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# In the aftermath of the Panama and Paradise Papers:
# How does offshore tax avoidance work and how can it be prevented?

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# List of Abbreviations

| | |
|---|---|
| ATAD | Anti-Tax Avoidance Directive |
| ATAP | Anti-Tax Avoidance Package |
| ATP | Aggressive Tax Planning |
| BEPS | Base Erosion and Profit Shifting |
| CSR | Corporate Social Responsibility |
| CCCTB | Common Consolidated Corporate Tax Base |
| CFC | Controlled Foreign Company |
| CJEU | Court of Justice of the European Union |
| DBCFT | Destination-based Cash Flow Tax |
| DPT | Diverted Profits Tax |
| e.g. | Exempli Gratia (for example) |
| EU | European Union |
| GAAR | General Anti-Avoidance Rule |
| GDP | Gross Domestic Product |
| i.e. | Id Est (that is to say) |
| IMF | International Monetary Fund |
| IP | Intellectual Property |
| IRC | Internal Revenue Code |
| MNC | Multinational Corporation |
| NGO | Non-Governmental Organization |
| No. | Number |
| OECD | Organization for Economic Cooperation and Development |
| p. | Page |
| par. | Paragraph |
| SAAR | Specific Anti-Avoidance Rule |
| SEC | Securities and Exchange Commission |
| sec. | Section |
| UK | United Kingdom |
| UN | United Nations |

| | |
|---|---|
| UNCTAD | United Nations Conference on Trade and Development |
| UNCTC | United Nations Centre on Transnational Corporations |
| US | United States |
| Vol. | Volume |
| WTO | World Trade Organization |

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# Introduction

„Citizens are asking, why do offshore financial centers exist at all? Americans want to know, why did one of their presidential candidates in 2012 keep his money in an offshore center? Wasn't there sufficient competency in the United States to manage his wealth? Or were there some tax or other benefits - available to the rich, who could avail themselves of these offshore centers, but not to others. It is not as if there is something special in the sunshine of the Cayman Islands or the other offshore centers that makes money grow faster than elsewhere. If anything, it is the *lack* of sunshine that is the problem“[1].

A series of data leaks put the spotlight on the offshore finance industry and the role it plays in tax avoidance and evasion strategies of wealthy individuals and multinational corporations (MNCs). With 2.6 and 1.4 terabytes of leaked information, respectively[2], the Panama and Paradise Papers come out on top as the biggest known data leaks ever.

Whilst offshore entities are not illegal *per se*, the 2016 Panama Papers showed that this type of entities is often used for illegal purposes of tax evasion as well as other forms of crime, such as bribery and corruption, money laundering or terrorism financing. Similarly, the 2017 Paradise Papers documented how wealthy individuals and organizations take advantage of discrepancies between national tax systems to minimize their tax burden, thereby pointing out at a significant grey area where, if not clearly illegal, offshore practices at least raise ethical questions.

Whereas many commentators consider Switzerland to be the cradle of the modern offshore finance industry and the country remains nowadays one of the most important offshore players, the sector underwent considerable changes in the course of the 20th century, evolving into an elaborate network of offshore financial centers and tax havens, including developed as well as developing nations. The strong growth of offshore financial centers in the second half of the 20th century was fueled by a multitude of factors, including over-regulation and taxation in the post-war Organization for Economic Cooperation and Development (OECD) economies, strategies of formal colonial powers to support the development of their formal dependencies and growing demand driven by organized crime and corruption[3].

Increased globalization and digitalization also had a profound impact on the world economy and further contributed to the boom of the offshore finance industry[4]. Traditional borders and

[1] Stieglitz and Pieth, Shadow Economy, p. 4.
[2] BBC, Paradise Papers: Everything you need to know about the leak, 10 November 2017, available at: https://www.bbc.com/news/world-41880153?ocid=socialflow_twitter.
[3] Kudrle and Eden, Campaign Against Tax Havens, p. 5.
[4] Christensen and Murphy, Tax Avoidance and CSR, p. 40.

boundaries became blurrier, making room for more interaction and competition between national states. Among others, these developments opened new possibilities for individuals and organizations to explore and take advantage of existing tax regimes, including those in offshore financial centers, in order to decrease their tax liability or avoid it altogether.

Initially, national governments appear to have been rather concerned by possible double taxation situations when two or more countries would tax the same income. This debate marked the beginning of the 20th century and oriented international taxation towards the fundamental principles consisting of source-based taxation, arm's length pricing and international cooperation based on bilateralism[5]. In contrast, challenges and issues raised by offshore tax avoidance and evasion seem to have remained unseen for a long period of time by most national governments.

First anti-avoidance legislation was adopted in the US in 1962, with the enactment of the foreign controlled company (CFC) rules under Subpart F of the Internal Revenue Code (IRC), followed by the UK, with Chapter IV Part XVII of the 1988 Income and Corporation Taxes Act. Progressively, international initiatives joined national attempts to curb offshore tax avoidance and evasion. Most notably, in 1998, the OECD published the report on *Harmful Tax Competition: An Emerging Global Issue.* The report focused for the first time on tax havens and preferential tax regimes. It laid foundations for further international work in this area[6].

However, recent scandals, in particular the Panama and Paradise Papers, indicate that the measures adopted so far are not sufficient to respond to the challenges and issues raised by the offshore finance industry. The report *Overcoming Shadow Economy* written by Joseph Stieglitz and Mark Pieth in response to the Panama Papers puts transparency in the center of the debate. Since „transparency is only as strong as the weakest link - as the least transparent member of the global community“[7], the report emphasizes the need for international cooperation and coordination to achieve global transparency standards necessary to fight against tax and secrecy havens around the world.

Due to their cross-border presence and growing importance in the world economy, MNCs are of particular interest when it comes to offshore tax avoidance. MNCs are business organizations whose activities are located in more than one country and organizational form is defined through foreign direct investment[8]. In the period from 1990 to 2015, revenues and assets held

[5] Zucman: Taxing Across Borders, p. 123 – 124.
[6] Kerzner and Chodikoff, Tax Evasion in the Global Information Age, p. 62.
[7] Stieglitz and Pieth, Shadow Economy, p. 22.
[8] Smelser and Baltes, International Encyclopedia, p. 10197.

by major MNCs grew on average 5.4 percent and 7 percent per year, respectively, whereas the world gross domestic product (GDP) grew at a rate of 4.8 percent annually[9]. Based on their annual revenues, 69 of top 100 entities were corporations rather than countries in 2015, up from 63 in the previous year[10].

Their presence in more than one tax jurisdiction makes it particularly easy for MNCs to exploit gaps between national tax systems. As a result, the effective tax rates paid by MNCs have been significantly below the statutory as well as effective tax rates paid by domestic corporations[11]. The extent of this phenomenon is well illustrated by 2014 Microsoft's 10-K filing with the Securities and Exchange Commission (SEC). The corporation disclosed 92.9 billion US dollar of accumulated offshore profits and a potential tax liability of 29.6 billion of US dollar[12], which would have corresponded to a 31.9 percent tax rate, had Microsoft decided to repatriate these funds to the US. Taking into account the US statutory corporate tax rate of 35 percent, Microsoft's disclosure suggests that the corporation paid a 3.1 percent foreign tax rate on its offshore profits[13].

The main objective of this paper is to study the particularities of offshore corporate tax avoidance and its impact on the world economy, examine possible solutions to respond to the problems raised by tax avoidance and assess their efficiency, hence a two-fold focus on tax avoidance in the international context and the corporate world, in particular MNCs.

In order to achieve the aforementioned objectives, we will focus in Chapter I on the breaking point between tax avoidance and evasion as well as the main offshore tax avoidance techniques observable in recent years. Chapter II will discuss the impact of offshore corporate tax avoidance on the global welfare and the welfare of individual states. In Chapter III, we will retrace the development of unilateral and bilateral measures and explain their inherent limits and inability to keep pace with the globalized world, which pushed the international community towards international cooperation and harmonization efforts described in Chapter IV. We will

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[9] Oliver Wyman Working Paper, How Multinational Corporations Can Thrive In The New World Order, February 2017, p. 3, available at: http://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2017/may/Oliver_Wyman_New_World_Order_Working_Paper.pdf.

[10] Global Justice Now, 10 biggest corporations make more money than most countries in the world combined, 12 September 2016, available at: http://www.globaljustice.org.uk/news/2016/sep/12/10-biggest-corporations-make-more-money-most-countries-world-combined.

[11] Oliver Wyman Working Paper, How Multinational Corporations Can Thrive In The New World Order, February 2017, p. 5, available at: http://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2017/may/Oliver_Wyman_New_World_Order_Working_Paper.pdf.

[12] Microsoft Corporation, Form 10-K for the fiscal year ended June 30, 2014, p. 81, available at: https://www.sec.gov/Archives/edgar/data/789019/000119312514289961/d722626d10k.htm.

[13] Zucman: Taxing Across Borders, p. 130.

also examine the limits of the international cooperation. Chapter V will propose alternative solutions to respond to offshore corporate tax avoidance.

# I. Offshore corporate tax avoidance - definition and delimitation

## A. Tax avoidance, tax evasion or tax competition?

Tax avoidance, tax evasion and tax competition are closely related, albeit not interchangeable concepts. They are intertwined through their links to tax planning activities. On the one side, tax competition enables taxpayers to develop and implement elaborate tax planning strategies. On the other side, under specific circumstances, these tax optimization strategies may translate into less desirable forms of behavior, including tax avoidance or evasion.

Tax competition refers to competition between different tax jurisdictions, with the aim to encourage businesses to locate their operations there. Examples of tax competition encompass lowering of tax rates or granting of a favorable tax treatment for a limited period of time, so called tax holidays, to corporations after their move into the country[14]. Tax competition provides taxpayers with a variety of alternatives, thereby allowing them to plan their tax affairs by taking decisions with respect to their residence, tax base, legal form or citizenship[15]. The main aim of tax planning activities is to minimize taxpayers' final tax burden and simultaneously to maximize their after-tax profits.

Mills, Erikson and Maydew (1998) observed the impact of tax planning activities. Their estimate indicate that large corporations save on average four US dollar for every US dollar spent on tax planning activities[16]. As a result, tax planning activities have become an important part of business strategies of corporations, whether they are MNCs or not.

The 1998 OECD report on *Harmful Tax Competition: An Emerging Global Issue* explains how globalization put national tax systems into competition and, in this way, became one of the driving forces behind tax reforms and modernization of national tax systems. However, the report also identifies negative effects of globalization and tax competition, as these may cause the race to the bottom among tax jurisdictions. The resulting pressure to continuously lower tax rates in order to attract cross-border economic operators prevents national governments from effectively shaping their tax policies in accordance with their needs and causes tax revenues to drop. As a result, intense tax competition and rapidly changing tax policies facilitate tax planning activities which, in turn, may ultimately result in tax avoidance or evasion[17].

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[14] Oats et al., International Taxation, par. 18.3.
[15] Dagan, International Tax Policy, p. 13.
[16] Cited in Oats et al., International Taxation, par. 2.7.
[17] OECD, Harmful Tax Competition: An Emerging Global Issue, OECD Publishing, 1998, par. 21 – 31, available at https://read.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en#page1.

Depending on the level of aggressiveness of the selected tax planning strategy, the degree of compliance with applicable tax policies differs across the wide range of tax planning activities available to taxpayers. The scale begins at full tax compliance when taxpayers consent to pay taxes in accordance with applicable legal provisions and solely take benefit from tax reliefs and deductions that are explicitly conceded by the legislator[18].

When taxpayers decide to actively exploit loopholes and gaps within as well as between existing tax policies, without, however, breaching any specific statutory duties, they move from tax compliance towards tax avoidance, also referred to as aggressive tax planning[19]. Tax avoidance practices usually result in tax advantages which were unintended by the law[20].

If taxpayers go one step further and breach applicable tax policies in order to diminish their tax burden, for instance by misrepresenting the true state of their affairs or through dishonest tax reporting, such as declaring less income than the amounts actually earned, or overstating deductions, they move towards tax evasion[21]. Appendix 1 provides an overview of various tax planning strategies and their implications for tax compliance.

Most scholars provide a broad definition of tax avoidance. For instance, Tim Edgar (2007) defines these practices as "any change in behavior that occurs as a response to the change in price of particular activities, assets or transactions occasioned by the imposition of taxation"[22]. Existing case law confirms that avoiding taxes does not imply anything improper, as long as it is achieved in compliance with legal provisions[23]. As held in the case *Helvering v. Gregory*, decided in March 1934 by the Second Circuit of the US Court of Appeals and, subsequently, confirmed by the US Supreme Court in January 1935: „One may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes"[24]. Similarly, in the *Duke of Westminster Case* from May 1935, the British House of Lords held that „every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be."[25]

[18] Loretz et al., Aggressive Tax Planning Indicators, p. 23.
[19] Loretz et al., Aggressive Tax Planning Indicators, p. 23.
[20] Petrin, Aggressive Tax Planning, p. 15.
[21] Loretz et al., Aggressive Tax Planning Indicators, p. 23.
[22] Cited in Duff, Tax Avoidance in 21 Century, p. 478.
[23] Dyreng et al., Long-Run Avoidance, p. 2.
[24] Helvering v. Gregory, 69 F.2d 809 (2nd Cir. 1934), cited in Likhovski, Tax Avoidance Adjudication, p. 5.
[25] Commissioners of Inland Revenue v. Duke of Westminster [1936] A.C. 1, cited in Likhovski, Tax Avoidance Adjudication.

Based on the above, the breaking point between tax avoidance and tax evasion is legality. Whereas tax evasion involves a violation of tax laws, aimed at escaping a tax liability that has already arisen, tax avoidance consists of tax arrangements that disregard the intention of the legislator but do not directly breach the letter of the law. The main objective of tax avoidance is to avoid a tax liability that would otherwise arise[26]. As a result, tax avoidance cases often involve legal interpretation as well as tax policy issues, requiring not only to interpret the letter of tax laws but, more importantly, to understand the policy intention behind those laws.

## B. Forms of offshore corporate tax avoidance

Due to inherent fuzziness of the tax avoidance concept, there is no generally admitted classification of these techniques. Heckemeyer and Overesch (2017) identified two main strategies, namely the use of internal and external debt as well as the use of transfer pricing and licensing of Intellectual Property (IP). Overesch (2016) refined this analysis by distinguishing the relocation of IP and related royalty payments from general transfer pricing[27].

Another approach for a systematic analysis of offshore corporate tax avoidance techniques is to identify main conduits that taxpayers use to diminish their tax burden. This classification results in three basic groups of offshore corporate tax avoidance techniques, including the following:

1. Methods which exploit differences resulting from various tax treatments of the taxpayer's entity (entity-based schemes);
2. Methods involving the use of specific transactions and financial instruments in order to obtain an unjustified tax advantage (transaction-based schemes); and,
3. Methods which use tax treaties in an improper way (improper use of tax treaties).

The aforementioned approach along with the underlying examples of tax avoidance techniques are used for the purposes of the present paper and are presented in more detail in the below paragraphs.

### 1. Entity-based schemes

Examples of tax avoidance schemes focusing on the set-up of taxpayer's entity and the resulting tax treatment include hybrid entity mismatches and inversions. Both aforementioned techniques lead to tax erosion in the affected tax jurisdiction.

