at the GAAR as set forth by the ATAD, it basically entails three cumulative conditions: 1. Artificiality; 2. Motive; 3. Defeat of object and purpose of corporate tax law. If all these conditions are fulfilled, the arrangements must be ignored, and the tax liability must be calculated in accordance with national law.

The first condition requires an arrangement or a series of arrangements which are not genuine having regard to all relevant facts

[282] In this respect, it has been highlighted that the ECJ's case law seems to point in the opposite direction. See, for instance, Case C-2/94 *Denkavit Internationaal and others*, EU:C::1996:229 and Case C-39/16 *Argenta Spaarbank NV* EU:C:2017:323.

and circumstances. Pursuant to Art. 6, paragraph 2, of the ATAD 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.

As established by the preamble of the evaluation of the non-genuine nature of an arrangement or a series thereof is must be made according to all the valid economic reasons such arrangement(s) could be based on[283].

This condition reflects the idea of source country entitlement underlying the ATAD, meaning that business profits should be taxed in the jurisdiction in which the economic activities generating these profits are performed and value is created. Interpretation of the GAAR on that basis could, however, undermine the Member States' corporate tax regimes which still take the legal reality as the starting for taxing multinational enterprises.

It might be argued that from an economic perspective, the establishment of subsidiaries in other Member States usually lacks of real economic substance, since it is necessary to determine where the activities take place and which value should be attributed to them, based on the arm's length principle[284].

If this is the approach to be followed under the GAAR, that would imply a hidden standard of the true tax charge, based on economic analysis and irrespective of legal reality[285].

In this respect, however, it must be pointed out that the application of the GAAR is not only related to transfer pricing issues, as it could be

[283] Recital 3 of the preamble of Council Directive (EU) 2016/1164.

[284] In this respect, see F. VAN BRUNSCHOT in his case note to the decision by the Netherlands Supreme Court dated 15 October 1986, n. 23 702, *Beslissingen in Belastingzaken*, 72 (1986).

[285] In this respect, see M. F. DE WILDE, *The ATAD's GAAR: A Pandora's Box?*, in *The Implementation of the Anti-BEPS in the European Union: A Comprehensive Study*, eds. P. PISTONE – D. M. WEBER, IBFD.

inferred by the previous statements. There is the risk, however, that the application of the GAAR may result in an evaluation of the correct price of a given arrangement or transaction, at least in those cases where the establishment of a subsidiary in a Member State is followed by intra-group transaction that do not comply with the arm's length standard[286].

For what concerns the second condition, the GAAR requires the non-genuine arrangement to have been put into place for the main purpose or one of the main purposes of obtaining a tax advantage. In its case law, the ECJ has typically looked for objective factors (for example, the absence of economic substance or the derogation from the arm's length standard) which are ascertainable by third parties that can shed light on the taxpayer's (assumed) intention. These factors also form part of the previous condition.

Motive, then, is mainly inferred from objective facts and circumstances which are difficult or impossible to explain if one ignores the tax effects. If the taxpayer does not simply admit that its main driver was tax, the motive condition operates as a rebuttal possibility: if the fact pattern has the suspicious looks of a tax avoidance set up, the taxpayer may prove otherwise by pointing out significant non-tax purposes.

Finally, the GAAR requires that obtaining the tax advantage defeats the purpose of the applicable tax law. This last condition must be fulfilled concretely, having regard to the actual effect of a given arrangement/transaction, and not just potentially. The assessment on whether an arrangement/transaction defeats the purpose of the corporate tax law is must be made a case-by-case in the light of the object of the domestic corporate tax provision at stake.

[286] Once again, as it was underlined in the first Chapter, the arm's length principle is seen as an anti-tax avoidance measure.

2.2.1 A first step into the "new world": the US General Anti-abuse rule

This subsection represents a bridge between this Chapter and the following one, that regards the US tax system.

As it was mentioned in the first Chapter, in fact, the approach followed by the EU and the US is very different and such a difference is shown, for example, by the comments to BEPS Action 6 received by the OECD: while the EU Member States were more inclined to the adoption of a PPT rule whereas the US seemed sceptical towards that strategy and preferred the Limitation on Benefits rule[287].

Until 2010, the United States resisted pressure to enact a statutory general anti-avoidance rule[288]. Instead of a statutory anti-avoidance rule, the US had a judicially developed anti-avoidance rule, first established by the Supreme Court in Gregory v. Helvering[289].

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[287] The BEPS Action Plan has been widely discussed in the U.S., and not only for the concerns related to the application of Action 6. For more details on the topic, see M. M. LEVEY – A. MANSFIELD, *The Key BEPS Action Items Causing Discussion in the United States*, in *Intertax*, 2016. The Author points out that "although generally supportive of the conceptual framework of these Proposals, the United States has been more sceptical of the OECD's BEPS Action Plan than other countries".

[288] Proposals to introduce a statutory general anti-avoidance rule to the United States have come before the United States House of Representative on a number of occasions. See, for example, the Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003, H.R. 1555, 108th Congress (2003).

[289] Case *Gregory v. Helvering*, 29 U.S. 465, 469 (1986). In Gregory, the Second Circuit, and then the Supreme Court, considered a transaction in which the United Mortgage Corporation dropped stock of the Monitor Corporation into the Averill Corporation, a wholly-owned subsidiary of United Mortgage; and then the stock of Averill was distributed to Mrs. Gregory, the sole owner of United Mortgage. Mrs. Gregory reported tax-advantaged capital gain when she dissolved Averill and promptly transferred to Monitor shares to a third-party buyer. The taxpayers claimed that there was no taxable dividend because the distribution qualified as corporate reorganization. The court held that the transaction would be taxed as a dividend distribution. In such case, Judge Hand declined to apply purely textualist approach to the interpretation of tax statutes. Instead, he decided that any "transactions lacking economic and business purpose, other than to capture a tax advantage by meeting specific statutory requirements fail [the substance-over-form] judicial test". In other terms, the case at issue stands for the proposition that transactions that only exist for

The rule is often referred to as the economic substance doctrine[290]. It operated in a similar manner to the U.K. judicially created rule[291].

The substance doctrine is based on a substance-over-form approach to distinguish transactions that unlawfully avoid taxes from those that simply minimize a taxpayer's tax burden to an extent that is consistent with the intent of the taxing statute[292].

In 2010, however, the United States codified its economic substance doctrine by means of a somewhat improbable vehicle: the Health Care and Reconciliation Act of 2010, which was primarily concerned with sweeping changes to the United States health care system[293]. There

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participants to take advantage of their associated tax benefits, without legitimate business-related purposes, will be deemed to lack economic substance. Courts will therefore deny any tax benefits that the participants sought to enjoy. See also S. A. BANK, *When Did Tax Avoidance Become Respectable?*, in *Tax Law Review*, 2017.

[290] In this respect, see C. M. PIETRUSZKIEWICZ, *Economic Substance and the Standard of Review*, in *Alaska Law Review*, 2009. See case *Frank Lyon Co. v. United States*, 433 U.S. 561, 1978., where the Supreme Court offered a formulation of the economic substance doctrine. The case involved a sale-leaseback transaction in which Worthem, a bank that did not need depreciation deductions to minimize tax, financed its new bank building by selling the building to Frank Lyon, which could use the deductions. The transaction gave Worthen an option to buy back the building from Frank Lyon. Because of the low exercise price of the option, Worthen was sure to exercise it. The Supreme Court upheld the transaction and allowed the depreciation deductions claimed by Frank Lyons. The Court reasoned that the overall transaction had both objective economic substance and subjective business purpose. The multiparty nature of the transaction provided evidence of objective economic substance. The goal of building a new bank building while remaining compliant with banking regulations provided evidence of business purpose. The *Frank Lyon* decision illustrates a weakness of a holistic analysis that focuses on business, or non-tax, purpose: such an analysis can validate tax avoidance that happens to occur in the course of a transaction otherwise motivated by nontax goals.

[291] Health Care and Education Reconciliation Act of 2010 § 1409, U.S.C. § 7701, 2010.

[292] In this respect, see H. ORDOWER, *The Culture of Tax Avoidance*, in *St. Louis University Law Journal*, 2010.

[293] President Barack Obama signed § 7701(o) of the Internal Revenue Code, the first U.S. statutory general anti-avoidance rule, into effect on 30 March 2010. The birth of the American GAAR was buried in § 1409(a) of the Health Care and Education Reconciliation Act of 2010 (H.R. 4872). With § 7701(o) the muster of common law jurisdictions without GAARs is dwindling, India and the UK remain prominent hold-outs.

appear to be two main reasons that delayed the introduction of a GAAR for so long[294].

First, it seemed that the US could manage without a GAARS. America take a more substantive, less formalistic, approach to statutory interpretation than to other common law countries; so, the IRS was generally able to get by with various forms of the economic substance doctrine. But since about 2000, the IRS has found the economic substance doctrine increasingly ineffective, as seen in cases like Compaq Computer Corp v. Commissioner[295].

Secondly, the public institutions of the US have always had a healthy respect of the rule of law[296].

The United States' (relatively) new statutory general anti-avoidance rule operates in much the same way as a statutory rule in other countries. Section 7701(0) applies to "any transaction to which the economic substance doctrine is relevant". A standard GAAR says that an avoidance transaction is void for tax purposes and authorizes the Commissioner to reconstruct the transaction and to tax that notional reconstruction.

The Obama GAAR strikes down a transaction where the economic profit is not "substantial" in relation to its net tax benefits.

In this respect, Section 7701(o) sets out a two-part test that can be implemented to determine whether a transaction has "economic substance" in the event that a court decides to apply the doctrine[297]. The test states that a transaction is to be "treated as having economic substance only if: a) the transaction changes in a meaningful way […]

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[294] In this respect, see J. PREBBLE, *An American GAAR*, in *Victoria University of Wellington Legal Research Papers*, 2017.

[295] Case *Compaq Computer Corp v. Commissioner*, 277 F. 3d 778 (5th Cir. 2001).

[296] For a critical opinion on the necessity to adopt a GAAR, see, for example, G. S. COOPER, *International Experience with General Anti-Avoidance Rules*, in *SMU Law Review*, 2001.

[297] I.R.C., § 7701(o) (2012) (clarifying out the objective prongs of the two-part economic substance test).

the taxpayer's economic position, and b) the taxpayer has a substantial purpose […] for entering into such transaction"[298].

The best reading of this two-part test is that both conditions are trying to get at why the taxpayer undertook the transaction, or whether the transaction was tax motivated. The goal of discerning motive is clearly stated in the "subjective" non-tax purpose condition[299]. It is also present in the objective prong, as this analysis similarly focuses on whether the transaction would happen without the tax savings, or whether "it alters the taxpayer's economic position in a meaningful way"[300].

Courts may choose to apply the economic substance-doctrine in cases where taxpayers claim tax advantages that carry potential for abuse[301]. Examples of such potentially abusive advantages include the foreign tax credit and other special tax benefits. When the U.S. income tax was born in 1913, taxpayers were permitted to deduct foreign tax expenses[302]. In 1918, Congress switched gears and decided to grant foreign tax credits to taxpayers who pay income taxes to foreign governments[303]. The reasoning behind the government's allowance of this dollar-for-dollar credit against U.S. federal income taxes stems from two fundamental attributes of the U.S. income tax system:

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[298] I.R.C., § 7701(o) (2012).

[299] In this respect, see D. HARITON, *Sorting Out the Tangle of Economic Substance*, in *Tax Law*, 1999.

[300] S. C. MORSE – R. DEUTSCH, *Tax Anti-Avoidance Law in Australia and the United States*, in *International Lawyer*, 2015.

[301] J. BANKMAN, *The Economic Subsatnce Doctrine*, in *California Law Review*, 2000. The Author underlines that "the recent phenomenon of corporate tax shelters has produced a resurgence in the use of common law [anti-abuse] doctrines […] Courts have […] used common law doctrines to deny tax benefits to shelter participants".

[302] M. GRAETZ, *Taxing International Income_ Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, in *Brooklin Journal of International Law*, 2001.

[303] See previous note.

taxation on the worldwide income of its taxpayers and a general aversion to double taxation[304].

The U.S. taxes resident aliens and citizens are taxed on their worldwide income. By taxing income sourced from outside the U.S., the government risks reaching income that has already been subject to income tax by a foreign government. This is where the foreign tax credit becomes relevant to the discussion[305]. The allowance of foreign tax credit has also opened an extra door to abusive tax avoidance. Certain tax shelters[306] involve the production of foreign tax credits, using transactions designed to create a tax arbitrage"[307]. As a result,

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[304] J. P. FULLER – F. R. CHILTON – R. B. SCHROTENBOER, *The Foreign Tax Credit*, in *Hastings International Comparative Law Review*, 1981. According to the Authors: "Under United States tax law, United States residents and corporations are taxed on their worldwide income […] When income is earned outside the United States, it is usually also taxed in the country in which it originates. As a result, the problem of international double taxation arises. The principal method coping with international double taxation by the United States is by means of the foreign tax credit [,which] is a dollar-for-dollar credit against U.S. income tax liability for income taxes paid to foreign countries […] During World War I […] the tax rates in the United States and abroad increase […] highlight[ing] the problem of double taxation of foreign income […] In order to minimize these problems, Congress enacted the foreign tax credit in 1919".

[305] Generally speaking, if a taxpayer paid or accrued foreign taxes to a foreign country or U.S. possession and is subject to U.S. tax on the same income, [the taxpayer] may be able to take either a credit or an itemized deduction for those taxes.

[306] Professor Bankman provided a working definition of tax shelter, according to which a tax shelter is "a tax motivated transaction unrelated to a tapayer's normal business operations that, under a literal reading of some relevant legal authority, produces a loss for tax purposes in excess of any economic loss, in a manner inconsistent with legislative intent or purpose". In this respect, see J. BANKMAN, *The Tax Shelter Problem*, in *National Tax Journal*, 2004. Such a definition, however, only focuses on transactions aimed at creating losses, but it should also include transactions structured to avoid or defer income recognition, to convert ordinary income into preferentially treated capital gain, or to achieve any other favourable tax treatment. In this respect, see E. M. JENSEN, *Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives*, in *St. Louis Law Journal*, 2012.

[307] In this respect, see J. H. TEMKIN, *The Economic Substance of Foreign Tax Credits*, in *New York Law Journal*, 2015. In the U.S. case-law there are some examples of tax shelters. In case *Black & Decker v. United States* (436 F.3d 431, 4th Circ., 2006), for instance, the tax results depended on the treatment of contingent liabilities. In 1998, Black & Decker ("B & D") and several other entities created a new corporation, Black & Decker Healthcare Management Inc. ("BDHMI"). B & D

courts have determined that certain tax benefits, like foreign tax credits, should be reserved for valid transactions with "economic substance"[308].

However, the application of such a principle has not been homogenous among the various U.S. Courts: in fact, while the First, Second, and Federal Circuits (also known as the "STARS" Courts) have stated that the foreign tax paid out should qualify as costs to be deducted in the calculation of pre-tax profit for the purposes of the economic substance doctrine, the Fifth and Eighth Circuits (also known as the "ADR Courts") have denied this deduction.

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transferred $ 561 million in cash, together with $ 560 million in contingent employee and retiree healthcare benefit claims, to BDHMI in exchange for all the shares of one class of preferred stock. B & D later sold the preferred stock to a third-party facilitator, a trust formed by a former B & D employee, for $ 1 million. Because B & D was part of a group of transferors of property in control of BDHMI immediately after the exchange, the formation of the corporation was tax-free under I.R.C. §351. The basis rules associated with §351 transactions generally provide for carryover or substituted bases: a transferor of property will generally have basis in stock received equal to the basis of the property contributed, and the corporation's basis in contributed property will generally be the same as the transferor's was. B & D took the position that, at the time of the healthcare claims' transfer to BDHMI, the obligations were too contingent to be treated as liabilities under the basis rules. As a result, B & D said its basis in the $ 1 million worth of BDHMI stock was $ 561 million, the amount of cash transferred, unaffected by the contingent obligations. When B & D sold the stock for $ 1 million, it claimed a $ 560 million loss. B & D had contributed net value of $1 million, had sold its interest for $ 1 million, and nevertheless had claimed a loss of $ 560 million – a loss that, if honoured, could have been used to offset substantial capital gains that had been realized by the corporation. The government challenged that position. There should have been a serious dispute about the meaning of "liability" in the relevant I.R.C. provisions, but, without discussing the Code, the trial judge in 2004 accepted B & D's interpretation and granted its motion for summary judgment. And, although the judge understood that only tax considerations had motivated the transaction – B & D had conceded that point for purposes of the summary judgment motion – he concluded that there was enough indisputable economic substance for the transaction to be honoured: BDHMI became responsible for the healthcare claims, had employees, and so on. Had the transaction, not taken place, B & D would eventually have been able to deduct the $ 560 million anyway, year by year as the claims were satisfied. But, under B & D's theory, accepted by the trial judge, the effect was an immediate deduction of the full $ 560 million – a dramatic acceleration of the tax benefits.

[308] C. J. LUBRANO, *Tax Law – Second Circuit Accurately Applies the Economic Substance Doctrine to Foreign Tax Credits – Bank of New York Mellon Corp. v. C.I.R., 801 F3d 104 (2nd Cir. 2015)*, in *Suffolk Transnational Law Review*, 2016.

As it was previously stated, The GAARs have often been sceptically considered in the context of U.S. tax law.

GAARs are flexible, broad standards and such flexibility affords both the ability to keep up with a fast-paced tax shelter industry and decreased certainty in the law for non-abusive taxpayers.

A GAAR, by definition, is broadly written.

Unclear boundaries make it far more difficult for avoidance-minded taxpayers to plan around or right up to its limitations[309]. From this, GAARs are considered nimble, flexible rules that can easily expand to cover the latest tax shelter[310]. They also eliminate the traditional lag between the introduction of a tax shelter and the promulgation of a SAAR prohibiting it[311].

However, this same flexibility results in a marked decrease in the certainty of law[312]: taxpayers may be unsure of whether a new method of structuring a transaction is an illegal tax shelter or a legitimate way to do business. Such uncertainty hits taxpayers, especially those with no interest in avoiding taxes, the hardest.

The question for a taxpayer trying to conduct business is whether the legitimate transaction that may have the effect of reducing the taxpayer's tax burden, or is the lesser taxed choice from a menu of alternative structures, could still be voided under the GAAR, notwithstanding the taxpayer's legitimate goals[313].

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[309] In this respect, see C. EVANS, *Barriers to Avoidance: Recent Legislative and Judicial Developments in Common Law Jurisdictions*, in *Hong Kong Law Journals*, 2007.

[310] In this respect, see J. PREBBLE, *Ectopia, Formalism, and Anti-Avoidance Rules in Income Tax Law*, in *VUWLRP*, 2011.

[311] In this respect, see R. LAVOIE, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, in *U. Col. Law Review*, 2004.

[312] In this respect, see E. TROMBITAS, *The Role for a General Anti-Avoidance Rule in a GST*, in *New Zealand Journal of Tax Law and Policy*, 2007.

[313] In this respect, see G. LOUTINSKY, *Gladwellian Taxation: Deterring Tax Abuse Through General Anti-Avoidance Rules*, in *Houston Business and Tax Law Journal*, 2012.

To sum up, § 701(o) of the I.R.C., as a recently enacted provision, does not yet have a breadth of court cases, Treasury determinations, rulings and written guidance, or scholarly articles that other nation's GAARs, has.

However, an educated prediction can be made.

The whole point of § 701(o) was to codify an existing judicial doctrine – the perennially popular economic substance doctrine. It will, like any law, raise a multitude of concerns and issues. It may deny legitimate tax benefits. However, the more immediate issue with new § 701(o) seems to be that GAARs are well intentioned but improperly aimed. They will not impact the chronic tax avoiders at whom Section 701(o) is aimed. The economic substance doctrine, as a judicial doctrine, was too broad to conclusively prevent chronic tax avoiders from abusing the tax code[314].

2.3 Controlled Foreign Company rule (art. 7 and 8)

The final subparagraph of this Chapter regards the EU statutory version of CFC rules.

As it was previously mentioned in the first Chapter, CFC rules have been addressed by the OECD BEPS Action Plan and apply to I.P. Companies.

The disposal to an offshore entity achieves its aim only if the multinational is able to understate (within transfer pricing rules) the value of the asset when it is transferred. Additionally, if the offshore entity remits royalties to its parent co in the full value of the asset, the

[314] In this respect, see A. MONRORE, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse)*, in *W. Res. Law Review*, 2010; J. B. LIBIN, *Congress Should Address Tax Avoidance Head-On: The Internal Revenuue Code Needs a GAAR*, in *Va. Tax Review*, 2010. According to the Author, the GAAR will not solve the tax abuse problem completely, because "tax minimization is part of our taxpayer culture".

tax planning motive is nullified. "Licensing-out a patent in a low-taxed subsidiary only results in a reduction of the group's effective tax burden, if the royalty payment corresponds only to a fraction of the return from exploiting the patent"[315]. Therefore, transfer pricing documentation and valuations is necessary for tax arbitrage and profit shifting, because it is a necessary tool for understating/overstating the value of an asset in a transaction whether it is a sale for consideration or a license in exchange of royalties.

A *caveat* to the above statement stems from the accounting treatment of intangibles, where it was ascertained that expensed, self-generated intangibles may hide their true value, thus allowing for an easy understatement of their actual value. On top of that, many academics claim that the public indignation with the emigration of IP is hypocritical, or at the very least ignorant: accusations in this respect would be valid if it was possible to simply make disappear an asset from the books and move it offshore. But most jurisdictional rules make it simply impossible to move the asset without recognizing capital gains (or losses) or without charging tax on the later inbound royalty. Therefore, both the increase in value and the income from the royalty are still subject to the taxation of the original jurisdiction[316] (unless perpetual deferral is achieved).

The counterargument to the accusations against MNEs migrating their IP, is threefold: 1. IP migration essentially only causes a deferral of taxation; 2. IP migration is often fully justified under business reality and the complex administrative needs of managing IP on a worldwide level; 3. Tax authorities have huge array of tools and provisions to

[315] R. GHAFELE, *WIPO, Getting a Grip on Accounting and Intellectual Property*, http://www.wipo.int/sme/en/documents/p_accounting_fulltext.html.

[316] M. HARDGROVEE – A. VOLOSHKO, *IP Migration, What the fuss is about?*, http://buildingIpvalue.com/taxation/hardgrove.html.

challenge both the deferral and to test, often unilaterally, the business reality of the emigration.

It is also important to note that global structuring of IP may not have a sole determinant tax arbitrage, but may be dictated by other legal, economic and administrative reasons (such as protection of intangible property, capital funding, sharing in intangible development risks, tax credit issues, etc.)[317].

IP migration to a low-tax jurisdiction is combatted by many jurisdictions, especially by the draconian IRS rules[318].

Whereas in the pre-BEPS era, legal ownership would entitle the offshore entity to full profits, in the post-BEPS era, economic substance and control, assumption of the risk etc. are much more relevant in the final attribution of profit.

Although the most direct contribution of the BEPS Action Plan in the fight against tax avoidance through IP Companies is the strengthening of TP Guidelines (as described in the previous Chapter), CFC rules are expected to have a certain impact too, especially in the EU context, considering the approach the EU Institutions have had towards national CFC rules so far.

Intellectual Property will usually migrate and be held in a jurisdiction with a lower or zero worldwide income tax rates.

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[317] International Tax Review: *IP migration strategies pre-and post-BEPS* http:internationaltaxreview.com/Article/3556018/IP-migration-strategiespre-and-post-BEPS.html. The next Chapter will focus on the recent Tax Cut and Jobs Act, that has certainly had an impact on the taxation of intangibles and possibly, on the MNEs' tax planning strategies. But just to give a glance at the US system, in order to avoid US tax of the IP income, taxpayers usually avoid entirely having IP owned in the US, and instead, prefer to develop it offshore (especially handy when a corporation already possess an undistributed offshore "cash box", for example Apple). In the case of the US MNEs, their offshore affiliates must avoid the designation of "subpart F" income which is taxable back to the US.

[318] J. D. HOLLINRAKE, U.S. Tax Implications of offshore migration of Intellectual Property, https://thetmca.com/flies/2016/04/More-U.S.-Tax-Implications-of-Offshore-Migration-of-Intellectual-Property-1.pdf

To sum up, the IPC will usually sublicense the IP in other countries and operating entities. The IP Company will receive franchise fees and royalty payments from the franchisees or licensees and accumulate income in its favourable jurisdiction. IP Companies are usually incorporated in a country with a substantial double tax treaty network, like Cyprus, Ireland, Luxembourg, Malta or the Netherlands, just to mention some EU Member States.

The challenge of the ATAD is to provide a set of rules that comply with the present legal framework and the EU fundamental freedoms, as interpreted and applied by the ECJ, and that, simultaneously, can tackle anti-avoidance threats.

One of the most interesting provisions in this respect is the CFC rule, as engraved in Art. 7 and 8 of the ATAD, since the national CFC provisions have often been regarded as in breach of EU Law, as it has been variously explained in this Chapter.

Art. 7 of the Directive defines implementation requirements with regard to CFC rules for the Member State of a taxpayer and it must be read in connection with the further provisions. Paragraph 12 sentences 1 and 2 of the introductory remarks of the Directive states that: "Controlled foreign company (CFC) rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Then, the parent company becomes taxable on his attributed income in the State where it is resident for tax purposes". It appears that it is the intention of the Council to limit the focus of CFC rules to parental companies, which are tax resident in an EU Member State (namely by an unlimited tax liability according to the respective national tax law), as it is typical for CFC rules. Given the obvious intention of the Council revealed in the provisions of the introductory remarks of the Directive and assuming that the Council presupposed a basic understanding on the usual functioning of CFC rules, the

minimum standard of Art. 7 ATA Directive in conjunction with Art. 1 ATA Directive should require the application of CFC rules only for parental companies which are subject to unlimited tax liability in the respective EU Member State.

The scope of CFC rules is typically limited to domestically controlled foreign corporations. Accordingly, Art. 7, paragraph 1, sentence (a) ATAD provides that a foreign corporation can be regarded as controlled if the following requirements are met: 1. In the case of an entity, the taxpayer by himself, or together with its associated enterprises holds a direct or indirect participation of more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of the entity.

The expression "associated enterprises" is defined in Article 2, paragraph 4, of the ATAD and implies: "a) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more or is entitled to receive 25 percent or more of the profits of that entity; b) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25 percent or more or is entitled to receive 25 percent or more of the profits of the taxpayer. If an individual or entity holds directly or indirectly a participation of 25 percent or more in a taxpayer and one more entities, all the entities concerned, including the taxpayer, shall be regarded as associated enterprise".

For what concerns the control requirement, it is not required that all associated enterprises which may control a CFC together are subject to unlimited tax liability according to national law in their respective state of domicile.

The fact that the minimum standard set in Art. 7 ATAD only covers associated enterprises seems appropriate from an economic

perspective, since a coordinated use of CFCs for tax planning can only be realized effectively if the shareholding enterprises are associated.

However, with regard to the scope of CFC rules, such limitations are by no means the world standard.

The three cumulative control criteria provided by Art. 7, paragraph 1, sentence 1 (a) ATAD, undoubtedly provide that the control prerequisite is fulfilled even if only one of these criteria is met. With reference to the legal consequences, however, it seems possible to refer to the actual profit participation when implementing the provisions of the ATAD[319].

According to Art. 7, paragraph 1, sentence 1 (b) of the ATAD, a low taxation is defined as follows: "the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.

The wording appears quite obscure.

It provides that the low tax threshold is effectively determined as half of the domestic tax rate, exactly as it was explicitly worded in previous drafts of the Directive. The wording of the Directive could be interpreted as providing that the relative point of reference is the corporate tax rate solely. Consequently, all other profit taxes and tax surcharges both in the State of domicile of the shareholder and in the State of domicile of the CFC would not be taken into account when determining the low tax threshold.

[319] In this respect, see T. MOSER – S. HENTSCHER, *The Provisions of the EU Anti-Tax Avoidance Directive Regarding Controlled Foreign Company Rules: A Critical Review Based on the Experience with the German CFC Legislation*, in *Intertax*, 2015.

Art. 7, paragraph 1, sentence 2, ATAD clarifies: "for the purpose of point b of the first subparagraph, the permanent establishment of a controlled foreign company that is not subject to tax or is exempt from tax in the jurisdiction of the controlled foreign company shall not be taken into account. Furthermore, the corporate tax that would have been charged in the Member State of the taxpayer means as computed according to the rules of the Member State of the taxpayer".

The purpose of the exception for tax exempt foreign permanent establishments in Art. 7, paragraph 1, sentence 2 of the ATAD when calculating the low-tax threshold is unclear. Assuming that the provisions of the ATAD aim at implementing effective anti-tax avoidance regulation, it would be more appropriate to include such permanent establishments in the determination of the low-tax threshold: for example, by defining different low tax thresholds for the income generated in the permanent establishment and in the jurisdiction of the head office. Based on the provisions of the ATAD, a high-taxed jurisdiction of the head office of a CFC, can block the CFC taxation of tax-free permanent establishments of the respective entity.

Also, according to Art. 7 of the ATAD, the Member State can choose between two alternative approaches of how to determine the tax base for the application of the CFC rules, that is: (1) a "Passive Income Catalogue", and a (2) "Principal Purpose Test".

The first way to detect the tax base for the application of the CFC rules is to define a passive harmful income, such as the non-distributed income of the entity or the income of the permanent establishment which is derived from the following categories: (a) interest or any other income generated by financial assets; (b) royalties or any other income generated from intellectual property; (c) dividends and income from the disposal of shares; (d) income from

financial leasing; (e) income from insurance, banking and other financial activities; (f) income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value.

Art. 7, paragraph 2 (a), sentence 2, of the ATAD determines the following counter-exception: "this point shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstance"[320].

However, the implementation of this counter-exception shall only be mandatory with regard to EU/EC companies.

Where the CFC is resident or situated in a third country the Directive provides that Member States may decide to refrain from applying the preceding paragraph.

With regard to the determination of income, Art. 8, paragraph 1 states: "where point (a) of Art. 7 (2) applies, the income to be included in the tax base of the taxpayer shall be calculated in accordance with the rules of the corporate tax law of the Member State where the taxpayer is resident for tax purposes or situated. Losses of the entity or permanent establishment shall not be included in the tax base but may be carried forward, according to the law, and taken into account in subsequent tax periods.

The approach under Art. 7, paragraph 2 (b) of the ATAD raises two problems: first of all, the requirements for the application of the CFC rules, similar to the general anti-abuse rules of Art. 6 of the ATAD, primarily focus on the motivation of the taxpayer, which is difficult to assess. Also, as the sources of passive income are not positively defined, the taxpayer faces a much higher degree of legal uncertainty

[320] This has probably been established in order to comply with the requirements set out in the *Cadbury Schweppes* ruling.

regarding the business activity carried out compared to CFC legislations that follow the patterns of Art. 7, paragraph 2 (a)[321] of the ATAD and provide a catalogue defining all positive sources of passive income.