[26] Baker, Improper Use of Tax Treaties, p. 5.
[27] Cited in Loretz et al., Aggressive Tax Planning Indicators, p. 24.

Hybrid entity mismatches are the most prominent example of an entity-based tax avoidance scheme. This technique exploits differences in the tax treatment of an entity under the laws of two or more jurisdictions to achieve double non-taxation[28] whereby the entity is disregarded for tax purposes, i.e. the entity is tax transparent, in one country and treated as non-transparent and therefore subject to taxation in another country. Such situations may lead to a double deduction of the same payment, expenses or losses or to a deduction of a payment without a corresponding inclusion of that payment in another jurisdiction[29].

The US tax system stands out with a specific set of rules, called check-the-box rules, which enable eligible US taxpayers to actively choose whether an entity shall be treated as transparent for US tax purposes or not. The check-the-box rules also list those entities which are always taxable as corporations, so called *per se* corporations, and, therefore, are not entitled to use the check-the-box election procedure. Whereas the check-the-box rules are meant to simplify the process of entity classification for tax purposes, they have quickly become a tool used by MNCs to actively engage in tax arbitrage[30].

Related forms of hybrid mismatch arrangements based on the taxpayer's entity encompass hybrid permanent establishment mismatches and dual resident mismatches. Hybrid permanent establishment mismatches occur in situations when the tax jurisdiction where business activities are carried out, does not consider that there is a permanent establishment and, therefore, does not tax these business activities. At the same time, the tax jurisdiction where the taxpayer is resident, considers that the business activities are carried out through a permanent establishment, which leads to a tax exemption in this tax jurisdiction. Dual resident mismatches may be observed in situations when two or more tax jurisdictions consider a taxpayer to be their resident and have similar tax deduction provisions. As a result, the taxpayer is able to deduct the same payment in both tax jurisdictions.

Another way to reduce the tax burden by modifying the taxpayer's corporate structure encompasses inversions. This term refers to a process by which MNCs relocate their holding company to a location with lower taxes and a limited ability to tax foreign income. In recent years, Bermuda and the Cayman Islands have been the most popular expatriation location

[28] European Commission, Commission staff working document accompanying the document Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries COM(2016) 687 final, SWD(2016) 345 final, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016SC0345&from=EN, p. 5.
[29] European Commission, Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, COM(2016) 687 final, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0687&from=EN, p. 5 - 6.
[30] Oats et al., International Taxation, par 12.23.

whereby these inversion transactions have often involved little to no shift in actual economic activity of the taxpayer[31].

Due to the worldwide tax system and high statutory tax rates, inversions have mainly occurred in the US and, up until recently, also in the UK. Whereas the UK carried out a substantive reform of the tax system, the US opted for dissuasive measures, aimed at penalizing inversion activities. In spite of these measures, a „second wave of inversions“ has been announced by several high-profile US taxpayers, including Pfizer, AbbVie, Burger King and Chiquita. Even though some of these plans were later abandoned, they have raised new concerns over possible erosion of the US tax base and re-opened debates about an in-depth reform of the US tax system[32].

### 2. Schemes focusing on transactions and financial instruments

The second type of tax avoidance schemes is based on specific transactions and financial instruments. It includes in particular debt financing, transfer pricing and hybrid instrument mismatches. This type of offshore corporate tax avoidance techniques usually causes profit shifting.

Debt financing, i.e. the use of interest and payments economically equivalent to interest, is one of the simplest and most accessible profit shifting techniques. This practice consists of measures aimed at shifting profits to affiliates located in low-tax jurisdictions and, simultaneously, concentrating interest expenses in affiliates established in high-tax jurisdictions[33]. When an affiliate in a jurisdiction with low or no corporate tax grants intra-group loans to affiliates in high-tax jurisdictions, the profits resulting from interests paid to the lender are subject to a low or no tax. Furthermore, the lendees are allowed to deduct the interest costs from their taxable income, thus reducing their tax burden.

Transfer pricing is another technique that may potentially lead to profit shifting. This term refers to the price setting in business transactions between associated persons[34]. The price setting between related parties may raise specific difficulties because of a close relationship between both parties to the transaction. In particular, it may lead to price manipulations in an attempt to reduce overall taxable income of the corporate group.

For instance, if affiliates in jurisdictions with high taxes reduce prices of goods or services sold to related parties in low-tax jurisdictions, income that is subject to high taxes will diminish. If,

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[31] Marples and Gravelle, Corporate Expatriation, p. 3, 5 and 7.
[32] Marples and Gravelle, Corporate Expatriation, p. 1 – 2.
[33] Loretz et al., Aggressive Tax Planning Indicators, p. 27.
[34] Oats et al., International Taxation, par. 13.1.

at the same time, affiliates in high-tax jurisdictions are facing higher prices for purchases from affiliates in low-tax jurisdictions, income that is subject to low taxes will increase. The above price manipulations enable an MNC to artificially shift a portion of its income from jurisdictions with high taxes to jurisdictions with low taxes, thereby lowering the overall tax burden of the corporate group.

The importance of transfer pricing along with the risks of manipulations have increased over time in response to a rapid growth of MNCs. Nowadays, MNCs represent a large share of the global economy. Based on the United Nations Conference on Trade and Development (UNCTAD) data, MNCs produce about ten percent of the total global GDP (2010) whereby intra-firm trade accounts to approximately 80 percent of global trade (2013)[35].

The 2017 OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* considers the arm's length principle to be the international transfer pricing standard[36]. This principle requires the prices for business transactions between associated persons to be similar to those charged for transaction between unrelated parties since business transactions between unrelated parties are usually governed by external market forces and, therefore, should not be biased by any ties and interdependencies between entities involved in the transaction. In the context of the simultaneous growth of MNCs and intra-firm trade, the arm's length principle has become a crucial concept of international taxation.

Whereas internal transfers of tangible goods and services do not raise specific difficulties with respect to the arm's length principle, it is particularly complicated to assess whether internal transfer prices charged for rights to IP and other intangibles fulfill the arm's length principle. For tangible goods and services, substitutable items are usually sold in the market, which allows a price comparison. Furthermore, alternative pricing methods, such as those based on production costs, are also available. In contrast, rights to IP and other intangibles often result from new inventions and, therefore, no substitutable products or services are available in the market[37].

The last example of schemes focusing on transactions and financial instruments, which is described in this paper, includes hybrid financial instrument mismatches. Similar to hybrid entity mismatches, this tax avoidance technique also exploits differences in the tax treatment of a financial instrument under the laws of two or more jurisdictions to achieve double non-

[35] Cited in Vandenhende, EU and Corporate Tax Avoidance, p. 12.
[36] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration 2017, OECD Publishing, Paris, available at: https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page36, p. 33.
[37] Gravelle, International Tax Avoidance and Evasion, p. 12.

taxation. At the risk of oversimplifying, one could say that the taxpayer sets up a transaction or a financial instrument in a way to ensure that this transactions or financial instrument is treated as debt by the tax jurisdiction where it was issued, and equity giving rise to tax exempt foreign dividends by the tax jurisdiction where the return on that transaction or financial instrument is expected[38].

### 3. Improper use of tax treaties

The last group of offshore corporate tax avoidance techniques refers to various practices involving the improper use of tax treaties. Due to a variety of provisions possibly targeted by this form of offshore corporate tax avoidance, the improper use of tax treaties may lead to base erosion as well as, more specifically, to profit shifting.

The commentary on Article 1 of the *United Nations Model Double Taxation Convention between Developed and Developing Nations* defines the improper use of tax treaties as follows: „Provisions of tax treaties are drafted in general terms and taxpayers may be tempted to apply these provisions in a narrow way so as to obtain benefits in circumstances where the Contracting States did not intend that these benefits be provided."[39]

According to the commentary on Article 1 of the OECD *Model Convention on Income Tax and on Capital*, „the extension of the network of tax conventions increases the risk of abuse by facilitating the use of arrangements aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in these conventions."[40] The main tax benefits granted by double tax treaties include exemption from tax in one or other of the countries, reduced withholding taxes on dividends, interest and royalties as well as a foreign tax credit or exemption to eliminate double taxation[41].

Treaty abuse includes situations when a taxpayer from a third country establishes a corporate entity, a so-called conduit entity, in one of the treaty countries in order to gain access to tax advantages granted by the tax treaty. Another form of treaty abuse encompasses instances when a resident in the treaty country attempts to circumvent conditions and thresholds regulating the access to tax advantages granted by that tax treaty. Paragraphs 40 to 99 of the commentary on

[38] Oats et al., International Taxation, par 12.4 and 12.5.
[39] UN, United Nations Model Double Taxation Convention between Developed and Developing Nations, Edition 2011, Commentary on Art. 1, par. 8, available at: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf.
[40] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, 2017, Commentary on Art. 1, par. 55, available at: https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page4.
[41] Baker, Improper Use of Tax Treaties, p. 3.

Article 1 of the *United Nations Model Double Taxation Convention between Developed and Developing Nations* contain a detailed overview of various forms of treaty abuse.

## C. Role of tax havens

Offshore financial centers and tax havens are often used as substitutable terms to designate what appears to be a crucial tool of offshore corporate tax avoidance. However, one should not confound them. Whereas all tax havens appear to be offshore financial centers, not all offshore financial centers necessarily meet the characteristics of a tax haven.

Offshore financial centers are jurisdictions in which transactions with non-residents far outweigh transactions related to the domestic economy (Dixon, 2001)[42]. These jurisdictions use various tools to attract investors, including favorable tax regime, legal and regulatory environment or a combination thereof. As a result, offshore financial centers may decide to exclude tax benefits from the package destined to attract foreign investors and replace them by some other advantages. In contrast, tax havens heavily rely on their tax regimes.

There is no generally admitted definition of a tax haven nor is there any universal consensus about the list of countries that qualify as a tax haven. Rather than trying to provide a straightforward definition, the 1981 Gordon Report, prepared for the US Treasury, identifies two main characteristics of tax haven. First of them is a low or zero tax rate on all or certain categories of income. The second feature is a certain level of banking or commercial secrecy. The report also lists additional features displayed by most tax havens, in particular importance of banking and financial activities for the country, availability of modern communication facilities, absence of currency exchange controls and self-promotion as an offshore financial center. The report points out at a special case of tax havens based on an extensive network of tax treaties[43].

Many offshore corporate tax avoidance schemes are actually based on discrepancies in tax rates and tax provisions within a particular tax jurisdiction or between several tax jurisdictions, thereby not necessarily requiring the use of a tax haven to be successfully implemented. Therefore, one can question the actual role and the extent of the involvement of tax havens in offshore corporate tax avoidance schemes. Empirical research suggests that the use of tax

[42] Cited in Oats et al., International Taxation, par. 16.3.
[43] Gordon, Richard A., Tax Havens and Their Use by United States Taxpayers: an Overview. A report to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy), Department of the Treasury, Internal Revenue Service, 1981, p. 14 – 20, available at: https://archive.org/details/taxhavenstheirus01gord.

havens may increase the impact of tax planning activities and lead to an additional reduction of the tax burden. For instance, Maffini (2009) indicates that, at the mean, effective tax rates of MNCs with tax haven subsidiaries are about one percentage point lower than effective tax rates of corporate groups without tax haven operations[44]. Generally speaking, one can assume that the more aggressive and complex the tax planning activities are, the more interest the taxpayer has in using a tax haven in order to add an additional layer of confidentiality and prevent tax authorities from getting a full understanding of the corporate set-up.

Tax havens have been experiencing a considerable boom since the end of the 1970s when new tax havens started to emerge and take over increasingly specialized tasks. According to Kudrle and Eden (2003), tax havens help foreign corporations to reduce their tax burden by either producing goods and services or shifting claims among jurisdictions or hiding them[45].

Based on their specialization, tax havens can be divided into four main categories. Production havens are tax havens in which real activities take place, i.e. goods and services are manufactured. With its 12.5 percent corporation income tax, skilled workforce and support provided to research and development, Ireland has been able to attract a significant number of foreign investors who moved their production there. Headquarters havens provide various tax advantages to firms that are incorporated in these tax jurisdictions. Kudrle and Eden (2003) list Singapore and Belgium as examples of headquarters havens. Sham havens, also referred to as base havens, offer low or zero taxes on all kinds of income. Sham havens can be found in the Caribbean and include countries such as Bermuda, the Bahamas or the British Virgin Islands. As they only have limited infrastructure, natural resources and labor, no real activity is usually transferred to sham havens. Finally, secrecy havens, such as Switzerland, Luxembourg and Austria, offer high levels of secrecy to foreign taxpayers, thereby enabling them to hide their income and wealth from their home tax authorities. Secrecy havens have been recently under increasing pressure to abolish bank secrecy, which led many of them to limit the corresponding provisions and weakened their status as a secrecy haven[46].

According to Zucman (2015), rather than competing with each other, various offshore centers in fact work in symbiosis by assuming tasks belonging to various stages of wealth management. In the context of the fight against money laundering, Switzerland abandoned the practice of numbered bank accounts, which led to the necessity to put in place other confidentiality mechanisms. Nowadays, to ensure confidentiality, bank accounts are held by intermediary

[44] Maffini, Tax Havens and Tax Liabilities, p. 39.
[45] Kudrle and Eden, Campaign Against Tax Havens, p. 3.
[46] Kudrle and Eden, Campaign Against Tax Havens, p. 4.

entities, including in particular trusts, foundations and shell corporations headquartered in tax havens, such as British Virgin Islands, the Cayman Islands and Liechtenstein. These tax havens not only allow a cheap and rapid creation of such intermediate entities but they often also provide further secrecy mechanisms, such as nominee directors and shareholders who step in for beneficial owners. As a result, more than 60 percent of bank accounts in Switzerland are held today through such intermediary entities[47].

## D. Offshore corporate tax avoidance in practice - a case study

Recent data leaks have revealed corporate structures used by high-profile MNCs, such as Apple, Amazon, Google, Starbucks and Nike, in order to reduce their tax burden. Interestingly, examples include both high-technology as well as low-technology corporations, which suggests that the actual business focus of the MNC has only a limited impact on its ability to set-up a corporate structure aimed at reducing the overall tax burden of the corporate group. In this section, the corporate structure of Nike will be discussed in detail, along with its evolution over the time that allowed Nike to take into account the closing loopholes in tax systems and identify the new ones. For a schematic overview, please refer to Appendix 2.

Available data suggest that effective worldwide tax rates of Nike continued to drop from over 35 percent in 2001, which corresponded to the normal corporate income tax rate in the US, to slightly over 30 percent in 2007 and approximately 25 percent in 2014. In 2017, the worldwide tax rate of Nike was 13.2 percent[48].

The Paradise Papers also revealed that Nike had been one of the clients who benefited from tax advice provided by the law firm Appleby. In the period from 2005 to approximately 2015, the non-US part of Nike's business was organized around a Bermudan company, Nike International Ltd., which held ownership rights to Nike's IP in markets outside of the US. In addition to Nike International Ltd., further offshore subsidiaries were progressively incorporated in the Bermuda. They were mainly named after various types of shoes produced by Nike. Whereas their role in the overall Nike's set-up remains unclear, the main function of Nike International Ltd. was to collect royalty fees paid by non-US sales operations in exchange for the authorization to sell Nike's products.

[47] Zucman, Hidden Wealth of Nations, p. 22 – 28.
[48] Bowers, Simon, How Nike Stays One Step Ahead of the Regulators, International Consortium of Investigative Journalists, 6 November 2017, available on: https://www.icij.org/investigations/paradise-papers/swoosh-owner-nike-stays-ahead-of-the-regulator-icij/.

During the aforementioned period, sales activities of Nike in Europe were coordinated by two corporate entities established in the Netherlands. One the one hand, Nike Retail BV was in charge of organizing the sale of Nike's products through a network of Nike department stores in the European market. From the legal perspective, Nike opted for a network of branches, rather than local subsidiaries. Nike Retail BV was also in charge of online sale. On the other hand, Nike European Operations Netherlands BV was in charge of coordinating the sale of Nike's products through conventional shoe retailers and department stores. As a result, the aforementioned Dutch affiliates of Nike were not only collecting the sales proceeds in Netherlands but also in the remaining countries in Europe.

The choice of both Bermuda and the Netherlands appears to have been a highly strategic decision of Nike. Sales revenues from the European market were first concentrated in the Netherlands. Production and other costs, including royalty payments to Nike International Ltd., were deducted from revenues. As a result, the taxable income in the Netherlands was significantly reduced, which also diminished taxes paid by Nike in the Netherlands. Subsequently, royalty payments were transferred to Nike International Ltd. It shall be noted that the Netherlands do not levy any withholding tax on royalty payments. This will change in 2021 when withholding tax will start to apply to intra-group royalty payments[49]. Bermuda does not levy any corporate income tax on foreign income, which enabled Nike to drastically reduce the amount of corporate income tax paid on non-US income.

Upon the expiration of the original tax agreement with the Dutch tax authorities in 2014, Nike's corporate structure changed again. Ownership rights to Nike's IP were moved to a new Dutch company, Nike Innovate CV, and royalty payments from other Dutch affiliates of Nike were redirected to this new corporation. Whereas Nike's initial set-up achieved the tax reduction mainly through transfer pricing and, more particularly, through the relocation of and the corresponding use of royalty payments, the new set-up is based on a hybrid entity mismatches. The corporate form CV, which stands for *commanditaire vennootschap*, corresponds to a Dutch version of a limited partnership. The Paradise Papers revealed that Nike Innovate CV is controlled by a chain of further limited partnerships, with on the top a Delaware corporation, Nike Holding LLC. Nike Innovate CV is tax transparent under the Dutch law, whereby from the Dutch perspective the ultimate general partner, Nike Holding LLC, is liable for paying taxes. However, from the US perspective, Nike Innovate CV is a foreign subsidiary of a US

[49] Stokmans, Sjoerd / Hasselaar, Thomas, Dutch Ministry of Finance introduces withholding tax on intragroup dividends, interest and royalties per 2021 and introduces new Dutch substance requirements, 28 February 2018, available at: https://www.vandoorne.com/en/knowledge-sharing/2018_q1/dutch-ministry-of-finance-introduces-withholding-tax-on-intragroup-dividends-interest-and-royalties-per-2021/.

corporation and, therefore, its income is primarily taxable in the Netherlands. In fact, Nike Innovate CV will not be subject to US corporate income tax until dividends are distributed to the US shareholder, Nike Holding LLC. This hybrid structure, with the US and Dutch tax authorities treating Nike Innovate CV in a different way, leads to double non-taxation, when Nike Innovate CV's income is subject to taxes neither in the Netherlands nor in the US.

In a short overview of frequently asked questions about Dutch CVs, the law firm Mossack Fonseca also pointed out at the use of the Dutch limited partnership for tax planning purposes: „The closed CV is often used in tax planning structures as a hybrid entity (…) For instance, although the Netherlands disregards the closed CV for tax purposes, other countries treat the closed CV as a regular legal entity. As a consequence, many kinds of tax planning opportunities arise[50].

Based on the Paradise Papers, in 2010, 2011 and 2012, royalty payments amounting to a total of 3.86 billion US dollar were transferred to Nike International Ltd. In subsequent years, royalty payments amounted to approximately one billion US dollar per year. The above strategies allowed Nike not only to significantly reduce the effective corporate income tax but also to accumulate offshore assets which grew from approximately one billion US dollar in 2005 to more than six billion US dollar in 2014 and more than twelve billion US dollar in 2017. It is worthy to note that sales figures reported by Nike for Western Europe are approximately six billion US dollar per year[51].

[50] Mossack Fonseca, Dutch CVs - Frequently Asked Questions, September 2013, available at: http://www.mossfon.com/wp-content/uploads/2014/11/NCV_FAQs.pdf.

[51] Gamperl, Elisabeth / Obermaier, Frederik / Obermayer, Bastian, Just Do It, Süddeutsche Zeitung, 6 November 2017, available at: https://projekte.sueddeutsche.de/paradisepapers/politik/nike-and-its-system-of-tax-avoidance-e727797/.

# II. Impact of offshore corporate tax avoidance

## A. Financial costs

Losses of tax revenues appear to be the most immediate negative impact of offshore corporate tax avoidance but the quantification of this phenomenon is rather challenging. According to the 2013 OECD report on *Addressing Base Erosion and Profit Shifting*, „with the data currently available, it is difficult to reach solid conclusions about how much BEPS actually occurs“[52]. Similarly, the 2015 EU Parliament study on *Bringing Transparency, Coordination and Convergence to Corporate Tax Policies in the EU* stated that in spite of „substantial evidence that tax avoidance and evasion impose significant revenue losses, most economists agree that estimating those losses with any precision is a challenge“[53].

As shown in previous sections, main features of most tax avoidance schemes are complexity and secrecy. Tax avoidance schemes evolve in the grey zone between tax compliance and tax evasion whereby the borderlines are often blurry and there may be disagreement over the classification of individual techniques. As there is no unique source of information which would provide comprehensive insights into taxation, potential information sources encompass data collected by various national tax authorities during random tax audits and tax amnesties, data leaks involving the offshore financial industry[54] as well as, more generally, financial and corporate information published by taxpayers and various public and private databases. Due to their heterogeneous nature, these data cannot be further exploited without any prior interpretation and reconciliation.

As a result of the above circumstances, there is no straightforward approach to assess losses of tax revenues caused by offshore corporate tax avoidance. Estimates usually rely on a series of assumptions and are subject to limitations and caveats. Limited availability of data and its heterogeneity may prevent from fully apprehending whether observed behaviors are a manifestation of aggressive tax planning activities or whether they are caused by other factors. Factors other than tax avoidance include strategic relocation of capital and investment by the taxpayer, deliberate decisions of national governments to grant tax benefits to specific taxpayers or lax attitude of tax authorities towards tax enforcement in order to attract foreign investment.

[52] OECD, Addressing Base Erosion and Profit Shifting, OECD Publishing, 2013, p. 15, available at: https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1.
[53] Dover et al., Transparency and the EU, p. 8.
[54] Alstadsaeter et al., Tax Evasion and Inequality, p. 1 - 2.

Furthermore, existing estimates often provide aggregated figures for both tax avoidance and tax evasion and/or fail to distinguish between individual and corporate as well as national and cross border tax avoidance.

Empirical research on the impact of tax avoidance evolves around two main approaches. The first group of studies focus on what is believed to be symptoms and tell-tale signs of tax avoidance in order to get a better understanding of this phenomenon. The second group of empirical research attempts to assess the direct financial impact of tax avoidance by quantifying tax revenue losses.

With respect to the first group of empirical research, one of the possible approaches to apprehend the impact of tax avoidance is to observe the effect of changes in the corporate income tax rate of the host country on reported pre-tax profits. This approach is based on an assumption that profits are shifted from high-tax to low-tax jurisdictions. Heckemeyer and Overesch (2013) confirmed a negative correlation between the corporate income tax rate and pre-tax profits, suggesting that a one percent decrease of the host corporate income tax rate leads to a 0.8 percent increase in a subsidiary's reported pre-tax profits[55]. In other words, a ten percent increase in the host corporate income tax rate lowers the subsidiary's reported pre-tax profits by eight percent.

This approach aims at „paper profit shifting“, involving a separation of economic activity and taxable income[56]. However, cross-border profit shifting for tax avoidance purposes is only one of the possible explanations. Further reasons, other than tax avoidance, could have contributed to the above finding, thereby overstating the actual impact of tax avoidance activities. For instance, the approach used by Heckemeyer and Overesch (2013) also takes into account situations when investments are strategically located in low-tax jurisdictions[57]. In such cases, the choice of a specific tax jurisdiction is not primarily motivated by a low statutory corporate income tax rate but by other advantages offered by that tax jurisdiction, such as highly skilled workforce or a stable legal system.

An alternative approach to assess the quantitative impact of tax avoidance compares corporate income tax payments carried out by corporate twins. Corporate twins consist of MNCs and national enterprises with comparable firm characteristics, such as industry, age, size and productivity. Egger et al. (2010) examined the data available for European high-tax countries

[55] Heckemeyer and Overesch, Tax Differentials, p. 26.
[56] Riedel, Quantifying Tax Avoidance, p.6.
[57] Riedel, Quantifying Tax Avoidance, p.6.

and concluded that the tax burden of MNCs was more than 30 percent lower than the tax burden of comparable national enterprises[58]. Similar to the research carried out by Heckemeyer and Overesch (2013), caveats apply to the approach chosen by Egger et al. (2010). Whilst tax avoidance activities of MNCs are one of the possible explanations for the gap observed between corporate taxes paid by MNCs and national enterprises, this gap may also be caused by firm-specific tax benefits granted by national governments to MNCs in order to secure large-scale investments and, subsequently, to prevent them from relocating to other countries. It could also be a consequence of a more aggressive government lobbying of MNCs to receive new or extent existing tax benefits[59]. As a result, the estimate presented by Egger et al. (2010) is likely to overstate the actual extent of tax avoidance activities of MNCs.

In contrast to the aforementioned studies that focus on the taxpayer's perspective, Devereux et al. (2008) zoomed in on tactics of national governments and provided useful insights into tax competition. The study was based on the basic assumption that „the fundamental incentive for profit-shifting is a difference in the statutory rate between jurisdictions“[60], and suggested that changes in statutory corporate income tax rates in the home country and abroad were not only closely observed and evaluated by taxpayers but also national governments.

Devereux et al. (2008) provide strong evidence showing that national governments compete over statutory tax rates, by responding actively to changes in other countries' taxes[61]. More particularly, national governments may use the statutory corporate income tax rate to convince taxpayers to shift profits into their jurisdiction[62].

The study suggests that, in addition to tax avoidance, tax competition between national governments could be another trigger of profit shifting activities. National governments confronted with tax competition from other tax jurisdictions may be tempted to take active part in tax competition in order to mitigate the negative impact on their tax revenues, thereby extending and amplifying the phenomenon. The study estimates that a one percentage point drop in the weighted average statutory rate in other tax jurisdictions tends to translate into a tax rate reduction of approximately 0.7 percentage in the home country[63]. In other words, a ten percent decrease in other countries' corporate income tax rate leads, on average, to a seven percent reduction of the statutory corporate income tax by the home country.

[58] Riedel, Quantifying Tax Avoidance, p. 9.
[59] Riedel, Quantifying Tax Avoidance, p. 5.
[60] Devereux et al., Tax Competition, p. 1211.
[61] Devereux et al., Tax Competition, p. 1231.
[62] Devereux et al., Tax Competition, p. 1212.
[63] Devereux et al., Tax Competition, p. 1212 to 1213.

According to Devereux et al. (2008), tax competition is the most appropriate explanation for the correlation observed between tax policies of individual countries. Possible alternative explanations for the findings observed by Devereux et al. (2008) include in particular mimicking behavior of national governments and their tendency to align national tax policies with those of their neighbor. Even though the alternative explanations do not provide a fully satisfying response to the observed trend, they cannot be fully ruled out[64].

Going a step further, the second group of empirical studies attempt to assess actual tax revenue losses due to tax avoidance. Depending on the methodology and data used, there is a wide range of estimates. The OECD *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report* estimated that global revenue losses due to base erosion and profit shifting activities amounted to 100 to 240 billion US dollar in 2014, which corresponds to approximately four to ten percent of corporate income tax revenues collected globally[65].

Further global estimates include those prepared by IMF and UNCTAD[66], with the financial impact of corporate tax avoidance estimated to approximately five and ten percent of yearly global corporate income tax revenues, respectively. The IMF study also showed discrepancies existing between developed and developing countries. Tax revenue losses suffered by developed countries amounted on average to five percent, as opposed to almost 13 percent of corporate income tax revenues lost on average by developing countries. The analysis of the aforementioned results requires precaution, since the studies used different sets of data and different methodologies with their inherent limitations. For instance, the IMF estimate did not isolate non-BEPS tax incentives and therefore possibly overstated the financial impact of tax avoidance. In contrast, the UNCTAD estimate only included investment-related BEPS and therefore possibly understated the financial impact of tax avoidance.

Studies examining the financial impact of tax avoidance at EU level reach equally divergent conclusions. In a study published in 2015, the EU Parliament Research Service assessed tax revenue losses suffered by the EU due to profit shifting, i.e. corporate tax avoidance in the narrow sense, to approximately 50 to 70 billion Euro. If special tax arrangements, inefficiencies

[64] Devereux et al., Tax Competition, p. 1231.

[65] OECD, Measuring and Monitoring BEPS, Action 11 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 104, available at: https://read.oecd-ilibrary.org/taxation/measuring-and-monitoring-beps-action-11-2015-final-report_9789264241343-en#page4.

[66] IMF, Spillovers in International Corporate Taxation, IMF Policy Paper, 2014 and UNCTAD, World Investment Report 2015: Reforming international investment governance, UN Reference: UNCTAD/WIR/2015 cited in OECD, Measuring and Monitoring BEPS, Action 11 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 107, available at: https://read.oecd-ilibrary.org/taxation/measuring-and-monitoring-beps-action-11-2015-final-report_9789264241343-en#page4.

in collection and other practices are taken into account, i.e. corporate tax avoidance in the broad sense, the total impact could increase to 160 to 190 billion Euro[67]. The latter figures are more in line with the 2012 report on *Closing the European Tax Gap* which estimated that tax avoidance in the EU amounted to about 150 billion Euro per yea[68]r. However, similar to other empirical studies, factors other than tax avoidance could have contributed to observed tax revenue losses, thus possibly overestimating the actual impact of tax avoidance activities.

The 2012 report on Closing the European Tax Gap provides further interesting insights into tax avoidance in the EU. Along with the estimate of tax revenue losses resulting from tax avoidance, it also brings forward a loss estimate resulting from tax avoidance. With the estimated loss of approximately 850 billion US dollar, the harm potential of tax avoidance appears to be significantly higher that the impact of tax avoidance. However, this first analysis could be misleading. Due to the challenging definition of tax avoidance and lack of data, it is possible that the existing studies only show the tip of the iceberg.