It has been argued[322] that the approach of Art. 7, paragraph 2 (b) of the ATAD is suitable for countries that prefer a flexible and individual implementation of the requirements of Art. 7, paragraph 2 (b) of the ATAD promotes a legal environment where the interpretation of the respective provisions and its application is more in the hands of the EU Member States. This also leaves more space for rather unobtrusive CFC rules that are still in line with the ATAD.

The requirements of Art. 8, paragraph 2, imply that only such income shall be imputed to the tax base of the taxpayer that was artificially transferred to the CFC. In that respect, Art. 8 paragraph 2 of the ATAD also distinguishes between active and passive income and does not provide an "all or nothing approach" in which all income of the controlled foreign corporation needs to be attributed to its shareholder.

It is worth noting, however, that the imputed income Art. 7, paragraph 2, (b) is determined completely independently from the passive income under Art. 7, paragraph 2 (a). Therefore, future CFC rules according to Art. 7 paragraph 2 (b) will result in substantially different legal consequences, even though the underlying facts of the case are identical.

As a consequence, it must be expected that CFC rules implemented by the respective Member States according to the ATAD standards will most likely still be quite heterogeneous in the future.

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[321] This Article sets forth also some exceptions with regard to the attributed income, which will not be analysed in this context.

[322] In this respect, see S. LINN, *Die Anti Tax-Avoidance-Richtlinie der EU – Anpassungsbedarf in der Hinzurechnungsbesteuering?*, in *Internationales Steuerrecht*, 2016.

The provisions of Art. 7 are relatively open regarding the question of how the attribution of the CFC income shall be included in the tax base of the taxpayer.

However, it does not clarify how.

Considering the theoretical and practical approaches of designing CFC rules developed so far, three alternative types of legal consequences CFC systems seem feasible.

It is quite common to subject the CFC to a fictitious unlimited tax liability[323]: under this approach, the CFC would be treated as a domestic corporation in the jurisdiction of the shareholder for tax purposes. The income of the CFC is consequently computed under the tax accounting standards of the jurisdiction of domicile of the shareholder, not the corporation itself. Based on this tax base, only the actual taxation itself taxes place at the level of the shareholder.

As an alternative, the attribution of the CFC income of the shareholder can take place as a fictitious dividend[324]: this would imply that the profits are calculated at the level of the foreign corporation, typically under the accounting standards of the jurisdiction of domicile of the CFC. The profits are then "fictitiously" distributed to the shareholder for tax purposes, where they are subject to taxation according to the tax provisions applicable for dividends.

Finally, a "fictitious tax transparency" of the foreign corporation could be implemented, which would imply that the income of the foreign CFC is attributed to the shareholder as if the CFC was transparent for tax purposes. Therefore, the CFC income is treated as original income of the shareholder and taxed as such.

[323] In this respect, see F. WASSERMEYER, *Aubensteuerrecht – Kommentar*, 2016.
[324] In this respect, see F. WASSERMEYER, *Aubensteuerrecht – Kommentar*.

Finally, Article 8, paragraph 7, of the ATAD requires the Member States implement the option for the domestic shareholder to a tax credit for foreign taxes paid at the level of the CFC.

CHAPTER III

BEPS AND THE US. THE AMERICAN RESPONSE TO TAX-AVOIDANCE

Table of content: 1. Introduction to the US Tax System; 1.1 State and Federal Taxation. How tax competence is distributed; 1.2 The definition of I.P. in the U.S.: a journey in time 1.3 The I.P. Company structure in the U.S.: the Google Alphabet Soup in Delaware; 2. The 2017 US Tax Cuts and Jobs Act. The improvement of CFC legislation; 2.1 The CFC rules and Subsection F of the 1986 Internal Revenue Code (IRC); 2.2 The Foreign Derived Intangible Income (FDII) and the Global Intangible Low Tax Income (GILTI); 3. Is the U.S. tax reform: in the direction of territoriality? Some critical aspects; 4. Conclusions.

1. Introduction to the US Tax System

1.1. State and Federal Taxation. How tax competence is distributed

Considering the huge differences between the EU and the US, stemming from the fact that the EU, unlike the US, is not a country, it is no surprise at all that the tax systems and the ways these systems respond to the threats of tax avoidance, are not similar.

Before dealing with the main topic of this Chapter, which is the way the US have tried to tackle tax avoidance practices and to attract

investors in the US, it is necessary to give some details on the US Corporate Tax System.

This Section is not meant to deliver a thorough analysis of the US Corporate Tax System but, rather, it is aimed at giving a basic understanding of the relevant provisions, which well come in handy in the next Sections.

Very briefly, in the U.S., the Federal Government, the States and the local jurisdictions (*e.g.* counties) exercise their own tax powers. In this respect, the Federal system is mainly based on taxing natural and legal persons income, while the States systems[325] are mainly based on sales tax and the local jurisdictions tax properties.

The Federal System on income tax is the most advanced, sophisticated and complex tax system in the world. More specifically, it is necessary to note that the US anti-avoidance provisions have always been studied and regarded as a model for the other tax jurisdictions.

Just to give an idea of how complex and voluminous the Federal US Tax System, the Internal Revenue Code (IRC) counts up to roughly four million words (whereas, for instance, the Italian Revenue Code reaches seventy thousand words).

The Federal Tax Legislation is all engraved in the Internal Revenue Code, but the taxpayers can also benefit from the interpretation of the Internal Revenue Service, the U.S. Tax Administration, and of the Tax Courts, whose work is essential in a common law country, such as the one in object.

[325] It is important to note, however, that the States do impose their own corporate taxes, usually based on the income. Forty-four States apply corporate taxes, with tax rates that go from 2,5% up to 12%, much lower than the Federal Corporate Income Tax rate (21%). In addition, some States (*e.g.* Delaware, Nevada, Ohio, Texas, Washington) do not apply the corporate taxes on the income but, rather, on the turnover (gross receipts taxes).

As much as it happens in other tax systems, the Federal Corporate Income Tax applies on the tax base, as calculated per each tax period, subtracting losses from gains.

The accounting criteria applied to corporate income is the accrual method and, based on such a method, the effect of the transactions carried on by a corporation in a given tax period must be identified in the tax period they refer to.

In order for a cost (either trade or business expense) to be deductible from the tax base, it is essential that such a cost is ordinary and necessary.

In *Case Welch vs Helvering*[326], the US Tax Court established that the term "necessary" describes an adequate and not anti-economic expense a cautious business enterprise would sustain in order to get an advantage.

The term "ordinary" qualifies a normal, usual expense, even if not recurrent. Also, the expense must be reasonably connected with the future production of income or, at least, with the protection of the assets used to produce the income itself.

With reference to the specific topic of this thesis, it is necessary to point out that one of the most complex elements of the Federal Tax System of corporate income involves the taxation of foreign income of U.S. residents through controlled corporations or permanent establishments.

The complexity of the outbound taxation system is given by the necessity to make formal distinctions among the legitimate business activities carried out outside of the U.S. and the elusive operations

[326] Case *Welch vs Helvering*, 3, USTC par. 1164, 12 AFTR 1456, 54 S. Ct. 8 USSC, 1933. In this respect, see also B. I. BITTCKER – L. LOKKEN, *Taxation of Income, Estates, and Gifts*, par. 20.3, *"Ordinary and Necessary" and Similar Qualifications on Deductibility of Business and Profit-Oriented Expenses*.

whose purpose is to obtain an indefinite tax deferral of the US taxes on the income gained through associated foreign companies.

For this reason, the U.S. Tax System allows the companies that intend to legitimately carry out their business, to benefit from a tax credit for the taxes paid abroad, and to defer the taxation of the residual taxes due in the U.S. at the moment of the repatriation of profits gained abroad.

Conversely, the structures deemed as elusive are denied the benefits of tax deferral and, thus, their income is immediately taxable in the U.S.

The outbound tax regime is mainly based on the foreign tax credit (FTC), the CFC and the passive foreign investment companies (PFIC) rules.

It must be reminded that, after the Trump Tax Reform, some new tax tools have been introduces, such as the participation exemption (PEX) regime for the dividends distributed by associated foreign companies, the global intangible low-taxed income (GILTI) regime and the foreign-derived intangible income (FDII), which all relate to outbound operations.

In few words, for what concerns the foreign tax credit for the taxes paid abroad, the US system entails quite a complex and highly analytical set of rules.

The US system uses the "overall limitation" which allows for the application of the tax credit notwithstanding the country of origin of the income.

The principle of overall limitation that establishes that the amount of foreign taxes cannot exceed the amount of US taxes that would apply if there were not the FTC. Such a concept can be expressed with the following formula:

Overall limitation = Foreign Taxable Income x US Corporate Tax
Overall Taxable Income

In other terms, the amount of U.S. tax credit cannot exceed the amount of U.S. taxes attributable to foreign generated income, in the proportion in which such income concur in the formation of taxable income.

The U.S. system also established the necessity to fraction the foreign-generated income in baskets, each of which refers to a specific category of income. Then, the tax credit will be calculated separately per each basket[327].

Based on the previous tax legislation, not only direct tax credit was allowed, that is to say the one regarding the taxes directly related to the subject the income is entitled to, but also the indirect tax credit[328].

After the Trump Tax Reform and the introduction of the "dividends received deduction" on the dividends received by foreign subsidiaries in which a corporation holds at least 10% shares, the indirect tax credit has been amended and remains applicable only to those cases regarding the taxation of CFCs.

For what concerns the CFC rules, the U.S. provisions date up to 1962.

From a U.S. point of view, a CFC can be defined as a foreign corporation the majority of shares is directly, or indirectly, held by U.S. tax resident shareholders, for at least one day in the relevant tax period.

[327] For a deeper analysis of the mechanism of the FTC, see J. R. REPETTI – D. M. RING- P. R. MCDANIEL, *Introduction to United States International Taxation, 6th Edition*, 2014; and D. J. J. SURINGA, *The Foreign Tax Credit Limitation Under Section 904*.

[328] See the version of Section 902 of the Internal Revenue Code before the Trump Tax Reform. For a more detailed analysis of this topic, see J. L. CARR – M. C. MOETELL, *Indirect Foreign Tax Credits*.

The relevant U.S. shareholders in this respect are those that hold, directly or indirectly, at least 10% of the shares of a CFC[329].

Each of these shareholders must include, in their taxable income, *pro-rata*[330] certain categories of income generated by the CFC, notwithstanding the effective distribution of the relative profits. The categories of income are defined in Subpart F of the IRC[331].

Despite the undoubted credit the CFC rules deserve, they turn out to be particularly hard and burdensome, from an administrative point of view.

In fact, for each foreign company, the U.S. shareholders are required to keep specific accounting books aimed at identifying, per each tax period, the layering, the sourcing, the basketing and the pooling of the income and the relative taxes.

If this were not complicated enough, the Trump Tax Reform introduced the global intangible low-taxed income (GILTI) which made the regime even more complex, and which will be further examined in this Chapter.

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[329] In this respect, it is necessary to point out that the Trump Tax Reform has widened the definition of U.S. shareholders, making it applicable not only to those that hold at least 10% of the voting rights in a CFC, but extending it also to those who hold at least 10% of the share capital in a CFC. In this respect, see Section 951(b) of the Internal Revenue Code.

[330] § 951(a)(1)(B) subjects a US shareholder of a CFC to tax on its *pro rata* share of the CFC's earnings that are invested in U.S. property under §956. §956(c)(1)(C) defines US property as including an "obligation of a [US] person". Therefore, a loan or receivable held by a CFC and owed by a U.S. shareholder or related U.S. person generally constitutes an investment in U.S. property unless an exception applies, and, as such, is potentially subject to inclusion in a U.S. shareholder's income under § 951. One exception, under § 956(c)(2)(C) and Regs. § 1.956-2(b)(1)(v), applies to trade receivables from the sale or processing of property to the extent those trade receivables are "ordinary and necessary" to carrying on the parties' trade or business had the sale been made between unrelated parties. In addition, under §956(d) and Regs. § 1.956-2(c), an obligation of a U.S. person for which a CFC serves as a pledgor or guarantor similarly is considered U.S. property held by the CFC.

[331] Subpart F, Subtitle A, Chapter 1, Subchapter N, Part III, IRC, § 951-965.

1.2 The definition of I.P. in the U.S.: a journey in time

The 1968 §482 Regulations[332] was the first provision that attempted to define somehow the concept of "intangible property" and included a vast array of items, which included: patents, inventions, literary, musical or artistic composition and other similar items; trademarks, trade names, brand names, and other similar items, franchise, licenses, contracts, and other similar items; and methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data and other similar items.

Such items were considered intangibles provided that they had substantial value independent of the services of individual persons[333].

The definition of "intangible property" is intended to be as broad as possible to include any type of right that enables the holder to undertake economic activity, regardless of the intrinsic value or merit of the right. The value of the intangible, determined using arm's length standards, is a separate matter[334].

The breadth of definition that is engraved in the term "intangibles" is illustrated by Hospital Corporation of America v. Commissioner[335], in which a U.S. Hospital management company (HCA) bid on a contract to provide hospital management services for a new hospital being built in Saudi Arabia.

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[332] Treasury Regulations § 1.482-2(d)(3)(i) (1968). The 1968 Regulations have been replaced by the 1994 Regulations. For a deeper analysis of the International Transactions enlisted in Section 482, see P. F. POSTLEWAITE – D. L. CAMERON – T. KITTLE-KAMP, *Federal Income Taxation of Intellectual Properties & Intangibles Assets*, ed. Thomson Reuters Tax and Accounting, 2018.

[333] See WILLS - DENNING, "*The Economic Life of Advertising: A Survey of the Evidence*, in *Tax Mgmt. Transfer Pricing*, 2012; J. ELMORE, T*he Valuation of Trademark-Related Intangible Property*, in *Willamette Insights*, 2015; A. RAMIREZ, *Estimating Intercompany Transfer Price Trademark Royalty Rates*, in *Willamette Insights*, 2015.

[334] In this respect, see C. LOWELL – M. MARTIN, *The Patenting of Tax Planning Strategies is Addressed*, in *U.S. International Taxation: Practice and Procedure*, ed. Thomson Reuters/WG&L, 2016.

[335] See Case *Hospital Corp. Of Am v. Comm'r,* 81 TC 520, 599 (1985)

When the contract was about to be concluded, HCA formed two Cayman Islands subsidiaries (a parent and subsidiary) for the purpose of undertaking the contract.

The subsidiary (LTD) was deemed to be responsible for negotiating, executing, and performing the contract. In the presentations to the hospital authority, HCA and LTD had emphasized the "system" that HCA had developed over the years, which was held out as being the state of the art in the worldwide hospital management business.

The Court found that LTD had used intangibles of HCA.

In the opinion of the writer, in the case at issue the Court stretched the concept of intangible property beyond the imaginable.

In fact, it held that these intangibles were HCA's experience and expertise in the management of hospitals in the United States.

The availability of this experience and expertise was considered as a crucial element of the presentation by HCA and LTD and was also significant from the standpoint of the hospital authority. Since LTD had "used these intangibles, an allocation [under §482] is proper.

There are, however, limits on how far the concept of an "intangible" will stretch in characterizing elements of value received by members of a multinational groups, and such limits are evidenced in Merck & Co. v. United States"[336], in which a U.S.-based pharmaceutical company had set up a possessions corporation subsidiary.