## B. Non-financial impact

In addition to financial losses, tax avoidance also causes potentially harmful side effects without any direct financial implications. Intracompany trade, offshore financial centers, derivatives and hedge funds as well as inability to tax financial capital are elements closely linked to tax avoidance. Some of them even appear to serve as tools used for tax avoidance purposes. They are also identified as „fiscal termites“[69] which, in spite of being an integral part of the today's globalized world, have a potential to harm the integrity of national tax systems. In particular, fiscal termites are believed to lead to and exacerbate „moral termites“, which, in turn, cause a decline in tax compliance and morality.

As an example of moral termites, Braithwaite (2005) named several well-respected sport stars who with tacit acceptance of competent tax authorities did neither pay nor officially reside in their own country[70]. On the one hand, other taxpayers can see the lax approach of tax authorities as message that avoiding taxes is an acceptable practice. On the other hand, citizens may also interpret the beneficial treatment of some prominent taxpayers as a sign of lacking equity of the tax system, thereby suggesting that it does not work properly. In both cases, moral termites not

[67] Dover et al., Transparency and the EU P. 7.
[68] Murphy, European Tax Gap, p. 23.
[69] Tanzi, Fiscal Termites (online version).
[70] Cited in Oats, Miller and Mulligan, International Taxation, par. 2.8.

only have an adverse impact on tax compliance and morality but also cause inefficiencies in the tax system and, ultimately, call into question its bases.

In the context of taxation, equity is a synonym of fairness and is an important indicator of the efficiency of tax systems. When taxpayers believe that a tax system and underlying taxes are fair, they are more inclined to comply with applicable provisions and duly pay their taxes. Horizontal equity implies that taxpayers with a comparable ability to pay shall bear the same tax burden. Vertical equity suggests that a taxpayer with a greater ability to pay shall be subject to a greater tax burden. Alternatively, the benefit principle requires taxes to be levied in line with the usage of government services.

In the context of international taxation, the cross-border dimension adds another layer of complexity to the analysis. Equity in the international context raises additional challenges with respect to the allocation of tax revenues among different tax jurisdictions in which taxpayers earn taxable profits[71].

Although they do not cause any direct financial harm, non-financial consequences of offshore corporate tax avoidance are not less damaging than the actual financial cost of tax avoidance. The above example of sport stars also apply to the corporate world where a gap opens between resources of national enterprises and MNCs as well as their ability to engage in tax avoidance activities.

As described above, empirical research has showed that both corporate entities and national governments closely observe the evolution of domestic and foreign corporate income tax rates and modify their strategies correspondingly. National enterprises pay on average a third of corporate income taxes more than comparable MNCs. One can assume that the tax gap between MNCs and national corporations is, at least partially, due to the limited ability of national corporations to mitigate their own tax burden.

Since the physical presence of national corporations is limited to the boundaries of one state, they do not have access to cross-border techniques of corporate tax avoidance. This provides MNCs with a significant advantage in comparison to national corporations. Ultimately, their ability to engage in tax avoidance practices may strengthen the market position of MNCs to the detriment of their national competitors, with overall harmful effects on the competition and, subsequently, national governments as well as consumers.

The non-financial impact of tax avoidance was summed up by Christensen and Murphy (2004) who noted that tax avoidance „enables companies to become economic free-riders, enjoying

[71] Oats et al., International Taxation, par. 2.6.

the benefits of corporate citizenship without accepting the costs, while also causing harmful market distortions and transferring a larger share of the tax burden onto individual taxpayers and consumers“[72]. This is certainly a justice issue, since the tax burden is shifted to those who do not have resources to put into place elaborate tax planning strategies.

As a result, offshore corporate tax avoidance creates wrong incentives. This perceived injustice may push taxpayers to actively explore possibilities to limit their tax burden or avoid it altogether. It may also strengthen their incentives to breach applicable tax provisions and engage in tax evasion. The 2015 EU action plan on *A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action* also pointed out that tax avoidance could possibly threaten the social contract between national governments and citizens and overall tax compliance. Low tax morality of many MNCs quickly spread to further taxpayers. Since tax collection is largely dependent on voluntary compliance of taxpayers and self-assessment, as opposed to tax enforcement, low levels of tax compliance oblige tax authorities to make use of coercive measures, which makes the tax collection process more costly and therefore less efficient.

[72] Christensen and Murphy, Tax Avoidance and CSR, p. 39.

# III. Limited reach of unilateral and bilateral remedies

## A. Overview of unilateral anti-avoidance measures

In an effort to curb tax avoidance, national governments resort to unilateral anti-avoidance measures as a first line of defense, since these remedies do not require any cross-border coordination with public authorities in other countries. Depending on their origin, i.e. legislative as opposed to judicial, as well as their scope, i.e. general as opposed to specific, there are three main categories of unilateral anti-avoidance measures:

1. Judicially developed unilateral measures;
2. General Anti-Avoidance Rules (GAARs); and,
3. Specific Anti-Avoidance Rules (SAARs).

Whereas judicially developed unilateral measures usually have a broad scope of application, aimed at preventing abuse of tax provisions by taxpayers, national governments enact specifically formulated measures with the aim of addressing individual tax avoidance techniques. However, SAARs are only adapted to counter particular practices. Therefore, national governments often complete them with broad "catch-all" measures[73] that allow tax authorities to disregard transactions which are carried out for tax avoidance purposes and do not reflect any business or economic reality.

### 1. Unilateral measures in judicial doctrine

The US offer one of the examples of a judicially developed anti-avoidance doctrine. The basic principles of this doctrine, also referred to as economic substance doctrine, were laid down in the 1935 *Gregory v. Helvering* case. Despite the fact that the circumstances of the case fell within the meaning of the term „reorganization" as it was defined in the Revenue Act of 1928, the judges decided not to apply this provision, since the reorganization transaction under review was not motivated by any business or economic purposes. Instead, its sole purpose was tax avoidance[74].

The *Gregory v. Helvering* judgment is based on a purpose-based approach to tax interpretation, considering that the „meaning of a sentence may be more than that of the separate words". The judges examined the reorganization provision and considered that its purpose was to exempt

[73] Wirz, Anti-Avoidance Measures, p. 369.
[74] Likhovski, Tax Avoidance Adjudication, p. 12.

„the gain from exchanges made in connection with a reorganization in order that ordinary business transactions will not be prevented". Consequently, transactions carried out for tax avoidance purposes did not qualify as „ordinary"[75].

The UK is another country with a judicially developed anti-avoidance doctrine. The House of Lords formulated the doctrine for the first time in the 1982 *W. T. Ramsay Ltd. v. Inland Revenue Commissioners*[76] case and further refined it in the 1984 *Furniss v. Dawson*[77] and 1989 *Craven v. White* [78]cases. Often referred to as the Ramsay approach, the doctrine allows courts to examine a series of transactions in order to determine whether they have any business or economic purpose other than avoidance of tax. Transactions with no commercial purpose can be disregarded whereby the relevant statutory provision shall be applied to the final result[79].

Whereas some may have applauded the Ramsay doctrine as a „broad spectrum antibiotic which killed of all anti-avoidance schemes"[80], the Ramsay ruling also introduced much uncertainty amongst taxpayers with respect to the extent of powers given to courts.

Subsequent decisions seem to have weakened the reach of the Ramsay doctrine by introducing a distinction between „unacceptable tax avoidance" and „acceptable tax mitigation"[81]. They also stressed that the Ramsay doctrine shall not be understood as a departure from the principles laid down in the *Duke of Westminster* case but rather examined in terms of purposive statutory interpretation[82]. As a result, the Ramsay approach shall be used to ascertain what was meant by using the language of the statute and verifying whether, upon its construction, the statute applies to the transaction under review.

Whereas both the *Duke of Westminster* case as well as the *Gregory v. Helvering* case stress that tax avoidance is not necessarily illegal, they depart in their approaches how to handle it. In the *Gregory v. Helvering* decision, US judges adopted a more substantive and pro-government stance. In contrast, UK judges maintained a more formalistic and pro-taxpayer approach until the 1960s. Different theories provide clues possibly explaining this discrepancy. One may suggest that the decisions of judges are motivated by their class interest and the demands of

[75] Likhovski, Tax Avoidance Adjudication, p. 12 – 13.
[76] W. T. Ramsay Ltd. v. Inland Revenue Commissioners, (1982) A. C. 300, 302-03 (H.L.)
[77] Furniss v. Dawson [1984], A. C. 474, cited in Halkyard, Common Law and Tax Avoidance.
[78] Craven v. White [1989], A. C. 398 (H.L.), cited in Halkyard, Common Law and Tax Avoidance.
[79] Halkyard, Common Law and Tax Avoidance, p. 23 – 24.
[80] The term used by Lord Hoffmann in MacNiven v Westmoreland Investments Ltd [2003] 1 AC 311 at 332, cited in Halkyard, Common Law and Tax Avoidance, p. 19.
[81] Halkyard, Common Law and Tax Avoidance, p. 20.
[82] Freedman, Taxpayer Responsibility, p. 335.

social solidarity in times of emergency (Stevens, 1978)[83] or result from differences between the UK and US societies, political institutions and tax systems (Steinmo, 1993)[84] or more general attributes of the UK and US legal systems (Atiyah and Summers, 1987)[85].

Notwithstanding the exact reasons of the above discrepancy, the UK and US judicial anti-avoidance doctrines illustrate the evolution of the tax avoidance topic over the time as well as the underlying controversies that expand well beyond taxation, such as the role and the extent of competencies assumed by judges.

## 2. General Anti-Avoidance Rules (GAARs)

In the light of controversies surrounding judge-made anti-avoidance rules, it comes as no surprise that numerous tax jurisdictions, including several common law countries, decided to add GAARs to their legislation. Newly emerged and innovative forms of tax avoidance are difficult to predict and, therefore, specific measures are not an appropriate tool to address them in a timely manner. The main advantage of GAARs is their broad scope that is based on a general definition of unacceptable forms of tax avoidance and covers a variety of different situation, rather than one specific tax avoidance technique[86].

Scholars support the enactment of general anti-avoidance rules. However, reasons and motivations listed by them diverge significantly. According to Gunn (2001), the main purpose of GAARs is to complement the existing judicial doctrine by adding new anti-avoidance measures. For instance, GAARs should incorporate the concept of abuse that refers to situations when a transaction has a business or economic purpose but yields „a tax result that no sensible legislator would have approved of if the transaction had been called to the legislator's attention when the statute was drafted"[87]. Aprill (2001) suggests to shift from judges to tax authorities the discretionary power to identify tax avoidance transactions[88]. Freedman (2004) stresses that the law should give more guidance to taxpayers, which could be best achieved by a „legislative general anti-avoidance principle". By explicitly enabling courts to go beyond the mere literal

[83] Robert Stevens, Law and Politics: The House of Lords as a Judicial Body, 1800 - 1976 (1978), cited in Likhovski, Tax Avoidance Adjudication, p. 16.
[84] Cited in Likhovski, Tax Avoidance Adjudication, p. 19.
[85] P. S. Atiyah & Robert S. Summers, Form and Substance in Anglo-American Law 1 (1987), cited in Likhovski, Tax Avoidance Adjudication, p. 19.
[86] Prebble and Prebble, GAARs and Rule of Law, p. 25.
[87] Gunn, Alan, The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations, 54 SMU L. Rev. 159, 2001, cited in Jones et al., Comparative Perspectives on Revenue Law, p. 109.
[88] Aprill, Ellen P., Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines, 54 SMU, L. Rev. 9, 2001, cited in Zelenak, Codifying Anti-Avoidance Doctrines, p. 177.

application of the statutory rules, the general principle would give legitimacy to judicial development, thereby reducing uncertainty and complexity[89].

Examples of national governments which enacted GAARs include Germany (Abgabenordnung [AO], Mar. 16, 1976, Bundesgesetzblatt, Teil I [BGBL. I] at 26, § 42), Canada (Income Tax Act, R.S.C. 1985, c. 1, s. 245), France (Code de procédure fiscal [C.L.P.F.] art. L64), New Zealand (Income Tax Act 1976 (N.Z.), s. 99(2) and Australia (Income Tax Assessment Act 1936 (Cth) s 260)[90].

The German GAAR is an example of a typical GAAR. The 1976 provision underwent several changes in 2001 and 2008 whereby these amendments could be interpreted as attempts to refine and further narrow the scope of the rule. The 2008 reform strengthened the general framework by providing a definition of tax avoidance to which it refers as abuse: „An abuse exists where an inappropriate legal arrangement has been chosen that, compared to an appropriate legal arrangement, results in a tax benefit on the side of the taxpayer or a third person, if such benefit is not provided by law. This does not apply where the taxpayer can prove non-tax reasons for the arrangement chosen if, with a view to the overall circumstances, these reasons are significant“. Based on the German GAAR, „the tax claim in the case of an abuse (…) is established as of it would have been established for an arrangement appropriate to the economic transactions."[91]

Both the US and the UK later joined tax jurisdiction which enacted statutory GAARs. In the US, the 2010 Health Care and Education Reconciliation Act enacted a new statutory GAAR which is applicable to „any transaction to which the economic substance doctrine is relevant“. Whereas the US GAAR uses a different language, the overall effect appears to be similar to standard GAARs, enabling tax authorities to disregard transactions carried out for tax avoidance purposes and tax the economic substance that lies behind them[92].

In the UK, a first proposal of a statutory GAAR was introduced in 1998. However, the 1998 proposal was rejected, since the wording was not considered as flexible and acceptable as the judicial language and an advance clearance procedure was deemed necessary by representatives of taxpayers. In 2011, a study group presented a new draft, based on a moderate and targeted approach. The new GAAR was enacted by the means of the Finance Act 2013.

[89] Freedman, Taxpayer Responsibility, p. 333.
[90] Prebble and Prebble, GAARs and Rule of Law, p. 26.
[91] Reimer, Anti-Avoidance Rules in Germany, p. 4 – 6.
[92] Prebble and Prebble, GAARs and Rule of Law, p. 27.

### 3. Specific Anti-Avoidance Rules (SAARs)

In addition to GAARs, national governments use custom-tailored SAARs to address specific loopholes and gaps in their tax systems. Transfer pricing, controlled foreign company (CFC), thin capitalization rules and exit taxation belong to the most common examples of SAARs. Transfer pricing and CFC rules are described in more detail in the below paragraphs.

Transfer pricing rules require cross-border trading and financial transactions between related entities to reflect the fair market value. Nowadays, most tax jurisdictions have rules aimed at protecting the tax base from manipulative transfer pricing practices and have elevated the arm's length principle to the pivotal concept of transfer pricing legislation. This principle requires the prices charged in transactions between related parties to be in line with those charged in similar circumstances by unrelated parties[93]. If an MNC is not able to demonstrate the use of arm's length pricing in intra-group transactions, tax authorities may adjust its profits to what they would have been if the arm's length principle had been used.

Origins of transfer pricing rules date back to the beginning of the 20th century in the US. In 1917, regulations under the War Revenue Act enabled US tax authorities to consolidate the accounts of foreign and domestic corporations, thus restating profits originally reported by a foreign entity as belonging to a domestic entity. This forced consolidation became a statutory principle under section 240 (d) of the Revenue Act of 1921, with the aim to formally respond to issues raised by transfer pricing manipulations: „Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to ‚milk' the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company“[94].