The government tried to support a §482 allocation on the basis of the fact that the parent had made available to the subsidiary an intangible in the form of the organizational structure of the multinational group and the various benefits that the subsidiary derived therefrom.

The Claims Court rejected this (rather intriguing but way too imaginative) suggestion, finding that organizational structure, with

[336] Case *Merck & Co. v. United States*, 24 Cl. Ct. 73, 91-2 USTC, 1991.

nothing more, could not be included in the concept of an enforceable property right that would support an arm's length license agreement as an intangible.

Similarly, in Veritas Software Corp. v. Commissioner[337], a domestic parent (V-US), entered a cost sharing arrangement with its indirect Irish subsidiary (V-Ireland), whereby V-US and V-Ireland agreed to combine their resources and research and development efforts related to the development and manufacture of certain software products. V-Ireland received the right to use certain V-US intellectual property (*e.g.*, patents, copyrights, trademarks, trade names, and service marks) for use in its business in a specified territory.

V-Ireland agreed to pay certain royalties in addition to a prepayment (the buy-in payment).

In arguing that the buy-in payment was not consistent with the standards of §482, the Internal Revenue Service contended that certain intangibles, such as workforce in place, goodwill[338], and going concern value, should have been considered in the buy-in payment calculation. Both §§367(d) and 482 define intangible property by reference to §936(h)(3)(B).

The Tax Court held that these items were not covered by the §482 Regulations in force for the year at issue.

Hospital Corporation of America, Merck & Co., and Veritas are interesting and important cases in giving content to the definition of the term "intangibles".

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[337] Case *Veritas Software Corp. v. Comm'r*, 133 TC 297, 2009.

[338] Even goodwill has been considered as an intangible. It has been stated, in fact, that it is the existence of an expectation of "not only continued excess earning capacity but also some competitive advantage or continued patronage i.e., the expectancy that old customers satisfied with the quality of services or product would return". In this respect, see C. H. LOWELL – P. L. BRIGER, *U.S. International Transfer Pricing, Part II Substantive Pricing Law*, ed. Thomson Reuters Tax and Accounting, 2018.

They are certainly relevant in the sense that they show how far the interpretation of the concept of "intangible" can go but, at the same time, it is hard to identify a pattern in those judgments.

In other words, the HCA Case gave relevance to the experience and the expertise and regarded them as intangibles, whereas in the Merck Case, the organizational structure (that could be easily a hint of experience and expertise) was not considered as a sort of intangible.

In the opinion of the writer, the latter seems to be the most reasonable and fair interpretation of "intangibles" while the former appears to unduly widen such concept.

Although not specifically articulated by the courts, it could be argued the term can fairly be described as including each of the elements noted in the Regulations that have value that would be produced if the element were transferred between uncontrolled parties dealing at arm's length.

Still, the attribution of value remains subjective rather than objective and there are no solid or convincing arguments in favour of the inclusion of experience or expertise rather than organizational structure.

The scope of the definition of "intangibles" for transfer pricing purposes has attracted extensive comments from practitioners and academics alike. Some take the position that the "intangible" definition of §367(d) should be viewed strictly while others support an expansive view.

The definition of "intangibles" was again carefully addressed by Congress in connection with the possessions corporation provisions of §936 in TEFRA 1982. Specifically, Congress was felt the possessions tax credit of §936 was unnecessarily beneficial for U.S. companies doing business in Puerto Rico, especially with reference to income imputable to intangibles transferred to the island affiliate.

Accordingly, Congress amended §936 to add a concept of "intangible property income" in §936(h), which would be currently taxed to the U.S. shareholder of the possessions corporation unless an election out were made.

The intangible property income provisions did not alter the definition of the term "intangibles," but provided a useful definition of certain categories of intangibles.

For these purposes, the definition of "intangibles" was drawn from the 1968 Regulations, with minor variations. The only differences in the definition were that the plural statement of the various categories was made singular, the catch-all "other similar items" at the end of each category was deleted and added as a sixth category, and the term "know-how" was added to the first category. The operative term in the expansion of the §936 provisions was "intangible property income", defined as the "*gross income of a corporation attributable to any intangible property*". If a possessions corporation and its affiliates do not choose to apply either a cost-sharing or profit-split option, the intangible property income is entirely allocated to the U.S. shareholders of the possessions corporation.

A critical element in applying these provisions is to separate the amount of intangible property income of the possessions corporation from other income.

The Regulations approach this issue by providing that "*income attributable to intangible property includes the amount received by a possessions corporation from the sale, exchange, or other disposition of any product or from the rendering of a service which is in excess of the reasonable costs it incurs in manufacturing the product or rendering the service* [other than costs incurred in connection with intangibles] *plus a reasonable profit margin*".

While the enactment of the intangible property income provisions included in §936(h) in 1982 was an important step in the evolution of intangible property concepts, it did not as such amend the definitional reach of the term "intangibles."

The 1994 Regulations restated the definition of "intangibles"[339].

The formulation in the §936(h) Regulations was essentially embraced, however with a single meaningful modification[340].

For purposes of analysis, intangibles can be divided into several broad categories[341]. These categories largely included "manufacturing" and

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[339] See Treas. Reg. § 1.482-4(b)(6). The same formulation of the six classes from Section 936(h)(3)(B), is embraced. The only difference is that the term "formulae" is spelled with an "e," and the categories are stated in the plural instead of the singular—i.e., "inventions" instead of "invention."

[340] In the 1993 Temporary Regulations, the introductory language to the six categories of intangibles was modified to include the phrase "commercially transferable." Treas. Reg. § 1.482-4(b)(6) (1993). Specifically, the language would be as follows: For purposes of §482, the term "intangible" means any commercially transferable interest in any item included in the following six classes of intangibles, that has substantial value independent of the services of any individual". While the Temporary Regulations, and their preamble, are silent as to what was intended by the addition of this phrase, it appears that the drafters of the Regulations intended a practical limitation on the otherwise unlimited reach of the broad definition of the term "intangibles." Specifically, it appears that the "commercially transferable" language is intended to mean that Section 482 will apply to an intangible only to the extent that it could be commercially transferred from one person to another as a matter of law. The 1994 Regulations deleted the "commercially transferable" language as being "superfluous." TD 8552, 59 Fed. Reg. 34971, 34983 (July 8, 1994). A clarification of the meaning of "other similar items" was provided, as follows: *[A]n item is considered similar to those listed...if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.* (Treas. Reg. § 1.482-4(b)(6)). An interesting issue with respect to the requirement that there be substantial value independent of the services of individual persons arises in the context of "personal goodwill." In such situations, there are at least two questions: (1) is there such "substantial value" and, if so, (2) who owns the resultant asset. See *Martin Ice Cream v. Comm'r*, 110 TC 188 (1998) (shareholder retained ownership of assets arising from services, not corporation).]. See generally WELLS - BERGEZ, *Disposable Personal Goodwill, Frosty the Snowman, and Martin Ice Cream All Melt Away in Bright Sunlight of Analysis*, in *Neb. L. Rev.*, 2012. See case *Boss Trucking, Inc. v. Comm'r, TC Memo. 2014-107* (no tax on corporation on alleged distribution of goodwill to its shareholder, as company had no goodwill to distribute, following Martin Ice Cream).

[341] These categories include, for example, the normal profit intangibles, the commodity intangibles and the soft intangibles. For what concerns this last category, it is worth mentioning that the Obama Administration proposed, in 2010, to expand the definition of intangibles to include "workforce in place, goodwill, and going

"marketing" for many years, but as the sophistication of intangibles issues has grown over the years, the range of categories has expanded.

The determination of what part of an intangible profit is attributable to a particular intangible element can be an especially burdensome aspect of the valuation of intangibles.

The definition of "manufacturing intangibles" generally includes those intangibles that are connected to the production elements of a business. The statute and Regulations under §482 do not define the term "manufacturing intangibles."

A definition is, however, included in the Regulations under §936(h); those Regulations provide that the term includes any "patent, invention, formula, process, design, pattern, or know-how," which are the elements listed in class (1) in the general and wide definition of "intangibles" from the §482 Regulations.

For example, in Eli Lilly & Co. v. Commissioner[342], the Tax Court found that the patents covering the pharmaceutical compounds in question were manufacturing intangibles because the patents gave the transferee the right to create the pharmaceuticals.

During their term of life, the patents provided their owner with an exclusive right to make the covered products, the value of which was held much greater than the rights to use the "Lilly" name (marketing intangibles).

The definition of "marketing intangibles" can cover an extended range of intangibles connected with the nonmanufacturing or selling activities of a business. There is no specific definition of "marketing intangibles" in the Internal Revenue Code or Regulations.

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concern value". In this respect, see *Obama Budget's Revenue Raisers Include Marked Changes in Treatment of Intangibles*, in *BNA Daily Tax Rep*., 2009.

[342] Case *Eli Lilly & Co. v. Comm'r*, 84 TC 996, 1985.

The 1988 White Paper stated that "[t]he section 936 definition of 'intangible property' includes marketing intangibles". Under §936, a U.S. parent or affiliate is allowed to transfer certain "manufacturing intangibles" to its subsidiary or affiliate operating in a U.S. possession.

If the transferee shares in the product research expenditures of the transferor, and has a significant business presence in the possession, it is deemed to own the "manufacturing intangible" for purposes of the intercompany pricing rules of §482, which gives them the right to obtain a full return thereon.

All other intangibles, such as marketing intangibles (including trademarks, trade names, and brand names) cannot be transferred to the island affiliate under this election, with the result that, for purposes of this election, the island affiliate cannot claim a return on such intangibles.

The §936 Regulations do not as such define "marketing intangibles." However, from the above quoted legislative history it seems quite straightforward that this category includes trademarks, trade names, and brand names, which are listed in class (3) of the general "intangible property" definition.

The courts have conceived similar definitions[343].

As noted, the Regulations under §936 define the term "manufacturing intangible" to include any "patent, invention, formula, process, design, pattern, or know-how," which are the items of intangible property listed in class (1). Therefore, other possible "marketing intangibles"

[343] See, *e.g.*, Case *Clarke v. Haberle Crystol Springs Brewing Co.*, 280 US 384, 1930 (goodwill in the nature of trademarks, trade names and trade brands); Case *JC Cornillie Co. v. Comm'r*, 298 F. Supp. 887 (goodwill in the form of customer lists); and Case *FW Drybrough v. Comm'r*, 45 TC 424, 1966 (goodwill consisting of agency's file of uncollected claims). See also Case *Priv. Ltr. Rul.* 8134193, 1981 ("marketing intangibles" defined as the right to use tradename, trademark, and related goodwill).

are the items of "intangible property" listed in classes (2) (copyrights, literary, musical, or artistic composition), (4) (franchises, licenses, and contracts), and (5) (methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, and technical data), in addition to trademarks, tradenames, and brand names.

An important definition of marketing intangibles was given in case Eli Lilly & Co. v. Commissioner, in which the courts had to distinguish between the manufacturing and marketing intangibles. The Tax Court found that the marketing intangibles owned by Lilly included the trademarks for the compounds in question (Darvon and Darvon-N), as well as the Lilly name and goodwill. While the court found that the manufacturing intangibles (patents and know-how) had a greater value during the life of the patents, it also found that after expiration of the patents "the trademark was the intangible with greater value".

As it is possible to understand also from this last-described case, in some situations, the distinction between manufacturing and marketing intangibles held by respective controlled corporations might be not so clear.

Another example is given by Case GD Searle & Co. v. Commissioner[344], where a U.S. pharmaceutical company (Searle) transferred certain patents and manufacturing know-how to a possessions corporation subsidiary (SCO), which manufactured the pharmaceutical products and sold them largely to unrelated distributors.

But Searle had the U.S. regulatory approvals necessary to sell the drugs in the United States and provided a variety of other administrative and marketing services for SCO.

[344] See Case *GD Searle & Co. v. Comm'r*, 88 TC 252, 1987.

The Tax Court claimed the transferred intangibles had "little value" to SCO without the "marketing and administrative services" provided by Searle.

Such an interrelationship can produce difficult pricing issues, especially where the record may not reflect data that will facilitate a determination of the respective elements of those issues.

1.3 The I.P. Company structure in the U.S.: the Google Alphabet Soup in Delaware

Before analysing the Trump Tax Reform and the relevant provisions applicable to the topic of this thesis, it is necessary to, at the very least, give a glimpse at the problem of I.P. Companies in the US and, more specifically, to the problem of tax avoidance within the US.

In other terms, this Section will explore the problem of tax avoidance through IP Companies and aggressive tax planning within the United States, with respect to the distribution of taxing powers.

The issue regarding international tax avoidance will be better addressed in the following Sections.

In fact, the content of this Chapter would be incomplete, if it did not deal with such a pivotal issue.

The title of this Section should be of no surprise, considering that the Google[345] Alphabet Soup, despite the misleading name, has nothing to do with food or "alphabets" but, rather, it is the paradigmatic example of a business structure involving an I.P. Company.

[345] With specific reference to Google and its attitude towards aggressive tax planning, Politicians in Europe have exhibited a similar attitude. One British Labour Member of Parliament, in speaking to an executive of Google, exclaimed "I get really irritated. You're a company that says 'Do no evil' but I think you do evil in that you use smokes [sic] and mirrors to avoid paying tax". For an interesting discussion on how tax avoidance is perceived in the U.S., see S. A. BANK, *When Did Tax Avoidance Become Respectable?*, in *Tax Law Review*, 2017.

On 10th August 2015, Google announced a restructuring plan in a new Delaware holding company referred to as "Alphabet". The new "Alphabet" holding company structure may represent the domestic tax avoidance replacement for Google's famous "Double Irish with a Dutch Sandwich" structure, that was previously mentioned in Chapter 1.

The Alphabet entity is designed as a Delaware I.P.H.C., created to reduce taxation by the deduction of royalty payments as an expense. The issue is to explain how Google may use the Delaware IP Company regime to achieve an ongoing reduction in State corporate taxation.

In this respect, several potential corporate tax advantages to the Alphabet restructuring can be summed up as follows: a) the intercompany IP licensing agreement between Google affiliates and Alphabet will create non-taxable royalty income in the State of Delaware, and additional royalty expense deduction in all the various US States to which Google files a corporate tax return. For any US State that does not apply combined reporting the corporate tax base will correspondently be automatically diminished[346]; b) Google could presumably argue that incoming foreign royalty payments to Alphabet in combined reporting states are excludable from the unitary group; c) for any US State which may try to tax Alphabet's income, Google gains the opportunity to file a constitutional challenge to the right of any State to tax Alphabet in Delaware; d) Google may be inclined to use the domestic IP licensing agreement as a benchmark for foreign IP licensing agreements as a matter of transfer pricing practice. In other terms, it could use it as a sort of comparable. If the amount of foreign royalty payments is thereby increased, then this will give rise to

[346] In this respect, see S. LASKIN, *Only a Name? Trademark Royalties, Nexus, and Taxing that which Enrichs*, in *Akron Tax Journal*, 2007.

automatic repatriation of foreign cash resulting in potential federal corporate tax avoidance.

The Google Inc. 8-K as filed with the SEC on 2nd October 2015 has as an attachment Exhibit 2.1 the "Agreement and Plan of Merger" which provided that Google intended the transaction to qualify as a §351 transaction under the Internal Revenue Code.

In a nutshell, a §351 transaction refers to both the initial transfer of property into a corporation, and also any subsequent transfers, where the transferor receives shares of company stock in exchange for the transfer.