In 1928, section 45 of the Internal Revenue Code which is considered a direct statutory predecessor of modern transfer pricing legislation in the US, replaced the forced consolidation regime. In 1935, the arm's length principle was formally included into US transfer pricing provisions[95]. However, up until 1960s, there was no formal regulatory guidance with respect to the use of the arm's length principle nor did courts apply this principle as a mandatory standard.

CFC legislation is another common tool used by tax jurisdictions to fight against tax avoidance. In particular, CFC rules help tax authorities to prevent abuse of tax deferral provisions by MNCs. Domestic entities usually do not pay any income tax on profits of their foreign subsidiaries until these profits are paid to the parent company, which usually happens by the means of dividends. As a result, it may be tempting for taxpayers to concentrate their profits

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[93] Oats et al., International Taxation, par. 13.1.
[94] Report 350 67th Congress 1st Session, cited in Avi-Yonah: Rise and Fall of Arm's Length, p. 30.
[95] Eden, Arm's Length Standard in North America, p. 674.

within subsidiaries located in low-tax jurisdictions and indefinitely postpone their payment to the parent entity located in a high-tax jurisdiction.

CFC rules allow the home country to levy taxes on income reported by foreign subsidiaries, without waiting for the repatriation, provided this foreign income fulfills certain criteria, such as a pre-defined control threshold and sources of income. For instance, CFC rules are usually limited to passive income. It is easier to shift passive income, such as income arising from financial investments, rather than trading or other forms of active income, as this may require the relocation of production facilities and employees.

In 1962, the Kennedy administration suggested to completely eliminate the US tax deferral through foreign subsidiaries, which is considered to be a first proposal of CFC legislation. Ultimately, the scope of CFC rules in the US was limited to passive income and certain sales and services income from related-party transactions. Other countries adopted CFC legislation in 1970s and 1980s[96].

Even though transfer pricing and CFC rules deal with different issues and operate in a different way, they are not completely unrelated. In order to illustrate differences, Kane (2010) describes „milking" of the home entity by a foreign subsidiary, which is dealt with by transfer pricing rules, and „parking" of the MNC's income in low-tax jurisdictions via its foreign subsidiaries, which is tackled by CFC rules. Transfer pricing rules establish a comparison between business transactions of a domestic entity with a related and unrelated foreign entity. In contrast, CFC rules rather compare situations of a domestic entity conducting business abroad either through a foreign subsidiary or by using a foreign branch.

Notwithstanding the aforementioned differences, current CFC rules appear to act as a partial backstop to transfer pricing rules, since they enable tax authorities to intervene in some instances when taxpayers have managed to circumvent transfer pricing rules and shift profits to low-tax jurisdictions.

## B. Anti-avoidance provisions in bilateral treaties

Tax treaties play an important role in „coordinating the interaction of otherwise separate income tax regimes to allocate shared tax bases between nations otherwise able to assert legitimate claims to tax income that is somehow connected to each of them"[97]. The first double tax treaty

[96] Oats et al., International Taxation, par. 17.5.
[97] Friedlander and Scott, History of Tax Treaties, p. 907.

was entered into by Austria-Hungary and Prussia as early as in 1899[98]. Nowadays, there are more than 3'000 bilateral tax treaties around the world[99].

Although double tax treaties are bilateral instruments whose application is limited to the contracting parties, the topic also attracted attention of the international community, which attempted to coordinate efforts of individual states to find an agreement with respect to the distribution of taxing rights. In early 1920s, the initiative was taken over by the League of Nations, which, in 1928, drafted first model tax conventions[100]. Later on, OECD and UN drafted their own model conventions, with the 1977 OECD *Model Tax Convention on Income and on Capital* and the 1980 *United Nations Model Double Taxation Convention between Developed and Developing Countries*. Model tax treaties also play a crucial role in facilitating the convergence of national tax systems involved in bilateral efforts.

Historically, the main purpose of double tax treaties was to prevent double taxation by providing contracting parties with a clear framework of how to distribute among themselves taxing rights over taxpayers with connections to both tax jurisdictions. However, instances of treaty abuse prompted contracting states to incorporate anti-avoidance provisions into their tax treaties. Common forms of anti-avoidance measures in double tax treaties include beneficial ownership clauses and limitations of benefits clauses.

Beneficial ownership clauses is the most widely used anti-avoidance provision in bilateral treaties. Beneficial ownership clauses enable tax authorities to deny treaty benefits when a company, resident in a country, is artificially interposed into a group or financing structure in order to gain access to treaty benefits. Such an entity usually acts as a conduit, which means that it receives and forwards income within the corporate group without becoming the beneficial owner of this income.

Interestingly, the existing legal texts provide few clues with respect to the meaning of the beneficial ownership. The OECD *Model Tax Convention on Income and on Capital* stresses that this term should not refer to any technical meaning that it could have under the domestic law of a specific country. The OECD model convention further suggests that the term shall be "understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance".

[98] Oats et al., International Taxation, par. 7.13.
[99] Lang and Owens, Tax Treaties and Development, p. 17.
[100] For instance, League of Nations Draft Model Treaty (1928) included in Double Taxation and Tax Evasion Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, Geneva, October 1928.

Limitations of benefits clauses are an established part of US double tax treaty policy and progressively started to be taken over by the OECD. In 2002, the OECD included this type of provisions for the first time in the 2002 update of the OECD model convention. Limitations of benefits clauses deny some or all of the treaty benefits to an entity that does not meet at least one of the pre-defined conditions whose purpose is to reveal the presence of a sufficient link between the resident of a contracting state and the contracting state itself[101].

Limitations of benefits clauses focus on taxpayers, by defining which taxpayers qualify for benefits, rather than attempting to identify various conduit arrangements which could lead to treaty abuse[102].

## C. Limits of unilateral and bilateral remedies

Whilst unilateral remedies are the most accessible tool of national governments to tackle tax avoidance, their one-sided nature limits efficiency and may ultimately damage the country's economy. This is particularly true in case of offshore corporate tax avoidance schemes that involve complex cross-border conglomerates of entities established in more than one tax jurisdiction.

Unilateral remedies usually work when taxpayers attempt to avoid the country's taxes. However, their impact is limited when tax avoidance occurs in other tax jurisdictions. In the context of the today's digital economy, offshore corporate tax avoidance techniques are also increasingly relying on ever-changing new technologies. Tax avoidance structures are becoming increasingly volatile and flexible, making traditional unilateral anti-avoidance measures out-dated and no longer appropriate to respond to these new challenges. Rixen (2010) speaks about "proliferation spiral" when "states must continually amend their unilateral rules to react to new tax planning schemes[103].

Lack of coordination among national tax authorities and information asymmetry are further factors with an adverse impact on efficiency of unilateral anti-avoidance rules when it comes to offshore corporate tax avoidance. Although MNCs consist of legally and formally separate entities, in practice, these entities are run as a single organization. In comparison to MNCs, the level of coordination and communication among national tax authorities is significantly lower, which limits their ability to respond to tax avoidance incidents in an efficient way and contributes to widen loopholes and gaps in both national and international tax systems. National

[101] Wirz, Anti-Avoidance Measures, p. 370.
[102] Oats et al., International Taxation, par. 15.21.
[103] Rixen, From Double Tax Avoidance to Tax Competition, p. 19.

tax authorities are also facing information asymmetry. Due to the cross-border nature of offshore corporate tax avoidance schemes and the lacking exchange of information between national tax authorities, it is particularly challenging to get a detailed understanding of the corporate structure of individual MNCs and the tax avoidance techniques which they used.

When designing unilateral anti-avoidance measures, national governments also have to deal with a trade-off between efficiency of these measures and the potentially negative impact on the country's competitiveness. Unilateral anti-avoidance measures are likely to increase migration of MNCs which may decide to flee tax jurisdictions with far-reaching anti-avoidance policies. Their international presence and flexible corporate set-up enable most MNCs to easily restructure their operations and move them to more lenient tax jurisdictions.

As a result, without any international coordination and harmonized implementation of unilateral anti-avoidance measures, national governments which wish to enact this type of measures, take a risk of ultimately damaging their own economies, if taxpayers consider these measures to be too harsh. In order to prevent any potentially harmful effects on their economies, national governments may also decide to deliberately limit the reach of unilateral measures, in which case, however, these measures will no longer be able to tackle the most complex tax avoidance schemes.

Similar to unilateral measures, the most significant limitation of bilateral remedies is the limited reach, since double tax treaties solely apply to the contracting parties. Bilateral remedies mainly focus on treaty abuse and do not offer any complex, i.e. multi-sided, solution to offshore corporate tax avoidance. In spite of harmonization and promotion efforts, the coverage rate is not 100 percent and contracting parties retain their freedom to enter into arrangements which diverge from provisions contained in the recommended model tax conventions.

Transfer pricing and CFC rules illustrate the aforementioned difficulties of unilateral measures to keep pace with modern forms of offshore corporate tax avoidance. Even though the arm's length principle is considered to be the international transfer pricing standard, conceptually, it also raises much criticism, since transactions between related parties are, by their nature, considerably different from those between independent parties. These differences impact both prices charged and types of transactions entered into, making it difficult to determine actual arm's length prices[104].

The arm's length principle is also facing a difficult task to assess the market value of intangibles which are so unique that no substitutes are available. As noted by Blair-Stank (2015), IP has

[104] Oats et al., International Taxation, par. 13.1.

become the leading tax-avoidance vehicle whereby one of the main reasons is precisely its uniqueness[105]. Interestingly, difficulties surrounding the pricing of intangibles are not limited to technology giants, such as Apple. According to the World Trade Organization (WTO), „many products that used to be traded as low-technology goods or commodities now contain a higher portion of IP in their value - for example brand-named clothing or new varieties of plants“[106]. With its business activities focusing on design and production of sport articles, Nike is an example of such a low-technology corporation whose tax planning structure, however, is largely based on intangibles, including the famous „Swoosh“ logo or „Just Do It“ phrase.

Whilst the operating mode of CFC rules does not appear to be sensitive to changing tax avoidance strategies nor to the impact of new technologies, the efficiency of these measures may be hindered by a restrictive CFC definition. A CFC is usually defined through the ownership and/or control criteria, which are expressed as a minimum percentage of shares or voting rights. Depending on the threshold selected, more or less entities will fall into the scope of CFC legislation. Certain tax jurisdictions add the tax residence criterion to the CFC definition. As a result, a foreign subsidiary needs to have its tax residence in a low-tax jurisdiction in order to qualify as a CFC. Further strategies to limit the scope of CFC rules focus on the types of income that are targeted by these rules. The scope can also be limited through exceptions as well as other tax provisions.

Subpart F in the US illustrate well various strategies to limit the scope of CFC legislation. Subpart F only applies to passive forms of income, exempting income derived from manufacturing activities. Furthermore, passive income may also be exempted if the CFC made a “substantial contribution” to manufacturing activities. Since there is no definition of the substantial contribution in Subpart F, this allows to further extend the scope of the exemption to the situations of mere supervision of contract manufacturing by another party. Other tax provisions, including check-the-box and look-through rules, can help to circumvent the application of Subpart F. Interestingly, some of these limitations and exceptions, such as the look-through rules, were temporary measures but the US government decided to extend their validity on several occasions. This illustrate the strategical thinking of national governments which may believe that the loopholes and gaps in their tax system provide them with advantages which actually outweigh the direct tax revenue losses caused by the very same loopholes and gaps.

[105] Blair-Stanek, IP and Tax Avoidance, p. 4 and 5.
[106] WTO, Intellectual Property: Protection and Enforcement, cited in Blair-Stanek, IP and Tax Avoidance, p. 14.

# IV. Towards multilateral solutions?

## A. Origins of international initiatives against tax avoidance

The Communiqué issued at the end of the G7 Summit held in 1996 in Lyon stressed that globalization was "creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment, and could lead to the erosion of national tax bases". The communiqué also urged the OECD to "vigorously pursue its work in this field aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices"[107]. Following the request of the G7 countries, the OECD issued in 1998 a report on *Harmful Tax Competition: An Emerging Global Issue* in which the organization focused for the first time on tax havens and preferential tax regimes.

The title of the 1998 OECD *Harmful Tax Competition: An Emerging Global Issue* suggests that harmful tax competition has been a relatively new phenomenon at the end of the 1990s. The fact that the report does not refer to any studies published prior to 1980s also reinforces this impression. However, a closer look reveals that first international initiatives against corporate tax avoidance took place well before the publication of the 1998 OECD report[108].

Rixen (2010) explains that, since its development in the 1920s and 1930s up until the 1960s, the sole purpose of the international tax regime was to mitigate international double taxation, thereby allowing countries to maximize benefits from international economic liberalization. Once this objective achieved, the attention of the international community shifted in the 1960s to issues raised by under-taxation, including tax avoidance and evasion[109]. In the period before the World War II, the main contributor to the discussion about international taxation was the League of Nations. In post-war years, the OECD along with the UN, whose contribution to this topic often tends to be overlooked, took the lead.

According to Ylönen (2014), the UN focused on two areas of international taxation. On the one hand, the UN explored ways to facilitate the conclusion of tax treaties between developed and developing countries. On the other hand, the UN also attempted to regulate operations of MNCs through a new set of international accounting standards. In addition to research work, the UN

[107] OECD, Harmful Tax Competition: An Emerging Global Issue, 1998, p. 7.
[108] Ylönen, Rise and Fall of Initiatives Against Tax Avoidance, p. 35.
[109] Rixen, From Double Tax Avoidance to Tax Competition, p. 1 – 2.

also contributed to policy proposals, including exchange of information, accounting standards and corporate responsibility as well as unitary taxation[110].

The UN Code of Conduct on Transnational Corporations was one of the key policy proposals issued by the UN. In his speech in the General Assembly of the UN in 1972, shortly before the coup d'état leading up to his death, Chile's President, Salvador Allende, drew attention to I.T.T.'s interference in Chile's domestic policy. Allende called for action to control "economic power, political influence and corruption action" of MNCs, which triggered code negotiations in 1975[111].

The Draft UN Code of Conduct on Transnational Corporations covered a large variety of topics, including international taxation. Pursuant to section 34: "transnational corporations should/shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle, or other means, to modify the tax base on which their entities are assessed"[112].

The UN abandoned code negotiations at the beginning of the 1990s. Peter Handes, last executive director of the United Nations Centre on Transnational Corporations (UNCTC), explained the reasons of the failure: "The effort to negotiate a comprehensive code of conduct in the United Nations was ahead of its time when it was conceived and negotiated. It was never completed because macro-economic and political circumstances changed"[113]. Sauvant (2015) provides a detailed insight into circumstances that caused the UN to stop code negotiations, including ideological changes and the disintegration of the socialist camp, the debt crisis and lack of solidarity among developing countries, the raise of international investment agreements as well as a progressive demystification of MNCs in the 1980s[114].