Such transfers into corporate form are generally neutral for tax purposes; however, the Google transaction is not a typical §351 transaction and is designed instead to create a holding company structure where the former Google parent company becomes a subsidiary of the new Alphabet.

As a matter of State law, the Google Inc. 8-K also provided that the transaction was intended to qualify under Delaware Code §251(g), pursuant to which a reorganization involving a swap of publicly traded stock for the stock of a newly-formed Merger Subsidiary is allowed without requiring the vote of shareholders.

Hence, if the transaction simultaneously qualified under IRC §351 and Delaware Code (DGCL) §251(g), the Alphabet restructuring would not be subject to federal taxation and would not require a vote of the public shareholders.

To set the reorganization under §251(g) DGCL, Google Inc. (a Delaware corporation), has incorporated Alphabet Holding as a Delaware corporation and wholly owned subsidiary of Google Inc., and, in turn, caused Alphabet to form a Google Merger Sub. The Alphabet holding company organizational structure was then

implemented pursuant to §251(g) DGCL by the Merger of Merger Sub with and into Google Inc.

As a result of the reorganization, Google Inc. would survive the merger as a direct, wholly owned subsidiary of Alphabet.

The reorganization of Google Inc. under §351[347] was accomplished by using a "single-dummy" structure. In the single-dummy structure, Google Inc. formed a new holding corporation (Alphabet Holding), which, in turn, formed a single new subsidiary (the "Dummy One corporation").

Dummy one corporation, then, merged as wholly owned subsidiary of new Alphabet Holding.

The newly formed Alphabet holding company (with subsidiaries including Google Inc., Calico, Google Fiber, Nest, Google X, Google Capital, Google Ventures, and Life Sciences) is domiciled in Delaware, a tax haven jurisdiction, very well known for its favourable rules on the taxation of passive income.

In particular, §1902(b)(8) of the Delaware corporation income tax code dealing with the imposition of tax on corporations, provides that a Delaware corporation (often referred to as Delaware holding company) shall be exempt from State taxation if its sole activity within Delaware is the maintenance and management of their intangible investments or of the intangible investments of corporations and the collection and distribution of the income from such

[347] The IRS position is that a §351 transaction requires a non-tax business purpose. It has been argued that the case law is mixed but on balance a business purpose requirement for a §351 transaction is the better view. Accordingly, the potential pitfall to Google is that the § 351 transaction is not respected by the IRS because the "focus on extraordinary business opportunities" explanation given by Google is not accepted by the IRS as a legitimate or bona fide business purpose. In other terms, from the IRS perspective, the § 351 transaction was undertaken primarily for federal and state tax avoidance purposes and that the "focus on extraordinary business opportunities" explanation was either ancillary or non-existent in fact. In this respect, see R. D. WHEAT, *Section 351 Transactions and Related Issues,* State Bar of Texas, 24th Annual Advanced Tax Law Course (Sept. 28-29, 2006).

investments or from tangible property physically located outside Delaware.

In other words, due to this State tax exemption on dividends, royalties or other investment income in Delaware, when earned by a Delaware holding company, Google may use this "Delaware loophole"[348] to benefit from a tax-exempt holding vehicle in Delaware.

The main "Alphabet" tax strategy relies on the fact that Alphabet became the owner of the IP after the restructuring.

Google appear to benefit from such IP licensing agreements as they may yield a preferential State tax treatment of Google in Delaware and in separate reporting States.

By concluding intercompany IP licensing agreements with Google affiliates (licensees), giving them the right to use the IP in exchange for royalty payments, Alphabet (licensor) may gain several tax benefits, as follows: 1. Benefits regarding royalty income: since Alphabet is now a Delaware-based corporation, the activities of which in Delaware are limited to maintaining and managing intangible assets that generate tax exempt income (§1902(b) of the Delaware law), the corresponding royalty income of Alphabet received from the use of these intangibles will be exempt from Delaware income tax; 2. Benefits in terms of royalty deduction: Alphabet's IP licensing agreements create royalty expense, deductible as operating expense in

[348] For a thorough analysis of the concept of "tax loophole", see H. M. FIELD, *A Taxonomy for Tax Loopholes*, in *Houston Law Review*, 2018. The Author claims that people actually have widely divergent views about what tax loopholes are. They do not agree about which provisions constitute tax loopholes. They do not agree about the policy concerns that motivate them to characterize something as a tax loophole. They do not agree about who is to blame for tax loopholes or the problems tax loopholes create. And they do not agree about what to do with the revenue that would be raised by closing tax loopholes.5 Often, critics of loopholes are not explicit about these details and let the negative connotation of the term "loophole" express condemnation without providing a substantive argument about why a tax preference is problematic or about how the problem could be remedied. Thus, "the term "loophole" has, to a large degree, become the tax law equivalent of calling someone a "loser" empty schoolyard name-calling".

all the various U.S. States to which Google files a corporate tax return and these expenses automatically diminish the corporate tax base in those separate reporting States.

Thus, the separate reporting regime prevents offsetting income from one affiliate with royalty expense deductions from other affiliates, as this would be the case in a combined reporting group.

After having briefly described the problem of tax avoidance within the US, a preliminary conclusion regarding this Section appears necessary.

The above-described situation appears quite similar to the one the EU has tried to address with the ATAD1, and that has often been regarded as one of the causes of distortion of the EU internal market.

In fact, the very existence of a State such as Delaware in the US makes it much more convenient to invest there and to set up corporation than in other States, as much as it happens in the Netherlands or in Luxembourg.

Unlike in the EU, which is not a country and does not have its own constitution but, rather, founding treaties, the US have a constitution and a well-established "substance doctrine", that was previously analysed in the second Chapter, that has allowed the US to deal with tax avoidance issues from a totally different perspective: tax avoidance has not been considered from a competition law point of view but from a tax law point of view.

In other terms, the US have faced the problem as a country with its own set of rules and principles, while the EU has tried to solve it mainly adopting a competition-oriented approach or, in some cases, has considered it a sort of "inevitable consequence for the sake of the market".

This has resulted in a formalistic approach[349], which could not be further from the so-called "sham transaction doctrine"[350].

Since the development of the "sham transaction" doctrine, the Congress of the United States has clearly established the "economic substance" doctrine[351] as the applicable method of legal interpretation for tax law at least in the United States.

The economic substance doctrine reflects a substantive method of legal interpretation (i.e., not pure formalism). As a contrary example, the European Union's approach to tax law reflects a tradition of formalistic legal interpretation in the tax laws particularly common in Continental Europe.

Multinational firms in the European Union are accordingly engaged in incorporation and reincorporation strategies in different Member States to claim the benefits of the EU Treaties in suspicious circumstances under the premise that there is such a "springing" right enshrined in those provisions that guarantee the fundamental freedoms.

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[349] In this respect, see B. LEITER, *Legal Formalism and Legal Realism: What is the Issue?*, in *Legal Theory*, 2010. According to the Author: "Formalist' theories claim that … the law is "rationally' determinate, i.e., the class of legitimate legal reasons available for a judge to offer in support of his decision justifies one and only one outcome … the majority of "Realists" advanced a descriptive theory of adjudication according to which (1) legal reasoning is indeterminate (i.e., fails to justify a unique outcome) in those cases that reach the stage of appellate review; (2) appellate judges, in deciding cases, are responsive to the "situation-types" - recurring factual patterns … that elicit predictable normative responses".

[350] See Case *Sherwin-Williams Co. v. Comm'r of Revenue*, 778 N.E.2d 504, 522 (Mass. 2002); *Syms Corp. v. Comm'r of Revenue*, 765 N.E.2d 758, 762 (Mass. 2002) (citing *Rice's Toyota World, Inc. v. Comm'r of Internal Revenue*, 752 F.2d 89 (4th Cir. 1985)).

[351] From a tax risk perspective, the IP Company should not be incorporated solely for the transferring company to avail itself of the tax benefit of reducing its tax base. The company must be able to prove substantial economic reasons other than the tax benefits as well as operational activities of the IP company. In this respect see *Re Express, Inc., DTA Nos 812330-812332, 812334*, 1995 NY Division of Tax Appeals.

As a matter of tax policy, neither the Supreme Court of the United States, nor a reviewing U.S. state court, would move further towards this European approach which has been a controversial and often debated tax policy as applied in Europe.

The prior tax literature often takes the existence of the economic substance doctrine in U.S. law as an afterthought to the determination of the constitutionality of taxation of non-domiciliary intangible income. However, the economic substance doctrine is not an afterthought as it establishes the applicable method of legal interpretation in the United States.

Therefore, individual States in the United States are not obliged to follow a non-substantive method of formalism in applying their own corporate tax laws, irrespective of how the Internal Revenue Service may view the Alphabet restructuring.

The Alphabet reorganization is accordingly best viewed not as a formalistic determination of a State's ability to levy tax on a business using intangibles within its borders without a physical presence, but instead a question of whether the federal government can force a state to treat a taxpayer differently based on a transaction recognized only for federal tax purposes (i.e., a § 351 transaction) and under a different State's general corporate law (i.e., a Delaware § 251(g) reorganization). The constitutional issue might then be decided solely on whether the state taxing law of a given State (*e.g.* Massachusetts) must recognize the federal or Delaware transaction which gave rise to Alphabet as a separate and distinct taxpayer from Google. If Massachusetts, for example, says it does not recognize Alphabet under these circumstances as a matter of substantive review (not formalism), then it must be able to levy tax on Google as it had the right to do before the federal and Delaware reorganization.

And, the implementation of a substantive version of legal interpretation in the United States is in stark contrast to the European formalistic approach to tax law (at least, until the ATAD and the new attention the EU has given to tax law issues in the internal market)[352]. There have not been cases before the U.S. Courts regarding the Alphabet Soup structure yet, so it is not possible to predict how the relative questions of tax avoidance will be dealt with.

2. The 2017 US Tax Cuts and Jobs Act. The improvement of CFC legislation

The above-mentioned Trump Reform, also known as US Tax Cuts and Jobs Act, is the main focus of this Chapter, at least in its provisions related to CFC rules. In fact, the taxation of intangibles-related income has been massively influenced by the tax reform in object.

On 22nd December 2017, President Donald J. Trump signed the Tax Act[353].

Unlike the reform introduced by President Ronald Reagan in 1986, that required two years to be implemented and agreements between the Democratic and the Republican Parties, the Trump Reform was conceived in only seven weeks and unilaterally approved by the Republican Party.

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[352] In this respect, see B. N. BOGENSCHNIDER – R. HELMEIER, *Google's "Alphabet Soup" in Delaware*, in *Houston Business and Tax Law Journal*, 2016. The Authors point out that" if the United States allows Delaware to proceed, similar to Luxembourg, without a corollary substantive review of the tax laws (i.e., "state aid" review) this could end with the *de facto* exemption of certain corporations from state level corporate tax. In that case, the state tax system in the United States would become a European-style formalistic system without any checks or balances against the rights of tax havens, principally Delaware". However, they admit that in certain circumstances, such as the decisions of the EU Commission with regard to State aid issued to Starbucks and Fiat indicate that even in the EU some form of substance must be taken into account. The Authors, however, do not mention the ATAD, since it had not been approved before the above-mentioned article.

[353] Public Law 115-97, "An Act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018.

The tax reform adopted was announced as a tax cut for the middle class and small business owners and has introduced some of the most significant changes of the last 30 years.

Such changes, however, often lead to different interpretation and the practical application of the new provisions appears tricky.

Preliminarily, it might be argued that, despite the time convergence of the BEPS Action Plan and the Trump Tax Cuts and Jobs Act, there is no real connection or synchronism between them[354].

More specifically, the U.S. seem to have adopted a unilateral and quite self-centred approach in dealing with tax avoidance, at least partially, and this is mainly reflected by the provisions that are being dealt with in this Chapter.

In addition, the U.S. tax reforms are layered over the provisions of prior law without altering the basic structure[355].

For example, the corporate rate reduction is dramatic but not structured; the adoption of deductions for pass through business, foreign dividends, GILTI and FDII are important changes but all rely or draw on prior architecture[356]. As a result, it might be stated that the

[354] The US have taken the position that few or no changes in its domestic law will be necessary because existing anti-avoidance rules are generally consistent with the BEPS Action Items. In this respect, see M. M. LEVEY – I. GERDES – A. MANSFIELD, *The Key BEPS Action Items Causing Discussion in the United States*, in *Intertax*, 2016. However, the statement according to which the U.S. 2017 Tax Reform does not go in the same direction as the OECD BEPS Action Plan is true up to a point, since the Trump Reform includes the base erosion and anti-abuse tax (BEAT).

[355] In this respect, also the BEPS Action Plan does not seem to be totally "destructive" against the provisions of prior law, as it was explained in the first Chapter. However, while, for instance, the criteria adopted by the EU in conceiving the ATAD reflect the spirit and the intention that generated the BEPS Action Plan, the U.S. Tax Reform appears totally detached from it.

[356] Or better yet, the GILTI and the FDII have to be applied in a manner consistent with the pre-existing Subsection F of the I.R.C., which follows different principles (*e.g.* worldwide taxation).

tax reform changes failed to modernize the income tax infrastructure, at least from an organizational level[357].

For what concerns the taxation of business enterprises, the key aspects of the Reform regard the reduction of the Corporate Income Tax rate[358], the expansion of the bonus depreciation and immediate expensing regimes, not to mention the elimination of the Alternative Minimum Tax (AMT) for the corporations. In addition, the Reform replaced the criteria for using net operating losses and the limits to deductibility of passive interests.

[357] It is necessary to admit, however, that some steps ahead have been made. In principle, the reform should trace a pathway towards territoriality.

[358] From a global perspective, the question arises as to whether such a drastic decline will initiate a race to the bottom. If so, an avalanche of other concerns also precipitated – not least of which are the issues pinpointed by the OECD's Harmful Tax Competition Report (1998), which identifies the "absence of tax or a low effective tax rate on the relevant income" as "the starting point of any evaluation" of whether a jurisdiction is a "tax haven". In this respect, see https://www.oecd-ilibrary.org/taxation/harmful-tax-competition. The same problem, but from a different point of view, has been dealt with by certain commentators, who wondered if the adoption of a lower tax on foreign source income (though not necessarily the minimum tax) could be an effective strategy to remain competitive. This is what both the Obama and Camp proposals envisaged: Obama suggested a 28% corporate tax on domestic profits and a 19% tax on foreign income, while the House Ways and Means Committee's Chairman Camp (February 2014) proposed a 25% on domestic profits and 1 12,5 to 15% tax on foreign income. In this respect, see R. S. AVI-YONAH, *All or Nothing? The Obama Budget Proposals and BEPS*, in *International Tax Law Review*, 2015. The Camp Draft Plan would take a different approach than the Baucus Discussion Draft. In November 2013, the "Baucus Discussion Draft" was released by Senator Baucus under the auspices of the Senate Finance Committee. The Discussion Draft was notable in its attempt to address in an entirely US context many of the same international tax issues addressed by the OECD in BEPS Action Plan 2 (Hybrid Mismatch Arrangements), 3 (Strengthening CFC rules), 4 (Limit Base Erosion via Interest Deductions and Other Financial Payments), and 8-10 (Transfer Pricing). Like the Baucus Discussion Draft, the Camp Draft was aimed at expanding Subpart F income by creating a new category of Subpart F income (foreign base company intangible income). It would also impose a one-time retroactive tax on previously untaxed foreign earnings, albeit at a lower rate. Unlike the Baucus Discussion Draft, which did not commit to any particular corporate tax rate, the Camp Draft Plan would lower the corporate tax rate to 25%. For more details on the topic, see R. G. RINNINSLAND – K. LOBO, *US-Based Pushback on BEPS*, in *Intertax*, 2015.

The Trump Reform also introduced important amendments regarding the provisions on international taxation, making the system more complex than it was.

On the international side, – which will be the main focus in this Chapter – the reform failed to address the most important defect in the current cross-border tax architecture: host country taxation of remote sellers who do not have a physical presence in the host economy.

Interestingly, the reasoning of the US Supreme Court's *Wayfair* decision, which upholds State use tax collection obligations on remote sellers, articulates why host countries, including the United States, also must reconfigure their income tax regimes to systemically tax remote sellers – digital and non-digital.

The Supreme Court majority said: "Each year, the physical presence rule becomes more removed from economic reality and results in significant revenue losses to States"[359].

Adopting US international tax rules to deal with the today's business reality has been (probably) left to future U.S. tax reforms.

2.1 The CFC rules and Subsection F of the 1986 Internal Revenue Code (IRC)

The recommendation of BEPS Action 3 is that CFC rules only operate with respect to CFCs that are subject to effective tax rates that are meaningfully lower than those imposed by the home State. Hence, from the non-U.S. point of view (i.e. when the U.S. are the host State), chances are that U.S. subsidiaries, which are controlled by non-residents, will fall within the reach of the CFC rules of the States concerned where the shareholders are resident.

[359] See Case *South Dakota vs Wayfair*, 585 US, 21st June 2018.

From the US standpoint (i.e. when the U.S. are the home state), another central element of the BEPS Action 3 affects its CFC rules because it entails a suggestion to switch to the territorial system. However, by its very nature, a CFC regime seeks to extend the scope of taxation extra-territorially, which inevitably puts it at odds with the territorial system.

The mischief that a CFC regime, in its role as an anti-avoidance measure, endeavours to cure is to tackle any tax leakage that arise when resident shareholders reroute profits to companies that they control in tax havens, which by definition impose low or no taxation[360].

Let alone the discussions on whether the U.S. have effectively turned into a tax haven[361], it is necessary to focus on the U.S. CFC rules, that will be the starting point for the analysis of the newly-introduced tax tools known as the GILTI and the FDII.

The U.S. Tax System sets forth specific anti-avoidance provisions that tackle tax structures the main purpose of which is the deferral of taxation of income gained through foreign subsidiaries.

As it was previously mentioned, the U.S. CFC rules apply to certain types of income, as enlisted in Subpart F of the I.R.C[362].

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[360] The issue arising from the Trump Reform is whether the low Corporate Income Tax Rate (15%) renders the US a tax haven. For an analysis of this issue, see V. T. CHEW, *Trump's Corporate Income Tax Rate Reduction: A CFC Trap for Foreign-Controlled US Subsidiaries*, in *Bulletin for International Taxation*, 2017.

[361] In this respect, there might be concerns coming from the EU. See J. P. FULLER – L. NEUMANN, *United States/Organization for Economic Cooperation and Development/European Union*, in *U.S. Tax Review*, 2018. The Authors suggest that, due to the Tax Cut and Jobs Act, the EU could consider the U.S. as a tax haven and report it to the OECD. See also R. S. AVI-YONAH – G. MAZZONI, *The Trump Tax Reform Plan: Implications for Europe*, in *Bulletin for International Taxation*, 2017. According to certain commentators, the new U.S. corporate tax rate could trigger the application of some EU Member States' CFC rules, like Germany. In this respect, see S.E. BÄRSCH – M. OLBERT – C. SPENGEL, *U.S. Tax Reform: The Implications in a Germany-U.S. Context*, in *Bulletin for International Taxation*, 2017.

[362] Before 1961, no country taxed the foreign source income of its multinationals' subsidiaries, because residence countries believed they lacked both source and

The tax system at issue is traditionally built on two principles that drive the need for tax structures. These principles are: a) corporations are treated as independent fictitious persons for the purposes of taxation; and b) (as it was previously stated) all U.S. based taxpayers are subject to worldwide taxation.

One distinctive and unique characteristic of the US Tax System is that it taxes all US citizens, residents and corporations on worldwide income. Corporations are determined as US domestic or foreign on the basis of their place of organization.

Foreign corporations are taxed on income that is from "sources within the US" or that is "effectively connected with the conduct of a trade or business within the US"[363]. There is a tension between the two principles insofar as tax persons are incentivized to use offshore corporations as a barrier to US taxation of the income earned through those corporations.

From 1913, when the US Income Tax was enacted, through 1962, a number of tax avoidance techniques were developed by international investors and were subsequently addressed through legislation, including transfers of property to foreign corporations to avoid US tax on the capital gains, the incorporation of the personal or foreign personal holding companies or "incorporated pocketbook" used to hold all personal holdings in stocks, bonds or other income producing

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residence jurisdiction over foreign corporations' foreign source income. However, in 1961 the Kennedy administration proposed taxing all income of controlled foreign corporations by using a deemed dividend mechanism derived from the FPHC. While this proposal was rejected, the resulting compromise (Subpart F, 1962) aimed at taxing income of CFC's that was unlikely to be taxed by source countries, because it was either mobile and could be earned anywhere (passive income) or structured to be earned in low-tax jurisdictions (base company income).

[363] See OECD, *Articles of the Model Convention With Respect to Taxes on Income and on Capital*, 2003.

property and foreign operating and investment companies in the wake of World War II[364].

In 1962[365], the US enacted Subpart F regulations (IRC §§ 951-964).

The Code provides: "Every person who is a United States shareholder […] of such corporations and who owns […[] stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with such taxable year of the corporation ends […] (i) his *pro rata* share […] of the corporation's subpart F income for such year".

As it was previously mentioned, a CFC is a foreign corporation more than 50% of which, by vote or value, is owned by U.S. persons owning a 10% or greater interest in the corporation by vote (U.S. shareholders). "U.S. persons" includes US citizens, residents, corporations, partnerships, trusts and estates.

Subpart F applies to certain income of CFCs and, thus, if a CFC has Subpart F income, each U.S. shareholder must concurrently include its *pro rata* share of that income in its gross income as a deemed dividend.

A major category of subpart F (IRC §954 (c)) is represented by the Foreign Personal Holding Company Income (FPHCI).

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[364] In this respect, see Office of Tax Policy, *The Deferral of Income Earned Through US Controlled Foreign Corporations: A Policy Study*, *Dept. of the Treasury*, 2000.

[365] Shortly after taking office in 1961, President Kennedy issued a message to Congress in which he described the basic tax avoidance problem with foreign corporations as involving: "artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven […]. What is interesting about this statement is the way in which it groups together two discrete phenomena under the single rubric of "artificial arrangements". Thus, questions about intercompany pricing and shifting of management fees are really about benefits that can be captured by related parties relative to unrelated ones.

This fairly wide category includes interests, dividends and rents and royalties, not to mention gains from the sale of property that produces passive income or that is held for investment, gains from commodities transactions, and gains from foreign currency transactions, as well as certain other income that is, in effect, the equivalent of interest or dividends.

Because of its passive nature, such income often is highly mobile and can be easily deflected.

Generally, rents and royalties earned by a CFC in an active business are excluded from FPHCI.

This exception does not apply, however, if the CFC's rents or royalties are received from a related person.

Another category taken into consideration by Subsection F is the Foreign Base Company Sales Income (FBCSI)[366], which is an exception, since Subpart F generally does not apply to active income.

However, certain sales income, referred to as foreign base company sales income, is subject to current inclusion under Subpart F because, when the manufacturing function is separated from its sales function, the sales income can easily be deflected from the jurisdiction in which the major economic activity that produced the value in the goods occurred, often a high-tax jurisdiction, to a low-tax jurisdiction where the sales activities occur.

This is particularly true in the case of related party transactions. Thus, the FBCSI rules require current inclusion of income of a CFC from the sale of property (a) that is purchased from, or on behalf of, or sold to, of on behalf of, a related person, and (b) that is manufactured and

[366] These rules are considered the paradigm rules that people have in mind when they describe in the CFC rules as functioning as a backstop to the transfer pricing rules.

sold for use, consumption or disposition outside the jurisdiction where the CFC is incorporated.

Then, Subpart F includes the category of Foreign Base Company Services Income, which applies to active income that can be deflected to a low-tax jurisdiction through related party transactions or through the performance of services.

Foreign Base Company Services Income includes, for instance, income from services performed outside the CFC's country of incorporation for, or on behalf of, a related person.

These rules generally were intended to address circumstances in which service activities are separated from the other business activities of a corporation into a separate subsidiary located in another jurisdiction to obtain a lower rate of tax for the services income.

Then, Subpart F mentions Foreign Base Company Oil-related Income, that includes income from all oil activities outside the CFC's country of incorporation.

The last income item taken into account by Subpart F is Insurance income, that includes all income derived from insurance and annuities related to risks that are situated outside the CFC's country of incorporation.

All other income, other from what was previously described, earned by a CFC is not subject to U.S. tax until the income is repatriated to the U.S.

2.2 The Foreign Derived Intangible Income (FDII) and the Global Intangible Low Tax Income (GILTI)

As it was previously mentioned, as a result of the 2017 Tax Cuts and Jobs Act, which entered into force in the tax year beginning after December 31, 2017, U.S. Tax Law now contains a new minimum tax

regime applicable to CFCs and provides tax benefits for domestic businesses using U.S. "intangibles" to exploit foreign markets.

Together, these provisions change the dynamics of cross-border taxation and their effect is difficult to quantify in the absence of IRS guidance.

In a nutshell, I.R.C. § 951A and 250 result in the following practices:1. a CFC's Global Intangible Low-taxed Income will pass through to its "U.S. shareholders"[367] (a term broadened under the new law) as a current year income inclusion; 2. In the case of a U.S. corporation (other than a regulated investment company or real estate investment trust), a deduction for foreign-derived intangible income (FDII) and GILTI will be allowed against its GILTI inclusion.

The Trump Tax Act and Jobs Act requires each U.S. shareholder of a CFC to include in income its GILTI which the shareholder is to add to its foreign-derived intangible. That income then generates a deduction such that the rate of tax the U.S. shareholder on its GILTI is 10% and on its FDII is 12,5%.

[367] Under §951A(a), each person that is a U.S. shareholder of a CFC for any tax year must include in gross income such shareholder's GILTI for such tax year must include in gross income such shareholder's GILTI for such tax year. Section 951A(e)(3) provides that a foreign corporation is treated as a CFC for any tax if it is a CFC at any time during such tax year. Pursuant to Section 951A(e)(2), a person is treated as a U.S. shareholder of a CFC for a given tax year only if it owns stock in the foreign corporation on the last day in the tax year of the foreign corporation on which it is a CFC. Ownership includes direct ownership and indirect ownership. Finally, Section 951A(e)(1) provides that in determining *pro-rata* shares of GILTI, including net CFC tested income in Section 951A(b) and Section 951A(c) (1)(A) and (B), the rules of Section 951(a)(2) apply in the same manner as to Subpart F income. Under that provision, Subpart F income is prorated to account for part-year ownership and dividend payments to prior owners, including amounts that are treated as dividends by reason of Section 1248. These rules, apparently, are designed to provide a straightforward answer, but that answer is not always clear when ownership changes occur. For a deeper analysis of the problem regarding the concept of "shareholders" as referred to GILTI rules, see K. KONSHNIK – A. HAAVE, *GILTI Until Proven Innocent: Down the Rabbit Hole of Global Intangible Low-Taxed Income*, in *Journals Tax Analysts*, 2018.

Since GILTI is composed of business income that would normally not be Subpart F income, the section regarding GILTI is a way to force some (not all) shareholders of foreign subsidiaries to recognize income from the subsidiary's foreign operations.

To calculate the deduction to which the payee of GILTI is entitled, we need to know what GILTI and FDII are.

GILTI requires a number of special definitions. The idea is that a minimal amount of U.S. shareholder's foreign income is subject to a minimum rate of tax. The taxpayer determines its GILTI by subtracting something the Trump Reform calls "net deemed tangible income"[368] from "net CFC tested income".

Net tested income is, essentially, the CFC's operating income net of its losses, so we call it, for easier reference, "net operating income". The number, in general, will be easy to identify.

Let's assume a CFC has net tested income of $ 300.000.

Now we need to understand the net deemed tangible income amount. That number is equal to the excess of 10% of the shareholder's so-called share of the subsidiaries' total qualified business asset investments (that is the total bases of the foreign corporation's adjusted bases in depreciable or amortizable property used in the foreign corporation's business) that exceeds the CFC's business interest expense. For example, if the combined average bases of the CFC's tangible assets (excluding land, of course, since land is not depreciable) is $ 1.000.000 and its interest expense for the year is $ 200.000, then the net deemed tangible income return is $80.000 (1.000.000 – 200.000 x 20%).

[368] Despite the acronym refers to low-tax intangible income, the GILTI rules apply to almost any income earned by a CFC that is not otherwise immediately subject to tax as passive or related-party income under the Subpart F rules, income that would typically be considered as active or operating income.

It is worth noting that the tangible income amount is not income at all: it is, simply, an amount representing assets. We refer to net deemed tangible income as "net assets" (net of the interest expense).

GILTI is the net operating income ($ 300.000) reduced by the net assets ($ 80.000) or $ 220.000. That amount ($ 220.000) is included in the taxpayer's income and is treated as subpart F income for virtually all purposes of the Code.

That is a significant change from current law, since GILTI is non-CFC income because, it is worth repeating, it consists primarily of operating income, not passive income. The new IRC Section 951A dovetails with the new IRC Section 245A we discussed just above, so that a significant number of foreign subsidiaries will generate immediate taxable income, even though they do not generate Subpart F income.

To determine how large the domestic corporate shareholder's deduction is, we add that number (the taxpayer's GILTI[369]) to the taxpayer's FDII, and then calculate the deduction from those two income items.

FDII[370] is the portion of domestic corporate shareholder's intangible income, determined on a formulaic basis (that is, the domestic corporation's income derived from the domestic shareholder serving foreign markets. The following formula for determining the

[369] For an interesting approach towards the calculation of GILTI, see M. A. SULLIVAN, *Economic Analysis: A User-Friendly GILTI Spreadsheet*, in *Journals Tax Analysts*, 2018.

[370] The Senate explanation of FDII, which appears immediately after the GILTI explanation, contains this odd sentence: "The Committee believes that offering similar [to GILTI], preferential rates for intangible income derived from serving foreign markets […] reduces or eliminates the tax incentives to locate or move intangible income abroad". In this respect, see §14202 of the Tax Cuts and Jobs Act, P.L., 115-97; §250(b); H.R. Rep. N. 115-466, at 622 (December 15th, 2017) (Conf. Rep.); Committee Print. Reconciliation Recommendations Pursuant to H. Con. Res. 71. However, it is hard to imagine how a brand-new penalty tax on GILTI can ever become a preferential rate. See J. L. CUMMINGS JR., *Foreign-Derived Intangible Income Deduction*, in *Journals Tax Analysts*, 2018.

corporation's deemed intangible income may come in handy in this context, in order to visualize the way the FDII is calculated.

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived eligible income}}{\text{Deduction eligible income}}$$

Income from intangibles is not a part of the formula, and it only works if we know what the phrases mean. Deduction eligible income is the gross income (calculated by disregarding certain items, such as Subpart F income, financial services income, foreign branch income); essentially, the domestic corporation's business income. Let's assume that number is, for instance, $ 10 million.

Deemed intangible income is the corporation's excess of its business income (the $10 million just discussed) over 10% percent of its qualified business asset investment.