In the course of the 1990s, the weight in international taxation matters definitely shifted from the UN to the OECD, with the 1998 report on *Harmful Tax Competition: An Emerging Global* Issue being the breaking point. The original purpose of the initiative was to persuade tax havens to abolish harmful tax practices. On the one side, tax havens were encouraged to modify their national tax laws in order to prevent taxpayers artificially shifting their profits there with the

[110] Ylönen, Rise and Fall of Initiatives Against Tax Avoidance, p. 38 – 39 and p. 44 – 45.
[111] Sauvant, UN Code of Conduct, p. 13.
[112] UN, Draft United Nations Code of Conduct on Transnational Corporations (1983 version), available at: http://investmentpolicyhub.unctad.org/Download/TreatyFile/2891
[113] Cited in : Khalil and Ruffing, Corporate Conduct and Public Interest, p. 109.
[114] Sauvant, UN Code of Conduct, p. 56 – 62.

aim of avoiding taxes. On the other side, this initiative also focused on preferential tax regimes in high-tax countries.

After a wave of discontentment and concerns that the initiative may interfere with national tax sovereignty, the OECD limited in 2001 its scope to information exchange and transparency[115]. As a result, this limitation removed corporate tax avoidance from the agenda, since more transparency and better information exchange only target on tax evasion by individuals (Webb, 2004)[116]. However, the 2008 financial crisis and subsequent revelations regarding tax arrangements of major MNCs revived again the discussion, which culminated with the OECD's Base Erosion and Profit Shifting (BEPS) project, initiated upon the G20's request in September 2013[117].

The OECD's efforts have spread in recent years to further international forums, including in particular the EU. Following sections provide a detailed overview of the BEPS project and its achievements as well as the EU's activities to curb tax avoidance.

## B. OECD's BEPS project

Undertaken at the request of the G20 leaders during the 2012 summit in Los Cabos, Mexico[118], the work to address BEPS is based on the 2013 G20/OECD BEPS Action Plan, which identifies fifteen actions to put an end to international tax avoidance. The action plan focuses on three areas, namely introducing coherence in domestic rules that affect cross-border activities, reinforcing substance requirements in existing international standards to ensure alignment of taxation with the location of economic activity and value creation as well as improving transparency and certainty for businesses and governments[119].

The 2013 BEPS Action Plan identifies main loopholes and gaps in tax systems that lead to or facilitate tax avoidance. These include in particular hybrid mismatch arrangements (Action 2), lack of efficiency of CFC rules (Action 3), use of interest deductions and other financial payments (Action 4), abuse of treaty benefits (Action 6), artificial avoidance of permanent establishment status (Action 7) as well as transfer pricing (Actions 8 to 10). The remaining action items offer a broader perspective on tax avoidance issues and aim at putting in place

[115] Rixen, From Double Tax Avoidance to Tax Competition, p. 19.
[116] Cited in Rixen, From Double Tax Avoidance to Tax Competition, p. 19.
[117] Ylönen, Rise and Fall of Initiatives Against Tax Avoidance, p. 34.
[118] OECD, OECD Secretary-General Report to G20 Leaders, Antalya, Turkey, November 2015, available at: http://www.oecd.org/g20/topics/taxation/oecd-secretary-general-tax-report-g20-leaders-november-2015.pdf.
[119] OECD, G20 finance ministers endorse reforms to the international tax system for curbing avoidance by multinational enterprises, OECD, 9 October 2015, available at: http://www.oecd.org/tax/g20-finance-ministers-endorse-reforms-to-the-international-tax-system-for-curbing-avoidance-by-multinational-enterprises.htm.

efficient tools to curb international tax avoidance. For instance, the Action Plan points out at the impact of the digital economy on international taxation. Based on this observation, Action 1 proposes to address the resulting tax challenges. Action 5 calls for transparency and substance in order to counter harmful tax practices. Further recommendations include mandatory disclosure rules (Action 12), transfer pricing documentation and country-by-country reporting (Action 13), improvements to the dispute resolution mechanisms (Action 14) and creation of a multilateral instrument to modify bilateral tax treaties (Action 15). Finally, Action 11 proposes strategies to measure and monitor BEPS.

The OECD describes the BEPS project as "the first substantial – and overdue – renovation of the international tax standards in almost a century"[120]. The approach proposed by the OECD to tackle international tax avoidance consists of a comprehensive package of measures, designed to be implemented domestically and through treaty provisions and supported by targeted monitoring and strengthened transparency[121]. Consequently, the BEPS project mainly deals with substantive international tax norms. This differentiates it from other international initiatives, such as the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) whose main goal is to facilitate a one-dimensional flow of information rather than reconcile competing tax claims[122].

The 2013 BEPS Action Plan also stresses the need to depart from the traditional consensus-based cooperation framework in order to ensure that the work is inclusive and effective. As a result, the Action Plan proposes to take into account the perspective of developing countries as well as increasingly involve businesses and the civil society. Furthermore, the Action Plan suggests an ambitious timing, with the expected delivery of most action items being within a two-year period[123].

According to the explanatory statement to the OECD/G20 Base Erosion and Profit Shifting Project, the level of interest and participation in the work has been unprecedented with more than 60 countries directly involved in the technical groups and many more participating in shaping the outcomes through regional structured dialogues[124]. The BEPS project delivered its

[120] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, 2015, available at: http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf, p. 5.
[121] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, 2015, available at: http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf, p. 5.
[122] Brauner, BEPS Interim Report, p. 13.
[123] OECD, OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013, p. 24 – 26, available at: https://www.oecd.org/ctp/BEPSActionPlan.pdf.
[124] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, 2015, available at: http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf, p. 4.

fifteen final outputs in October 2015, two years after its launch in 2013[125], which opened a new phase of the project, namely the implementation of the recommended changes in a consistent and coherent manner as well as monitoring the impact on double non-taxation and on double taxation[126].

The implementation phase of the BEPS project has raised new challenges. Several countries have enacted unilateral measures, with some of them adopting a more aggressive approach. In the long term, this could cause uncertainty among taxpayers and lead to growing competition among national governments, ultimately slowing down or stopping the process of implementation of the BEPS recommendations.

The UK Diverted Profits Tax (DPT), also called the Google tax, provides an example of such a unilateral initiative. The DPT was enacted by the means of the Finance Act 2015 and is applicable as of 1 April 2015, only a couple of months prior to the submission of the full BEPS package by the OECD. It aims at counteracting the diversion of profits from the UK by large groups that either seek to avoid creating a UK permanent establishment or use arrangement or entities which lack economic substance in order to exploit tax mismatches either through expenditure or the diversion of income within the group[127].

The enactment of the DPT legislation attracted much criticism. Pascal Saint-Amans, director of the OECD's Centre for Tax Policy and Administration, stated that he was "embarrassed" by the UK's decision to introduce the DPT and added that "unilateral actions are not exactly in the sense of what we are trying to develop" since they could "push countries (…) to take unilateral measures"[128]. Consequently, such unilateral measures pre-empt any international consensus on what should be a balanced allocation of taxing right and encourages further countries to adopt the same approach, leading to a more fragmented, unpredictable and conflict-ridden international tax system[129]. These concerns appear to have been well founded since other

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125 OECD, Policy Brief, BEPS Update No. 3, October 2015, p. 1, available at: http://www.oecd.org/ctp/policy-brief-beps-2015.pdf.

126 OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, 2015, available at: http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf, p. 9.

127 HM Reveue & Customs, Diverted Profits Tax: Guidance, 30 November 2015, p. 4, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf.

128 Watson, William, Base Erosion and Profit Shifting: UK contra mundum?, Slaughter and May, October 2016, p. 4, available at: https://www.slaughterandmay.com/media/2536172/base-erosion-and-profit-shifting-uk-contra-mundum.pdf.

129 Schwarz, Jonathan, Does the UK Diverted Profits Tax help or hurt BEPS?, Kluwer International Tax Blog, 11 February 2015, available at: http://kluwertaxblog.com/2015/02/11/does-the-uk-distributed-profits-tax-help-or-hurt-beps/.

countries followed the example given by the UK. For instance, in 2016, Australia enacted its Multinational Anti-Avoidance Law.

## C. EU's initiatives

In spite of advances achieved in other areas of European integration, direct taxation remains the sole responsibility of the EU member states. Articles 113 – 115 of the Treaty on the Functioning of the European Union require unanimity in the European Council in order to adopt a tax policy applicable to the entire EU[130]. This explains why substantial differences persist among national tax system of the EU member states.

However, the restrictive framework for harmonization of national tax systems, in particular with respect to direct taxation, has not prevented the EU from progressively adopting a series of directives addressing specific tax issues, such as the Merger Directive[131], the Parent / Subsidiary Directive[132] and the Interest and Royalties Directive[133]. In the light of other international initiatives and recent revelations about tax planning activities of major MNC's, tax avoidance topics are in the focus of the EU. In addition to harmonization efforts by the means of directives, the EU member states are also required to exercise their sovereign decision-making authority within the framework defined by EU law and further refined by the case law of the Court of Justice of the European Union (CJEU).

The below sections will examine both the CJEU's case law as well as regulatory efforts of the EU towards more harmonization among the EU member states in topics involving the fight against tax avoidance as well as the interaction between the BEPS project and the EU's initiatives.

### 1. CJEU's case law

The CJEU's decisions mostly focus on the elimination of discriminatory measures selectively targeting cross-border investments, as opposed to domestic investments, whereby some of these decisions have had a profound impact on tax systems of the EU member states. The CJEU's

[130] Vlcek, Tax Nomad, p. 71.

[131] Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, 90/434/EEC.

[132] Council Directive of 23 July on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 90/435/EEC.

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

decision in the well-known Cadbury-Schweppes case[134], which has limited the applicability of CFC rules within the EU, illustrates how far-reaching this impact can be. Based on the Cadbury-Schweppes decision, CFC rules are only compatible with EU law insofar as they are limited to “wholly artificial arrangements” that do not unfold any economic activity. This decision pushed the EU member states with CFC legislation to amend their legislation in order to comply with the CJEU’s requirement[135]. Even though there is no systematic research with respect to the general impact of CFC rules and the Cadbury-Schweppes decision on tax neutrality in Europe, the available studies suggest that the Cadbury-Schweppes decision led to an increasing use of low-tax regimes by German MNCs in Europe (Ruf and Weichenrieder, 2013)[136].

The CJEU’s decisions have been attracting the scholars’ attention, such as Lang (2002), Bizioli (2008) and Pistone (2010), with many of them have complaining about the lack of clear guidance with respect to the exact meaning of an EU-law compliant tax policy[137].

Faulhaber (2016) speaks about “the Luxembourg Effect”, after the primary seat of the CJEU, to describe the vacuum created in areas such as direct taxation within the EU. On the one hand, the EU member states are not allowed to pass laws or regulations that violate the fundamental freedoms. On the other hand, the EU institutions cannot adopt EU-wide laws or regulation to fill the empty space. Due to the CJEU’s decisions, the EU member states lost many tools to fight against tax avoidance, since the CJEU disallowed the rules that discriminated against non-resident taxpayers and recognized only a limited exception for the prevention of tax avoidance[138].

Bräutigam et al (2015) further argues that some EU member states have promptly used the new possibilities for attracting foreign investments and have started to provide reduced tax rates on the income arising from IP assets. This led for instance to the rise of patent box regimes within the EU. Even though patent box regimes have existed since 1970s, it was not until the Netherlands adopted the innovation box in 2007 and the UK adopted the patent box in 2013 that commentators focused their attention on these tax regimes[139]. where income from patents and other IP assets is separated from a taxpayer’s other income and subject to lower tax rates[140].

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[134] Court of Justice of the European Union, Judgment of 12 September 2006 ,Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd. V. Commissioners of Inland Revenue, C-196/04, EU:C:2006:544.
[135] Bräutigam et al., Decline of CFC Rules, p. 2.
[136] Bräutigam et al., Decline of CFC Rules, p. 5.
[137] Bräutigam et al., Decline of CFC Rules, p. 1.
[138] Faulhaber, Luxembourg Effect, p. 39.
[139] Faulhaber, Luxembourg Effect, p. 8 – 9.
[140] Faulhaber, Luxembourg Effect, p. 3.

IP box regimes are under increased scrutiny by the EU Commissions since some of their features could constitute forbidden state aid.

According to Faulhaber (2016), the CJEU's jurisprudence does not only affect the EU member states. Through international competition, it also creates pressure on non-EU countries to reduce their own anti-avoidance standards and maintain their competitiveness. In areas where the CJEU had rules on the inconsistency of member state rules with EU law, the OECD members were not able to raise international standards as high as they could have in the absence of EU law.

For instance, the OECD report on Designing Effective Controlled Foreign Company Rulesm Action 3 – 2015 Final Report refers to the Cadbury-Schweppes case and explains that "this Action Item need to be broad enough to be effective in combatting BEP, they also need to be adaptable, where necessary, to enable EU members to comply with EU law". As a result, the report recommends to the EU member states to include "a substance analyses that would only subject taxpayers to CFC rules if the CFCs did not engage in genuine economic activities"[141].

**2. Regulatory efforts to implement and align anti-avoidance rules within the EU**

The Code of Conduct for business taxation is one of the first attempts of the EU to implement tools aimed at countering improper tax practices. The European Council adopted the Code of Conduct in 1997. The Code aims at identifying and elimination harmful tax practices[142].

Even though the EU Code of Conduct for business taxation is not a legally binding instrument, it implies the political commitment of the EU Member States to take specific measures to counter harmful tax competition, by both rolling back existing tax measures that constitute harmful tax competition ("rollback") and refraining from introducing any such measures in the future ("standstill")[143].

Although the Code primarily focus on harmful tax competition, its provisions contain elements that are useful in the fight against tax avoidance. The Member States are required to outline their plans to achieve transparency and effective information exchange for all tax matters. The Code further requires the EU Member States to eliminate any regimes that facilitate or promote

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[141] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 17, available at: https://read.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report_9789264241152-en#page4.

[142] Oats et al., International Taxation, par. 20.14.

[143] European Commission, Harmful tax competition, available at: https://ec.europa.eu/taxation_customs/business/company-tax/harmful-tax-competition_en.

the set-up of artificial structures and transactions without any substantial business activity. The Code has also enabled the EU Member States to put pressure on neighboring non-EU states to amend their national tax or banking secrecy regimes. Nowadays, the role of the Code of Conduct Group does not seem to fade away, since the Group has recently been mandated to monitor the implementation of BEPS[144].

Since direct taxation, including the tax avoidance topic, remains within the sovereign decision-making authority of the EU Member States, directives represent the most widely used tool of the EU harmonization efforts. On the one hand, anti-abuse or anti-avoidance provisions are progressively being included in the existing and new directives. On the other hand, new directives, entirely dedicated to the tax avoidance topic, has started to emerge. Following paragraphs will provide various examples of the directives touching upon the tax avoidance topic to illustrate the developments and successes achieved in this field.

In 1990, the Parent / Subsidiary Directive abolished withholding taxes on payments of dividends between related companies established in the different Member States, thereby preventing double taxation of parent companies on the profits of their subsidiaries and insisted on a full credit for underlying tax. The Parent / Subsidiary Directive was amended in December 2014 to incorporate a general anti-abuse rule aimed at preventing tax avoidance by MNCs, with the deadline to transpose the anti-avoidance rule into domestic law being set to 31 December 2015[145].

The amendment defined the common minimum anti-abuse standard in Article 1 (2), using the following wording: "Member States shall not grant the benefits of this Directive to an arrangement or series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part". The text further specifies that "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"[146].