The "qualified business asset investment" (QBAI[371]) is a similar concept to that contained in the GILTI discussion – that is, the adjusted bases of its depreciable tangible assets used in its business. Let's say that the QBAI number is $ 2.000.000; 10% of that number is, of course, $ 200.000. Modified business income (that is, the deduction eligible income) is $ 9,8 million.

Foreign derived deduction eligible income is the taxpayer's business income that is derived by the taxpayer that comes from property sold (or leased) to a non-U.S. person for foreign use and services provided

[371] In other terms, QBAI means, with respect to any CFC for a taxable year, the aggregate of its adjusted bases (determined as of the close of the taxable year and after any adjustments with respect to such taxable year) in specified tangible property used in its trade or business and with respect to which a deduction is allowable under §168. Specified tangible property means any tangible property to the extent such property is used in the production of tested income or tested loss. The adjusted basis in any property is determined without regard to any provision of law that is enacted after the date of enactment of this provision, unless such law specifically and directly amends this provision's definition.

by the taxpayer to a person or with respect to a property not located in the United States.

In other words, that phrase refers to the taxpayer's foreign source business income. Let's assume the taxpayer's foreign source business income is $ 400.000.

In our hypothetical, FDII income then is the taxpayer's modified business income (deemed intangible income or $ 9,8 million) multiplied by a fraction: the taxpayer's foreign derived deduction eligible income ($ 400.000) divided by its business income (deduction eligible income or $ 10 million) or 4%. Four percent of $ 9,8 million is $ 392.000. So, the taxpayer's FDII is $ 392.000.

Unlike the FDII rules (which incentivize U.S. corporations to minimize their investment in QBAI), the GILTI rules create a meaningful incentive for U.S. multinationals to increase the amount of depreciable tangible assets held by their CFCs, which in most circumstances will presumably be situated outside the United States. Assuming a more or less steady amount of overall income potentially subject to new IRC §250), increasing QBAI held by CFCs may be one of the most effective ways to manage or reduce GILTI.

The "aggregate" approach that the GILTI rules adopt for purposes of calculating net CFC tested income and QBAI is quite helpful in some respects, but also potentially restrictive in other respects.

Determining tested income and QBAI on an aggregate basis allows tangible assets held by one CFC to reduce GILTI attributable to tested income earned by a different CFC. This is generally a helpful aspect of the rules, as it eliminates the need to restructure existing supply chains to align tangible asset ownership with revenue and income recognition. At the same time, however, the aggregate approach may also limit the extent to which intercompany transactions can be used to effectively manage net CFC tested income, as a reduction in tested

income for one CFC will very often create tested income for the counterparty, resulting in no net change.

Also, whether intentional or unintentional, the Conference Committee's decision to forego repealing IRC §956 for corporate U.S. shareholders narrows a potential approach for managing QBAI and GILTI. Neither the Senate nor Conference Bills explicitly require that QBAI be located outside the United States. Thus, tangible assets of a CFC located in the U.S. may qualify as QBAI but can also result in IRC §956 inclusions.

Then, it is not clear whether the computational elements of GILTI will be done on a single entity or separate entity basis in the case of U.S. shareholders that are members of a consolidated group, an affiliated group filing separate returns, or an expanded affiliated group.

Finally, as noted, the FDII deduction mechanics incentivize domestic corporations to minimize the amount of tangible property (whether located in the U.S. or outside the U.S.) on their balance sheets, whereas the mechanics of the GILTI regime incentivizes groups to maximize the amount of tangible property owned by CFCs, which in most cases will presumably be outside the United States[372]. These competing incentives are surprising and somewhat troubling in light of the Act's policy goal to increase U.S. investment and employment.

One can question the longevity of these rules if a significant number of taxpayers make decisions to increase foreign, not U.S., investment in tangible assets.

The intricate system generated by the combination of GILTI and FDII has spawned a brand-new industry subset of the tax planning industry

[372] This particular effect is what mostly puzzles commentators. In fact, it has been argued that the promotion of foreign tangible investments coupled with an encouraged reduction in U.S. tangible investments was not among the advertised goals of the legislation. In this respect, see E. STEVENS – H. D. ROSENBLOOM, *GILTI Pleasures*, in *Journals Tax Analysts*, 2018; M. A. SULLIVAN, *Economic Analysis: Two Approaches to Less BEATing on the GILTI*, in *Journals Tax Analysis*, 2018.

to address the issues they raise. The new industry is focused on how to plan for the potential exposures or benefits of, and to restructure businesses, supply chains, and financing to deal effectively with, GILTI and to take advantage of FDII.

With FDII, for example, it can be expected that U.S. companies will consider leaving IP onshore, and will also evaluate how much of their export income can be put into the "intangibles" bucket.

This is certainly an effected wished for by the Reform, that was mainly aimed at stopping the location of I.P. in foreign countries.

With GILTI, planners will be looking at ways to lessen the burden of GILTI especially on non-C corporation[373] affected U.S. shareholders. And, of course, with GILTI the opposite of FDII applies, which for GILTI planning is to increase tangibles, in order to parallelly decrease the "intangibles" bucket subject to GILTI.

Although GILTI and FDII encourage keeping IP type assets at home in the U.S., there may still be considerable offshoring resulting from lower labour costs, or even talent pools, abroad that may not be available in the U.S.

In turn, these sorts of non-tax, economic considerations can be expected to continue to raise transfer pricing issues on cross-border related company transactions.

Code §951A significantly reduces a taxpayer's ability to generate tax free returns through a CFC from a U.S. tax perspective.

With the introduction of this provision into the Code, a U.S. shareholder's net deemed tangible income return ("NDTIR") and

[373] Corporations subject to tax are commonly referred to as C corporations after subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (real estate investment trusts) or in stock and securities (regulated investment companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to subchapter C.

CFC income that qualifies for the "high tax" exception to subpart F in appear to be the only CFC income streams that are not subject to tax in the United States on a current basis.

The remainder of the income, if it is not subject to immediate tax under the historic subpart F regime or otherwise, is subject to tax under the GILTI regime.

Before the Tax Cuts and Jobs Act introduced section 951A into the Code, U.S. multinationals could defer U.S. tax on income that did not fall into one of the traditional Subpart F categories (*e.g.* foreign base company sales income ("FBCSI"), foreign personal holding company income ("FPHCI"), or foreign base company services income ("FBCSvI")).

In a common deferral structure, a U.S. corporation entered into a cost sharing arrangement under Reg. §1.482-7 with a non-U.S. affiliate in a low tax jurisdiction with respect to the corporation's intangible property ("IP"). The non-U.S. affiliate typically made what is known as "platform contribution transaction," ("PCT") payment to the U.S. corporation for the U.S. corporation's IP rights that were reasonably anticipated to contribute to developing cost shared IP. The non-U.S. affiliate typically licensed the cost shared IP to a disregarded principal company.

Key to the deferral of U.S. tax was making sure that the CFC's income was outside of subpart F or qualified for an exception to subpart F.

Many taxpayers managed the subpart F issues for products by having the CFC buy from, and sell to, unrelated parties or by having the CFC provide the services directly to unrelated parties.

Electing to disregard related entities for tax purposes made it possible to avoid related party transactions, which trigger subpart F income under Code § 954(d) and (e).

In these structures, the immediate tax cost was generally limited to foreign tax, which could be relatively low if the principal non-U.S. operating company and/or the owner of the non-U.S. IP were resident in low tax jurisdictions. The benefit was particularly high for high margin companies because they could often derive and retain a very significant portion of the overall income.

Under Code § 951A, income earned by subsidiaries of U.S. companies will generally be subject to a U.S. tax rate of at least 10.5 percent. The NDTIR, which would reduce GILTI, is generally extremely low in many high margin businesses.

Companies in the digital sector generally have limited investments in depreciable tangible property. Companies that make and sell tangible products often engage unrelated contract manufacturers instead of investing in and maintaining factories and plants themselves. Companies that in fact manufacture often have very low or no tax basis in older factories and plants because they may have fully depreciated their initial investments in these facilities.

One very unfortunate impact of these rules is that they effectively penalize efficient taxpayers that maintain property and equipment for a long time. These taxpayers typically have a much lower tax basis in their tangible assets than their competitors.

As such, the Code now handicaps many of the United States' most efficient companies, making it more difficult for many of the United States' best companies to compete with their foreign competitors.

The final piece to the puzzle the Tax Reform has handed to the U.S. taxpayers is the foreign tax credit[374].

[374] For more details on the FTC, see T. K. DILWORTH, *Presumed GILTI (Until Proven GILTI): The GILTI Gross-Up Belongs in the GILTI Basket*, in *Journals Tax Analysts*, 2018.

The rule now is that the domestic shareholder of a CFC that generates GILTI is allowed a foreign tax credit in the amount of 80% of the taxpayer's "inclusion percentage" multiplied by the CFC's "tested foreign income taxes".

The taxpayer's inclusion percentage is its GILTI (in the above hypothetical, that number is $ 220.000) divided by the taxpayer's share of the CFC's tested income, which in the above hypothetical was $ 300.000 (220/300= 73%).

The tested foreign income taxes are the foreign taxes that are properly attributable to the taxpayer's tested income. So, for example, if the CFC's tested income accounted for $ 10.000 in foreign income tax, then the taxpayer would multiply that number by its inclusion percentage (73%). The taxpayer takes that number ($ 7.300) and multiplies it by 80% to arrive at $ 5.5840 as the taxpayer's foreign tax credit against its U.S. tax.

3. Is the U.S. tax reform in the direction of territoriality? Some critical aspects

The previous Section regarded the most interesting and rather complicated innovations introduced by the Trump Tax Reform, the scope of which is supposed to make it more convenient to invest in the U.S. and, at the same time, more disadvantageous to invest in other countries for U.S. companies.

According to Republican lawmakers, in fact, the Tax Cut and Jobs Act was intended to promote economic growth, increase jobs and level the global playing field for U.S. multinationals.

While the "selling" of the Tax Reform was its ability to grow and revitalize U.S. manufacturing base and attract foreign based companies to continue to invest in the U.S., the effect the Congress

triggered was to increase the competitiveness of U.S. companies overseas through FDII and GILTI.

As previously noted, the treaty partners have noticed these benefits the Tax Reform grants U.S. domestic corporations including domestic groups that are part of a multinational enterprise of corporations[375].

However, not all commentators seem to appreciate the result of this controversial Reform.

Apart from the unexpected result of reducing the competitiveness of some U.S. multinational[376], which has been discussed in the previous Section, one of the most criticized aspects of said Reform is the fact that it shifts from a worldwide taxation principle to a territoriality principle[377].

The Tax Cut and Jobs Act has been defined as the "most sweeping federal tax reform since the Tax Reform Act of 1986"[378] because, among the many federal income tax changes under this piece of

[375] In this respect, see J. D. AUGUST, *Tax Cuts and Jobs Act of 2017 Introduces Major Reforms to the International Taxation of U.S. Corporations*, in *Practical Tax Lawyer*, 2018. The Author points out that cries of unfair export subsidies have already been heard from the European countries and Canada and expects that another round of WTO litigation is to be expected. As it was previously mentioned, this effect is still quite controversial, and it has been argued that certain types of productions may suffer from this tax reform. In this respect, it is interesting to notice that while, on the one hand, the Trump Tax Reform is said to have turned the U.S. into a tax haven or to have increased the competitiveness of U.S. MNEs, on the other hand, it has been ferociously attacked by those who claim the drawbacks of this reform, either they are expected or unexpected, are more than the advantages it grants.

[376] Or, at least, the effect of having generated a hostile tax environment for these companies.

[377] Such effect is reached also through the enactment of the new §245, which provides a 100% dividends-received deduction (DRD) for the foreign-source portion of certain dividends.

[378] S. SMITH, *The DiRTTy and the GILTI*, in *Journals Tax Analysts*, 2018. The Author points out that the significance of the Trump Tax Reform's shift from a worldwide tax regime to a quasi-territorial one is not isolated to federal income taxes, but may also affect state taxes. In this respect, see also J. SEDON – W. HELLERSTEIN, *State Corporate Income Tax Consequences of Federal Tax Reform*, in *Journals Tax Analysts*, 2018. Conversely, other Authors believe the Trump Reform failed to deliver on its promise of a territorial system for CFCs. In this respect, see N. BOIDMAN, *The U.S.'s Illusionary Turn to Territoriality*, in *Journals Tax Analysts*, 2018.

legislation its new international tax provisions are designed to shift from a worldwide system of taxing U.S. corporations to a quasi-territorial regime.

It has been pointed out, however, that notwithstanding the intention of the Tax Cut and Jobs Act to depart from a worldwide tax system, it still preserves the anti-deferral regime of Subpart F, a legacy of complex provisions that relate back to the administration of former President John F. Kennedy.

As explained by Ault and Bradford[379], Subpart F is designed to curtail the worldwide system ability to defer the current recognition of income for tax purposes.

In principle, if global operations were carried out through foreign subsidiaries, the foreign source income would be subject to U.S. tax only on its distribution. However, under Subpart F, the income of a CFC is effectively treated as if it had been currently distributed as dividends to the U.S. shareholder and the reinvested.

Even with the U.S. new territorial (or quasi-territorial) tax system, qualified taxpayers are still required to calculate their *pro rata* share of predetermined categories of foreign-source income to be included in their current U.S. tax return, under Subpart F. This situation applies regardless of any dividend distribution.

Following the disruption initiated by the Tax Cut and Jobs Act by the introduction of a territorial tax system, Subpart F still resists with all its convoluted rules that endure as vestiges of past times where the system of American worldwide taxation was law of the land and was regarded as an example in the international context. Consequently, the

[379] H. J. AULT – D. F. BRADFORD, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in *Taxation in the Global Economy*, 1990.

"new territorial tax system of the Trump Tax Reform will find its nemesis with Subpart F"[380].

The move towards a territorial regime, including the new DRD, is expected to change the way that companies manage offshore versus onshore cash.

For example, some companies with cost sharing structures may already have restructured in response to the BEPS Project and other non-U.S. developments, or their IP supply chain structures may already be optimal from a commercial and non-U.S. tax standpoint. For such companies, restructuring to mitigate GILTI may be inappropriate. For these companies, checking some or all of the offshore structures into the U.S. group may be the better option.

For companies with a global non-U.S. effective rate of 21 percent or greater, checking the entire offshore structure into the U.S. group could make sense.

In this case, all of the foreign taxes of the non-U.S. group would fall within the separate "basket"[381]. This approach would migrate all non-U.S. I.P., including goodwill, going concern value, and workforce in place, to the United States.[382] As both Code Secs. 367(d) and 482 provide for a commensurate with income approach with respect to an outbound transfer of IP as defined in Code Sec. 936(h)(3)(B), the cost of migrating the non-U.S. IP back out of the United States at a later

[380] C. PÉREZ GAUTRIN, *US Tax Cuts and Jobs Act: Part 1 – Global Intangible Low-Taxed Income (GILTI)*, in *Bulletin for International Taxation*, 2019. The Authors explain that the U.S. are departing from the worldwide tax system in response to the Tax Cuts and Jobs Act's expansionary fiscal policy that is intended to provide U.S. MNEs with much greater flexibility to expand and compete in global markets with the benefit of obtaining tax-free repatriation on foreign revenue that would otherwise not be available in the worldwide tax system. This purpose, however, might be discouraged by the pre-existing rules set forth in Subpart F.

[381] These taxes would enjoy the one-year carry back and 10-year carry forward periods under Code Sec. 904(c). Moreover, these taxes would not be subject to the 20% GILTI "haircut."

[382] The definition of IP in Code Sec. 936(h)(3)(B) now includes goodwill, going concern value, and workforce in place.

date could be expensive, and possibly prohibitive as a practical matter. Unfortunately, if the U.S. statutory rate increases and/or Congress repeals or limits the FDII regime, the taxpayer may deeply regret having the IP back in the United States.

In other terms, taxpayers should rely on the fact that the current system will not be wiped out by the following tax policies and that the set of rules that justify new forms of tax planning will remain effective for a reasonable period of time.

For companies with a global non-U.S. effective rate of less than 21 percent, or for higher tax companies that wish to keep IP off shore, an alternative approach is to check the high tax operations into the U.S. group to maximize foreign tax credits, and to leave the lower tax operations, and the IP, offshore.

As the effective GILTI tax rate still is generally well below the U.S. statutory rate, leaving lower tax operations outside the U.S. group likely achieves a better tax result even if the income from these operations is treated as GILTI. In this case, it is quite evident that the anti-avoidance purpose of the Trump Reform was not accomplished.

Accordingly, checking active foreign operations into the U.S. group, by itself, may not be sufficient to obtain FDII benefits.

To obtain the benefit, the foreign branch or disregarded entity will usually have to take the additional step of assigning contracts with foreign parties from the disregarded foreign subsidiaries to the U.S. group.

Income under the contracts could then benefit from the FDII regime, and, while payments to the subsidiaries for their services in connection with the contracts would be disregarded, the expenses of the subsidiaries still could flow up to the U.S. group to reduce income under the contracts.

Although the company could achieve a similar structure without checking the subsidiaries into the U.S. group, that other structure would likely require outbound payments to the subsidiaries.

These payments could give rise to GILTI and also could be subject to the base erosion and anti-abuse tax (BEAT) in Code §59A.

It is necessary to spend few words on the BEAT to complete this Section of the Chapter.

New I.R.C. §59A imposes a base erosion and anti-avoidance tax on certain corporations making payments to related foreign persons. Because these payments are also governed by the arm's length principle (I.R.C. §482) the BEAT adds fresh complexity (as if it was requested) to the complexity of transfer-pricing tax and accounting results.

The BEAT is a measure that answers to the anti-abuse needs emerging from the OECD BEPS Action Plan.

To be subject to the BEAT in any tax year, corporate taxpayers must meet a three-part test: 1. The taxpayers must be a corporation that is not a regulated investment company, a real estate investment trust, or an S corporation[383]; 2. The taxpayer must have average annual gross receipts or at least $500 million over the three-year period ending with the preceding tax year; and 3. The taxpayer's base erosion percentage determined under §59A must be at least 3%.

While the first criterion is relatively easy to apply, the latter two conditions require greater analysis.

Two factors complicate the three-year-average-gross-receipts test: 1. The gross receipts of certain taxpayer groups must be aggregated and treated as gross receipts of one taxpayer, and 2. Not all gross receipts of foreign entities count toward the $500 million BEAT trigger.

[383] That is to say, a company that is not subject to the Federal Corporate Income Tax.

§59A cross-references §§52 and 1563(a) to identify entities whose gross receipts must be aggregated for purposes of the gross-receipts test. The essence of these cross-references is that any chain of corporations affiliated by 50% or more ownership, by vote or value, will be treated as a single taxpayer for purposes of determining the $500 million BEAT threshold. Under §1563(a), controlled groups may include parent-subsidiary chains, sibling corporations with a common parent, or any combination of the two.

Significantly, §59A(e)(3) also removes an exception to the controlled group rules of §1563 under which foreign corporations are not considered part of the controlled group.

As a result, foreign-parented groups of U.S. resident corporations, the foreign parent itself, and other foreign persons within the group may have to aggregate gross receipts in the three-year-average-gross-receipts determination. For example, to determine whether they are subject to the BEAT, two U.S.-resident corporations under common foreign ownership of 50% or more must aggregate their gross receipts, even if they do not file a consolidated return.

Not all gross receipts of the foreign parent or other foreign group members are included in the $500 million gross-receipts test. §59A(e) includes only the gross receipts of a foreign group member to the extent they are effectively connected with the conduct of a trade or business in the United States.

Therefore, while two or more U.S. resident corporations sharing a common foreign parent must aggregate all gross receipts, the gross receipts of the foreign parent often will not count in the aggregated gross receipts total.

The apparent purpose of the BEAT is to identify and impose a special tax on entities that make payments to affiliates for intangibles and most services that substantially reduce U.S. taxable income. A

corporation that passes the $500 million average-gross-receipts threshold for the most recent three tax years will still not be subject to the BEAT as long as its "base erosion percentage," a proportion of those payments compared with total deductions, is less than 3%.

Two concepts underlie the 3% test: 1. A "base erosion payment" is any amount paid or accrued to a foreign related party for which a deduction is allowable, including amounts subject to depreciation or amortization, as well as certain reinsurance payments[384]; 2. A "base erosion tax benefit" is generally any allowable deduction with respect to a base-erosion payment[385], excluding amounts subject to withholding on fixed or determinable annual or periodical income under §871 or 881.

A simpler formulation of the concept would be to consider the base-erosion test passed when deductible payments to related parties are greater than 3% of all deductible payments, including payments to related parties but excluding cost of goods sold. As an obvious and common example, many U.S. resident corporate subsidiaries of foreign parents that make large royalty or service payments to the foreign parent or other foreign group members and that pass the $500 million average gross-receipts threshold could be subject to the BEAT[386].

[384] "Related parties" are broadly defined to include any 25% owner of the taxpayer by vote or value, related persons under §267(b) or 707(b)(1), or any person related under §482. Base-erosion payments also include amounts paid or accrued to a surrogate foreign corporation and members of the expanded affiliated group of the surrogate foreign corporation, as defined in the anti-inversion rule of §7874.

[385] The "base erosion percentage" is the taxpayer's aggregate base-erosion tax benefit divided by all allowable deductions.

[386] For a deeper analysis of the BEAT calculation, see L. NGUYEN – J. MCOMBER, *Which Taxpayers are Potentially subject to the new 'BEAT'?*, in *The Tax Adviser*, 2018.

BEAT operates as a minimum tax. The amount is equal to 10% (it was 5% for tax year 2018) of the taxpayer's modified taxable income over the regular tax liability of that taxpayer.

Thus, in principle, a taxpayer could have no base erosion payments subject to BEAT and still suffer the BEAT minimum tax if its regular tax liability, for instance, were reduced by foreign tax credits.

In this respect, BEAT has nothing to do with base erosion payments, but rather operates as a true minimum tax[387].

A second observation, which perhaps is particularly appropriate for taxpayers who are caught by the pure minimum-tax effect described above: BEAT has an off and on switch.

It applies only to "applicable taxpayers," that is to say, those that have average annual gross receipts for a three-year period exceeding a certain amount and that also have a base erosion percentage of at least 3 percent for the tax year (2% for banks or registered securities dealers).

The BEAT switch is turned on, which makes the BEAT rules applicable, if the taxpayer has the tainted base erosion percentage or higher.

If the taxpayer can keep its base erosion percentage below that amount, the BEAT rules are turned off.

Base erosion percentage is determined by dividing the taxpayer's BEPs by the amount of deductions allowable to the taxpayer for that tax year.

A third observation relates to the exception for amounts paid for certain services[388].

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[387] In this sense, see J. P. FULLER – L. NEUMANN, *United States/Organization for Economic Cooperation and Development/European Union*, *supra*.

[388] In this respect, see T. ZOLIO – T. CHAMBERLIN – A. BAJWA – M. MOORE, *U.S. Tax Reform Considerations for Multinational Services Companies*, in *Journals Tax Analysts*, 2018.

Under §59A(d)(5), amounts paid for certain services are not treated as BEPs.

4. Conclusions

After having analysed the various topics of this thesis and its critical aspects, it is possible to draw some conclusions.

The purpose of the thesis was to identify the actions taken at international level (OECD), EU level and U.S. level to tackle tax avoidance, specifically in those cases where the exploitation of I.P. rights is involved and to compare them in order to assess their effectiveness. The starting point of the thesis was certainly the OECD BEPS Action Plan, that acts a sort of pioneer in the field of international taxation and that has traced the pathway the OECD Member States are required to follow, in order to be all "on the same page".

What the OECD has stressed out the most is the necessity to counter aggressive tax planning with a global approach, trying to give an example also to those countries that are not part of the OECD but look at it as a lighthouse.

The aim of the OECD is to eliminate the distortive effects of tax avoidance in terms of fair competition in the market even if it sees tax avoidance as a problem itself for the budgets of the States.

That being said, the OECD does not have enforcing powers, and this makes the activity of voluntary cooperation of the Member States vital, in order to achieve the objectives of the BEPS Action Plan.

If this were not the case and the OECD had such binding powers, then the analysis of the thesis could be limited to the relevant Actions of the BEPS Project.

Instead, and – in this respect – more interestingly, the OECD Member States have their own approach in the implementation of the OECD Recommendation and they usually act like a sort of pendulum: on the one hand, countries tend to adopt countermeasures against tax-avoidance but, on the other hand, they usually shape their tax systems in such a way that they get more interesting and encouraging for the foreign investors.

What makes things even more complicated is the case where a "screen" is juxtaposed between the OECD and its Member States.

In other terms, in all those cases where the OECD Member States are also EU Member States and this is because the EU is, as such, part of the OECD and because it is not a country, nor a federation of countries, which, as it is widely known, are asked to comply with the EU provisions and, thus, cannot – as a general principle - adopt pieces of legislation that are in breach with EU law.

As it was observed in the second Chapter, the EU has adopted a piece of legislation that is supposed to implement some of the recommendations included in the BEPS Action Plan, known as the ATAD (1 and 2). What is curious about the EU, is its sudden twist in the consideration of tax avoidance as a threat for the market and the adoption of some particularly restrictive anti-avoidance provisions, that the EU Member States have often been required to amend, in order to comply with EU law.

It appears that the EU has not felt the urge to intervene in the field of tax avoidance to defend the Member States and their taxing rights but, rather, to protect the market, which confirms the market-oriented approach the EU adopts in its activity.

There might be two possible standpoints in this controversial issue: on the one hand, the EU could not act differently, considering the limits the Treaties impose to its range of actions and powers, and is forced to

intervene even in ways and circumstances where the Member States could claim their tax sovereignty has been reduced (it must be borne in mind that the field of direct taxation is in the competence of the EU Member States); on the other hand, adopting a market-oriented approach partially weakens the EU and Member States' strategies in tackling tax avoidance, because the protection of the market is only part of the problem. Tax avoidance is a problem itself and it cannot be regarded exclusively as an obstacle in the cohesion of the internal market.

The two solutions envisaged in the second Chapter could not be more different: strengthening the EU by giving it more powers in the field of direct taxation, or limiting the activity of the EU, by giving back part of the sovereignty to its Member States.

It is probably the dilemma of our time, but the problem of tax avoidance within the EU probably stems from this dichotomy.

The "mistake" (justified by historical and political reasons and inevitable, considering the "step by step" approach adopted in the setting up of the Union) of the EU and of its Institutions has been to focus on the market and on the fundamental freedoms, underestimating the necessity of a harmonized market even in the field of direct taxation.

The result was that the ECJ has often expressed judgments in favour of the protection of fundamental freedoms (as it could be expected) and against the application of anti-avoidance measures. Since the EU Member States are free to shape their tax systems the way they prefer, and (to a certain extent) they can introduce favourable tax conditions in order to attract investments, the diabolical mechanisms triggered was that taxpayers have little by little transferred their residence from high-tax jurisdictions to low-tax jurisdictions, up to a point where such a practice could not be any more tolerated.

But the paradoxical situation is that the EU, that has often ruled against the application of anti-avoidance tools, recently enacted the ATAD, that enlists a series of anti-avoidance principles or minimum standards, whose compliance with the freedom of establishment has been debated.

What is most puzzling is the GAAR provision, that is supposed to sum up and implement the recommendations enshrined in OECD BEPS Action 6.

As it was previously highlighted, two are the main problems arising from this provision: first, its interaction with the specific anti-avoidance provisions included in the Directive. Does the GAAR prevail over the SAARs, in those cases where the conditions for the application of a SAAR are not fulfilled but the GAAR could theoretically apply? And, second, how far can the GAAR be stretched? In other terms, how wide can the interpretation of a GAAR in assessing if a given transaction or arrangement is aimed at obtaining undue tax benefits?

For what concerns the application of those principles to structures exploiting I.P. rights, a GAAR conceived the way the EU Institutions have conceived it, together with the CFC rules, set forth in Articles 7 and 8 of the Directive in object, should be able to limit episodes of tax avoidance, but the problem of the Directive provisions is still the same: its compatibility with the fundamental freedom.

If we imagine a company that transfers its legal seat from a high-tax jurisdiction (EU Member State A) to a low-tax jurisdiction (Member State B), keeping a branch in the first country where part of the business is carried out, and then sets up a subsidiary in another low-tax jurisdiction (EU Member State C), where it carries out its business and keeps the I.P., such a structure could easily be considered as in breach of the ATAD, as the main purpose of this structure would be to

benefit from the low tax rate provided by EU Member States B and C, which would trigger the GAAR at the very least. But would the application of the GAAR be compliant with EU primary law?

The extent to which the application of these ATAD provisions is allowed does not appear clear and some questions still remain unanswered.

Compared to the EU situation, the U.S. system could appear easier to evaluate, at least at first sight, provided that the U.S. are a country and are based on their own system of rules and principles.

However, things are not as clear as they seem.

If the EU have tried to comply with the BEPS Action Plan and have looked at the problem of tax avoidance exclusively from a problem-solving standpoint, the U.S. have adopted a slightly different and twofold approach: on one side, countering aggressive tax planning and addressing especially MNEs that exploit I.P. rights; on the other side, becoming more appealing for foreign investors by making it less interesting to invest in other countries.

As mentioned in the third chapter, such an approach has irritated many countries, some of which have started to look at the U.S. as a sort of hybrid country, half tax haven, half transparent and cooperative.

In other terms, the U.S. are a curious example of a country that is concerned of tax avoidance but, at the same time, wears some make up and struggles to look like a tax haven.

The combination of the low corporate tax rate, the DRD, the new Foreign Tax Credit, the participation exemption regime, the GILTI and the FDII as introduced by the Trump Tax Reform were meant to "make America great again" and to allow the U.S. to leap forward in the race against tax avoidance.

However, some controversial aspects deserve to be pointed out.

Let alone the competition issues and WTO-related problems mentioned in this third Chapter, the point of the international provisions was to make it more convenient to locate I.P. profits in the U.S., both for U.S. and foreign companies, and less convenient to place investments in intangibles in other countries. What appears from the analysis of the relevant provisions is, instead, that apart from encouraging I.P.-based business enterprises to invest in the U.S., the reform has made it more convenient to invest in "tangibles" abroad and, at the same time, discouraged to invest in the "tangibles" in the U.S.

The question that needs to be answered, then, is as follow: has the Trump Tax Reform by accident created new ways to avoid taxation in the U.S. by forgetting?

The second problem regards the cohesion of the tax system. Traditionally, the U.S. tax system has been based on a worldwide taxation principle and Subpart F of the I.R.C. is still firmly based on such principle.

As it has been observed by some commentators, the Tax Cuts and Jobs Act international tax provisions have resulted in a progressive abandonment of the worldwide taxation principle, in favour of the territoriality principle, which has certainly added more confusion to a system that was everything but simple to deal with and to comply with.

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