As early as in 2001, the European Commission has also initiated the work on a Common Consolidated Corporate Tax Base (CCCTB), which culminated in 2011 with a Proposal for a

[144] Oats et al., International Taxation, par. 20.14.
[145] Oats et al., International Taxation, par. 20.8.
[146] Council Directive (EU) of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 2015/121.

Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)[147]. The main objective of the initiative was to determine the precise income tax base for MNCs operating within the EU and, then, to equitably distribute that tax base among the EU Member States in which the MNCs have operated. The directive would not impose any corporate income tax rate. The proposal also contained a comprehensive set of general (Article 80) and specific anti-abuse provisions, including disallowance of interest deductions (Article 81) and rules on CFC (Article 82). The mechanism established by the proposal was voluntary, since MNCs would have to opt in for the CCCTB[148].

The CCCTB initiative was revived in 2013 and included to the agenda of the Action Plan for Fair and Efficient Corporate Taxation in the EU that was launched on 17 June 2015[149]. The Action Plan pointed out that low corporate income tax payments of MNCs create a perception that the tax system is not fair which “threatens the social contract between governments and their citizens”[150] and could impact the overall tax compliance within the EU. However, the European Commission eventually withdrew the 2011 proposal due to difficulties achieving consensus[151].

The Action Plan also led to a proposal for an Anti-Tax Avoidance Directive (ATAD) on 28 January 2016. The Council adopted the Anti-Tax Avoidance Directive in June 2016[152]. The Directive became part of the Anti-Tax Avoidance Package of the EU (ATAP) and goes beyond the scope of the existing directives, by implementing substantive law to put into place a minimum level of protection against corporate tax avoidance within the EU.

The Anti-Tax Avoidance Directive contains several legally binding anti-abuse measures. In particular, the Directive contains a general anti-abuse rule (Article 6) as well as specific regulations, including interest limitation (Article 4), exit taxation (Article 5), CFC (Article 7) and switch-over rules (Article 8) along with a rule on hybrid mismatches between the EU

[147] Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4.
[148] Oats et al., International Taxation, par. 20.21.
[149] Oats et al., International Taxation, par. 20.26 and 20.20.
[150] Communication from the Commission to the European Parliament and the Council, A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, COM/2015/0302 final, available at: https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A52015DC0302.
[151] Oats et al., International Taxation, par. 20.29.
[152] Council Directive (EU) of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, 2016/1164.

Member States (Article 9). The Member States should apply the ATAD measures as from 1 January 2019[153].

There has recently been a considerable acceleration of harmonization efforts with respect to the corporate tax avoidance topic. The Anti -Tax Avoidance Directive from July 2016 was amended in May 2017 to include provisions on hybrid mismatch arrangements with third countries[154].

## D. Limits of multilateral solutions

After having examined the progressive development of multilateral measures and the most significant international initiatives to curb offshore corporate tax avoidance, one can ask whether these initiatives has achieved more than anti-avoidance projects carried out by individual national governments. Could we consider the BEPS project as a breaking point that has brought national governments to stop competing with each other and, instead, start cooperating together to put an end to tax avoidance[155]?

The basic truth of a free market is that as long as there is demand, there will also be supply. The main purpose of MNCs, as well as of any other corporate entities, is to increase the value for their shareholders, which they can do by maximizing their profits. One of the ways for MNCs to achieve this outcome is to limit their tax burden to the extent possible. On the supply side, small countries located in remote areas and without any natural resources may be reluctant to modify their tax systems to be in compliance with global anti-avoidance standards, as they have few possibilities of revenue raising other than acting as offshore financial centers or tax havens[156].

There are no doubts that the BEPS project has offered value-added with respect to the working methods, since it has brought together a significant number of developed and developing countries. However, the project appears to be less innovative when it comes to the content. Avi-Yonah and Xu (2016) describe the BEPS project as "the first substantial renovation of international tax standards in almost a century". However, it is "not the final destination of international tax reform" but rather "the first step toward the modernization of global tax governance in the long run"[157].

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[153] European Commission, The Anti Tax Avoidance Directive, available at: https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en.

[154] Council Directive (EU) of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, 2017/952.

[155] Oats et al., International Taxation, par. 19.25.

[156] Oats et al., International Taxation, par. 19.25.

[157] Avi-Yonah and Xu, Evaluating BEPS, p. 208.

In fact, it is questionable whether the OECD is the best forum to carry out a major reform of the international tax system. Whereas the BEPS project has involved approximately 60 countries, including not only developed OECD member states but also developing countries which are not members of the OECD, this represents only a third of all the UN members. Since MNCs are truly global entities, their business activities are also located in non-cooperating tax jurisdictions, which limits the efficiency of the BEPS project[158]. Developing countries may also suffer from the lack of resources to implement action items suggested by the BEPS project. They may also be increasingly targeted by MNCs which try to exploit the weakest elements in the international tax system in order to secure unjustified tax benefits.

According to Avi-Yonah and Xu (2016), the BEPS project does not replace old principles of international taxation with the new ones, which could be used as a basis to redesign the existing rules. Instead, the BEPS project rather attempts to respond to deficiencies of the existing principles and rules. The BEPS project also does not provide any guidance with respect to the basic concepts of residence and source or where profits should be considered to be earned. This "patch-up work has produced complex, discretionary, uncertain, costly, and contradictory rules" whose effectiveness may be compromised either by the emergence of new BEPS opportunities or arbitrariness of tax authorities[159].

Avi-Yonah and Xu (2016) list two main when the BEPS project failed to replace the existing principles, even though these do no longer seem to be adapted to current BEPS challenges. The first case encompasses the independent entity and arm's length principles. It would have been more efficient to put into place the single unitary entity principle in order to reflect the actual structure of MNCs which, in spite of consisting of legally independent entities, act as a single firm. Under the single unitary entity principle, intra-group transactions could be disregarded, which would also eliminate the difficult application of the arm's length principle. Furthermore, the BEPS project kept the traditional benefits principle, maintaining residence jurisdiction for passive income and source jurisdiction for active income, which again does not allow to address BEPS concerns in an efficient manner.

The BEPS project attempts to increase revenues from corporation tax. By doing so, we can expect the BEPS project to have an impact on employee and shareholders taxation where tax revenues are likely to decrease, since corporations will distribute less profits. As a result, the final amount of tax revenues collected may remain more or less the same. There is also a risk

[158] Avi-Yonah and Xu, Evaluating BEPS, p. 210 – 211.
[159] Avi-Yonah and Xu, Evaluating BEPS, p. 208.

that the tax jurisdiction benefitting from the increase of revenues from corporation tax may not by the tax jurisdictions suffering a decrease of tax revenues collected from employees and shareholders, thereby causing inequity within the international tax system[160].

Last but not least, lack of coordination and conflicting sets of rules and principles may also negatively impact the implementation process of the BEPS project or any other multilateral initiative. DPT legislation in the UK and the CJEU's case law requirement of wholly artificial arrangements are some of the examples. This limitation is closely related to the very nature of national states and their relations which are characterized by competition, rather than cooperation. Since multilateral instruments are often not binding, national governments may be tempted to, at least partially, depart from these initiatives in order to secure a competitive advantage.

[160] Oats et al., International Taxation, par. 19.25.

# V. Alternative approaches

## A. New ways of allocating tax revenues

The aim of this section is to determine whether, in the light of the inherent limitations of both unilateral and multilateral initiatives, there are any alternative suggestions on how to curb offshore corporate tax avoidance and to examine whether they could offer a viable alternative to the current system.

A first option how to curb offshore corporate tax avoidance encompasses alternative ways of allocating tax revenues. These solutions include radical measures, such as the full repeal of the corporate income tax as well as new methods of computation.

### 1. Repeal of the corporate income tax

The easiest solution to put an end to all the discussions surrounding offshore corporate tax avoidance would certainly be to abolish the corporate income tax and complement missing tax revenues through other taxes. This approach often refers to the theory according to which the corporate income tax is, by its nature, double taxation, so-called economic double taxation, because profits of a company will eventually be taxable in the hands of its shareholders[161].

For instance, Toder and Viard (2014) believe that tax revenue losses from the corporate income tax could be replaced by increased shareholder taxes. However, this would raise only a half of the revenue of the current corporate income tax[162]. Furthermore, tax on dividends and capital gain is usually not levied immediately. Tax authorities have to wait until dividends are paid out to shareholders or shares are sold by taxpayers, instead of receiving tax revenues annually[163].

The repeal of the corporate income tax would also have a negative impact on the individual income tax, since people would shift their income and consumption to corporations. Mankiw (2014) suggests to abolish both the individual and corporate income taxes and replace them rather by a “broad-based tax on consumption”[164]. According to Mankiw (2014), “the first step is to acknowledge that corporations are more like tax collectors than taxpayers. The burden of the corporate tax is ultimately borne by people – some combination of the companies’ employees, customers and shareholders. After recognizing that corporations are mere conduits,

[161] Oats et al., International Taxation, par. 19.5.
[162] Cited in Zucman, Taxing Across Borders, p. 134.
[163] Oats et al., International Taxation, par. 19.5.
[164] Mankiw, Repeal of Corporate Tax (online resource).

we can focus more directly on the people"[165]. Consumption-based taxation would make the source of income irrelevant and solely focus on the amount that a person has consumed to determine the amount of taxes payable by that person.

Mankiw (2014) further insists that the principles of international taxation are no longer adapted to the globalized economy. A good tax system should focus on the economic fundamentals rather than the legal determination of a corporation's tax residence in order to reflect the modern concept of an MNC whose activities are not limited to a single tax jurisdiction[166].

## 2. Corporate Income Tax Apportionment

Other proposals involving the reallocation of tax revenues do not require the repeal of the corporate income tax but, instead, propose alternative ways to allocate taxable income to various tax jurisdictions. The corporate income tax apportionment approach proposes to replace the traditional international tax law concepts of source and residence as well as the price setting based on the arm's length principle by an apportionment formula, which would distribute income among various tax jurisdictions where it has been earned[167].

Contrary to the traditional way of computing taxing right of each country by looking into the separate accounting of individual subsidiaries operating in those countries, the apportionment formula divides out the global profits of a corporate group according to a pre-defined formula[168]. The apportionment formula could consist of a combination of sales, capital and labor. For instance, a standard, equally weighted three-factor apportionment formula, based on property, payroll and sales components, is in use in many US states[169]. A more radical proposal would be based solely on the location of sales, assuming that whereas it is possible to move, to at least some extent, capital and workforce, it is impossible to move the client base[170].

The apportionment formula approach could replace the problematic single entity and arm's length principles, which do no longer seem to be adapted to the needs of the globalized and digital economy. This approach is particularly useful when it is not possible to trace income to the source or such exercise would be too burdensome due to the complexity of the case[171].

[165] Mankiw, Repeal of Corporate Tax (online resource).
[166] Mankiw, Repeal of Corporate Tax (online resource).
[167] Zucman, Taxing Across Borders, p. 134.
[168] Oats et al., International Taxation, par. 13.42.
[169] Fichtner and Michel, OECD's Conquest of the US, p. 17.
[170] Zucman, Taxing Across Borders, p. 134.
[171] Fichtner and Michel, OECD's Conquest of the US, p. 17.

The apportionment approach would eliminate incentives for artificial profit shifting. It is worthy to note that, under the three-factor formula, including capital and labor in addition to sales, corporations would still have incentives to move the real economic activities to low-tax jurisdictions. In contrast, the more radical approach based solely on sales could address both artificial profit shifting and tax competition[172].

Whilst the apportionment formula approach appears to be easy to apply, serious limitations can negatively impact the overall reach of this solution. First, sales, capital and employment are in fact only mildly correlated with profits (Hines 2010b)[173]. As a result, this approach is not in line with the principle, according to which corporate taxes shall be paid to the tax jurisdictions from which profits originate.

Second, the formula apportionment approach may create new forms of distortions. For instance, corporations would have incentives to outsource routine activities that have been so far carried out in-house in high-tax jurisdictions. A possible response to this type of strategies would be a distinction between a fixed return applied to routine activities and a sales-based formula applied to non-routine activities, as suggested by Avi-Yonah, Clausing and Durst (2008)[174]. The efficiency of this solution is largely dependent on the definition of a routine activity, which, according to Dharmapala (2016), is far from being self-evident[175].

Third, the apportionment formula approach is strongly dependent on cooperation and harmonization among various tax jurisdictions in order to prevent both double taxation as well as double non-taxation. This issue is further aggravated by difficulties with respect to consolidated profit reporting. If a corporate group is not systematically required to account for all its subsidiaries, the apportionment formula cannot fully eliminate transfer pricing incentives[176].

Fourth, although it is believed that the apportionment formula could eliminate one of the main tools currently used by MNCs to avoid taxes, it is questionable whether there is enough political support to replace the arm's length principle by this measure as a globally accepted standard of international taxation. The CCCTB initiative within the EU, which, if implemented, would correspond to a limited system of formula apportionment applicable to corporate groups

[172] Zucman, Taxing Across Borders, p. 134.
[173] Cited in Zucman, Taxing Across Borders, p. 134.
[174] Cited in Dharmapala, Corporate and Business Tax Reform, p. 23.
[175] Dharmapala, Corporate and Business Tax Reform, p. 23.
[176] Fichtner and Michel, OECD's Conquest of the US, p. 18.

resident in the EU Member States, illustrates how difficult it is to gain global acceptance for this approach[177].

### 3. Destination-Based Cash Flow Taxation

Another option how to respond to offshore corporate tax avoidance is a destination-based cash flow tax (DBCFT). In 2016, the Republican members of the US House of Representatives have released their proposal for a reform of the US tax system with the title *A better Way: Our Vision for a Confident America*. The proposal has suggested a major reform of US corporate taxation, with the current worldwide tax system being replaced by the DBCFT[178].

The DBCFT consists of two basic elements, namely the cash flow and the destination-based elements. The cash flow element gives immediate relief to all expenditures by recognizing expenses when they are paid. Revenues are taxed as they accrue. As a result, the tax base in any given period is a difference between receipts and expenses. The destination basis of the DBCFT describes how, in the international setting, a country determines which components of a corporation's tax base fall within its tax jurisdiction. In contrast to the traditional source-based approach in which business profits are taxed where they are generated, i.e. based on the location of the production or value added, under the destination-based approach, a tax jurisdiction only levies taxes on the profits from sales which were incurred within that tax jurisdiction. As a result, according to the destination-based element, the tax base under the DBCFT is calculated as a difference between sales of goods and services in the country and expenses incurred in the country. This means that exports are untaxed whilst imports are taxed[179].

The underlying idea of the DBCFT is that international mobility of consumers remain low and can hardly be manipulated by corporations. Under these circumstances, corporations can no longer diminish their tax burden by moving the production to low-tax jurisdictions nor can they manipulate their tax base through transfer pricing[180].

Becker and Englisch (2017) believe that, if globally implemented, the DBCFT would solve a major part of the issues and challenges of the current international tax system, including various tax avoidance strategies of MNCs. However, the US proposal does not contain any plans for a global implementation. As noted by Becker and Englisch (2017), in case of the unilateral implementation of the reform in the US, the DBCFT would coexist with traditional source-based tax systems. Whilst, under the DBCFT, the US tax liability would be independent of the

[177] Oats et al., International Taxation, par. 13.42.
[178] Baumann et al., Spillovers of Destination Based Border Adjusted Tax, p. 4.
[179] Auerbach et al., Destination-Based Cash Flow Taxation, p. 9 and 13 – 14.
[180] Becker and Englisch, European Perspective on Destination Based Cash Flow Tax, p. 4

location of production and assets, tax liability in other tax jurisdiction would depend on the allocation of taxable income across locations. This would increase incentives to shift taxable income to the US to reduce the overall tax burden and, subsequently intensify tax competition between the US and other tax jurisdictions[181].

The DBCFT "solves many of the most vexing problems of international taxation of corporate income, problems that have occupied the OECD in its BEPS project for several years without any satisfactory conclusion" (Graetz 2017)[182]. However, according to Auerbach et al. (2017), the overall efficiency of the DBCFT depends on how much the implementation departs from the ideal version of the DBCFT. The more the actual design is flawed, the more weaknesses taxpayers can exploit, and *vice versa*[183].

Auerbach et al. analyses the efficiency of the DBCFT to fight against the most common forms of tax avoidance, namely profit shifting through the use of debt, transfer pricing and the relocation of IP in low-tax jurisdictions. Both unilateral and universal alternatives are envisaged. Whereas, under the universal scenario, the adoption of the DBCFT helps to eliminate the aforementioned tax planning practices, tax planning opportunities remain in case of the unilateral adoption of the DBCFT[184].

A transfer pricing example illustrates the impact of the DBCFT under the unilateral as well as universal adoption. The example involves an intra-group transaction from a corporation established in a tax jurisdiction with the DBCFT (corporation A) to a foreign subsidiary in a source-based tax jurisdiction (corporation B) and the subsequent sales to the final customer. Such a cross-border intra-group transaction would not appear in the tax base of the corporation A. However, there would be incentives to overprice the transaction between A and B in order to reduce the final tax burden of B. Inversely, in case of a transaction from the corporation B to the corporation A, there would be incentives to artificially lower the price. In case of the universal adoption, the export would be disregarded for tax purposes whereas the import would be taxed but the value of the import would be, subsequently, deducted from the tax base of the corporation on the import side[185].

Auerbach et al. (2017) also discusses the impact of a unilateral adoption of the DBCFT on other tax jurisdictions. As explained in previous sections, empirical research shows that national

[181] Becker and Englisch, European Perspective on Destination Based Cash Flow Tax, p. 13 – 14.
[182] Cited in Auerbach et al., International Tax Planning under DBCFT, p. 4.
[183] Auerbach et al., International Tax Planning under DBCFT, p. 4 and 7 – 8.
[184] Auerbach et al., International Tax Planning under DBCFT, p. 9 – 12 and 15 – 17.
[185] Auerbach et al., International Tax Planning under DBCFT, p. 9 – 12 and 15 – 17.

governments follow closely tax strategies in other countries and adapt their own strategies accordingly. This suggests that the more countries adopt the DBCFT, the more attractive this system will become, since tax jurisdictions based on the traditional source-based system would be at a competitive disadvantage in comparison to the tax jurisdiction with the DBCFT[186].

## B. Corporate Social Responsibility and voluntary compliance

This paper has focused so far on actions taken by public authorities to counter tax avoidance practices of MNCs. Whereas it is true that, through the design of their national tax systems as well as international taxation, public authorities may incentivize MNCs to act in a specific way, thereby encouraging or discouraging tax avoidance practices. However, such approach appears to work with a limited and limiting conception of MNCs as purely economic operators, with the sole purpose of maximizing profits.

The concept of Corporate Social Responsibility (CSR) have been gaining importance over the past 50 years. Nowadays, this concept is widely considered as an essential quality of successful firms (Avi-Yonah, 2008)[187]. There is no generally admitted definition of CSR but there is consensus that “CSR firms should strive to make a profit, obey the law, be ethical, and be a good corporate citizen” (Carroll, 2006)[188]. The CSR topics usually encompass environmental issues and sustainability, child labor and workforce rights, animal rights, corruption and similar. Surprisingly, tax compliance or, more particularly issues involving tax avoidance and evasion, seem to be rarely listed among the CSR topics. According to an OECD survey of 233 codes of conduct issued by individual companies, industry and trade associations and inter-governmental organizations found that taxation was mentioned only in one code. A similar study involving code of conducts of 200 largest companies in the world found out that timely payment of taxes was included in only one of the codes[189].

Although taxation topics have long been omitted by CSR, we can expect this situation to change in the near future. As the director of the OECD tax policy center noted in 2004, “tax is where the environment was ten years ago”, thereby establishing a link to the CSR evolution with respect to environmental issues in the 1990s[190]. The recent data leaks along with the 2008 financial crisis, which increased pressure on public budgets, have certainly contributed to raising the public awareness regarding the tax avoidance and evasion topics and, subsequently,

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186 Auerbach et al., Destination-Based Cash Flow Taxation, p. 44.
187 Cited in Stephenson and Vracheva, CSR and Tax Avoidance, p. 5.
188 Cited in Stephenson and Vracheva, CSR and Tax Avoidance, p. 5.
189 Cited in Jenkins and Newell, CSR, Tax and Development, p. 12.
190 Cited in Jenkins and Newell, CSR, Tax and Development, p. 9.

have increased the pressure on MNCs to refrain from tax practices, which are in compliance with tax law but breach ethical standards.

The main reason named to justify the inclusion of taxation into the CSR topics refers to the concept of corporate citizenship, which describes the range of duties and obligations of a corporation towards the society in which it operates. Similar to other citizens, MNCs have access to public services, which, in turn, also generates an obligation to contribute and creates a relationship between MNCs and the state or states in which they operate. Whereas tax planning activities may be seen as an integral part of legitimate business strategies, the corporate citizenship concept adds additional viewpoints to the discussion by introducing stakeholders other than shareholders. As a result, when determining their tax planning strategies, MNCs should not disregard an overall impact of their strategies. In particular, tax avoidance is particularly harmful for developing countries with weak public authorities, since their capacity to supervise and control tax avoidance practices is low, which, in the context of their dependence on tax revenues, may have considerable consequences for the further development[191].

In an article from 2013, the BBC reported about the rise of "tax shaming" as follows: "But the tide of public opinion is visibly turning. Even 10 years ago news of a company minimizing its corporation tax would have been more likely to be inside the business pages than on the front page" The article went on by asking how effective tax shaming is. "The idea that Starbucks would voluntarily pay more tax than it legally needs to seems extraordinary on the surface, and an argument for an effectiveness of tax shaming". Michael Devereux, a tax expert at Said Business School, University of Oxford, added: "Starbucks appears to be saying they don't think they owe any more money, but will pay anyway. If that's true, it's having a reputational effect – but it's a bit odd in terms of the tax system, we wouldn't want the tax system to be voluntary"[192].

The above article provides an overview of what CSR could achieve in the field of taxation and, more specifically, tax avoidance. Whilst it will not sort out the issue of tax avoidance, CSR along with the public pressure can contribute to curbing these practices.

[191] Jenkins and Newell, CSR, Tax and Development, p. 10 – 11.
[192] Barford, Vanessa / Holt, Gerry, Google, Amazon, Starbucks: The rise of 'tax shaming', BBC, 21 May 2013, available at: https://www.bbc.com/news/magazine-20560359.

# VI. Summary and Conclusions

The Panama and Paradise Papers reminded the public that tax avoidance and evasion are not some distant and marginal concepts, reserved to dubious businessmen and criminals acting at the edge of law. The recent data leaks showed that renowned corporations as well as publicly known individuals do not content themselves with the tax reliefs granted by tax law. They are exploring gaps and loopholes in the existing tax provisions in order to further reduce their tax burden or avoid it altogether. This paper focuses on offshore tax avoidance practices carried out by MNCs. In their mildest form, tax planning activities merely correspond to benign tax mitigation. However, the more aggressive their approach is, the more they depart from what one can see as being in line with ethical as well as legal standards. As shown in this paper, legality is the fine line which separates tax avoidance from illegal tax evasion practices.

Even though tax avoidance is not illegal, we cannot ignore its obvious financial and non-financial impact on global welfare. When computing the financial impact of tax avoidance, scholars usually provide wide ranges, which is symptomatic of difficulties to define tax avoidance as well as of its secretive nature. For instance, the OECD estimates the annual cost to be between 100 and 240 billion US dollar. Similarly, the EU Parliament Research Service suggests a range between 50 and 190 billion euro. Whilst tax revenue losses are the most immediate consequence of tax avoidance, these practices also provide wrong incentives to other taxpayers, thereby having a negative impact on overall tax compliance.

This paper further shows that the traditional unilateral or multilateral solutions to counter offshore corporate tax avoidance are not able to face the challenges of the today's globalized world, consisting of a web of mutually dependent national economies. Alternative approaches, which would rethink the bases of international taxation as we know it nowadays, appear to be necessary, whereby persisting tax competition between countries could be a double-edged sword. On the hand, tax competition could push countries to act unilaterally in order to secure a competitive advantage against other tax jurisdictions, thereby defeating the universal adoption of the tax reform. On the other hand, tax competition could also lead to a convergence of strategies in order to benefit from advantages offered by the alternative system.

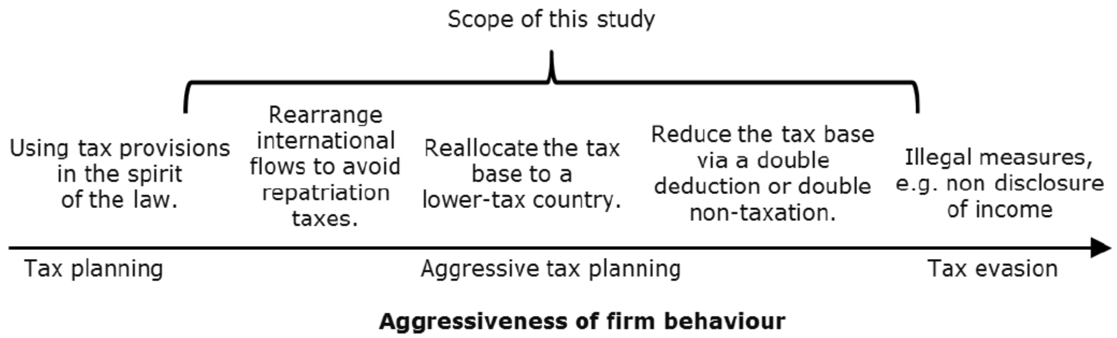
Whilst the discussions regarding the reform of the international tax system are ongoing, we should not underestimate the impact of the public opinion, which has become aware of the tax avoidance issue and could have the potential to push MNCs to abandon at least the most blatant practices.

# VII. Appendices

**Appendix 1**

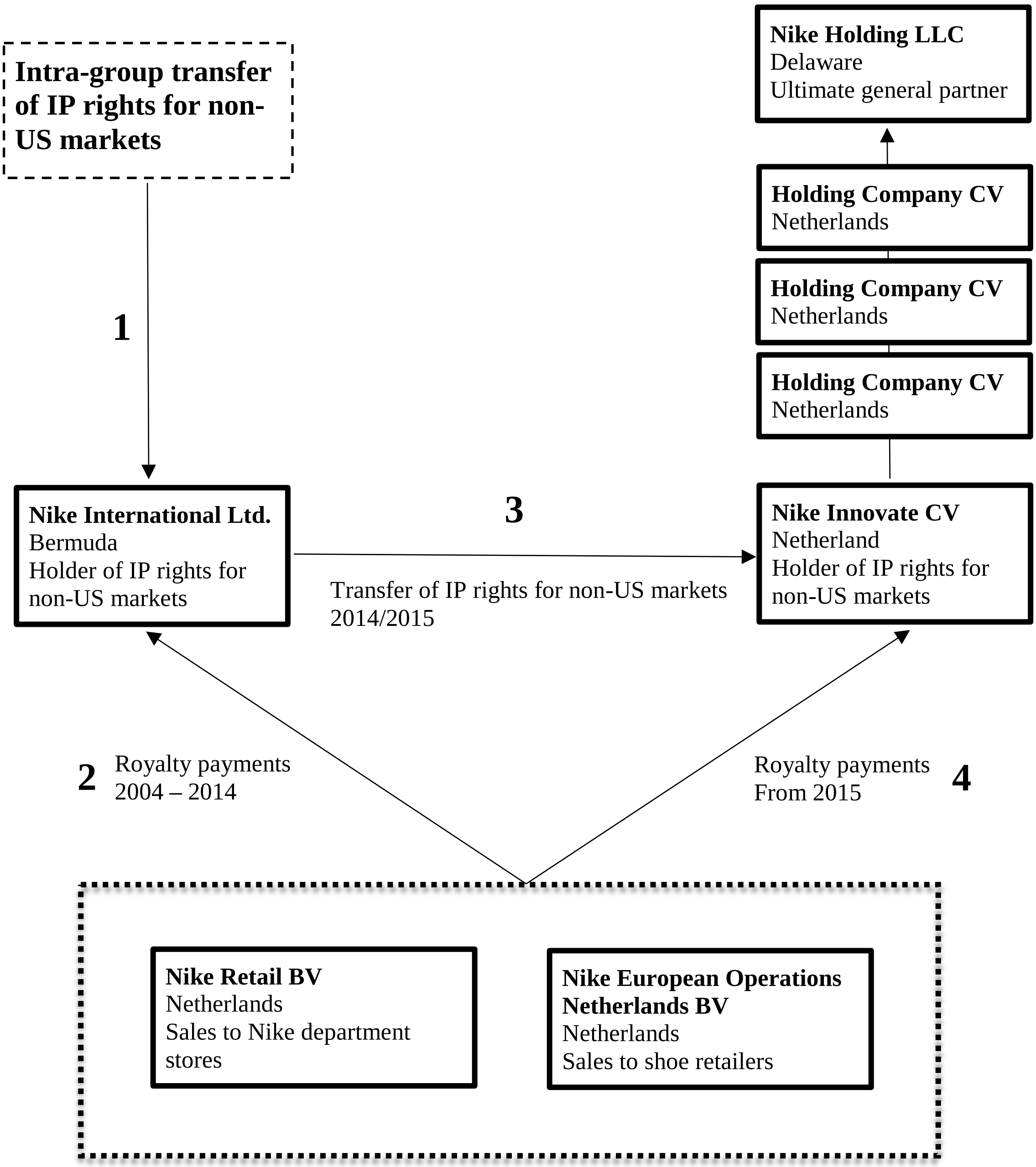
Source: Loretz, Simon / Sellner, Simon / Brandl, Bianca / Arachi, Giampolo / Bucci, Valeria / van’t Riet, Maarten / Aouragh, Ali, Aggressive tax planning indicators – Final report, European Commission, Taxation Papers, Working Paper No. 71 – 2017

**Figure 1: Boundaries of ATP definition**



**Appendix 2**

Source: own



# Resume

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# Statement

I hereby declare

- That I have written this paper without any help from others and without the use of documents and aids other than those stated above,
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Zürich, 18 July 2018

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