universität wien

MASTER THESIS

Titel der Master Thesis / Title of the Master‘s Thesis

„CCCTB: The road to a Corporate Unifom Tax Base in Europe“

verfasst von / submitted by

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angestrebter akademischer Grad / in partial fulfilment of the requirements for the degree of

Master of Laws (LL.M.)

Wien, 2018 / Vienna 2018

Studienkennzahl lt. Studienblatt / Postgraduate programme code as it appears on the student record sheet:	A 992 548
Universitätslehrgang lt. Studienblatt / Postgraduate programme as it appears on the student record sheet:	Europäisches und Internationales Wirtschaftsrecht / European and International Business Law
Betreut von / Supervisor:	Dr Dimitar Hristov

CCCTB:
The road to a uniform Corporate Tax Base in Europe

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ACCA	Association of Chartered Certified Accountants
AcSB	Canadian Accounting Standard Board
ACT -	Advanced corporation tax
AICPA	American Institute of Certified Public Accountants
AL	Arm's length
ALP	Arm's Length Principle
ALpool	Assets leaving the pool.
AO	Abgabenordnung
AOA	Authorized OECD approach
APA	Advanced Pricing Agreements).
ARSIW	UN Articles on Responsibility of the State for Internationally Wrongful Acts
ATAD	Anti-Avoidance Directive
BAR	British Accreditation Regency
BEPS	Base Erosion and Profit Shifting
BIT	Bilateral Investment Treaty
BNDS	Banco Nacional de Desenvolvimento Social
BRL	Brazilian Real
CAPCHTA	Completely Automated Public Turing test to tell Computers and Humans Apart
CCAs	Cost Contribution Agreements
CCCTB	Common Consolidated Corporate tax Base
CCTB	Common Corporate tax base
CDO	Collateral Debt Obligation
CDS	Credit Default Swap
CEN	Capital Export Neutrality
CESR	Committee of European Securities Regulators
CFC	Control Foreign Company
CGT	Capital Gains tax
CGUs	Cash-Generating Units
CICA	Canadian Institute of Chartered Accountants
CIN	Capital Import Neutrality
CIT	Corporate Income Tax
CIV	Collective Investment Vehicle
CJEU	Court of Justice of the European Union
COAF	Conselho de Controle de Atividades Financeiras
COGS	Costs of goods sold
CORTAX	Corporate Taxation Model
CRA	Contract Risk Analysis
CSA	Canadian Securities Administrators
CSP	Capital Support Payments
CUP	Comparable Uncontrolled Price
D/NI	Deduction non-inclusion
DBPA	Depreciation base polled assets.
DD	Double Deduction
DIM	Direct Imported Mismatch

DT	Double Taxation
DTA	Double Tax Agreement
DTC	Double Tax Convention
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EApool	Assets entering the pool, including acquisition, constructions and improvement.
EATR	Effective Average Tax Rate
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest Tax Depreciation and Amortization
EBT	Earnings Before Tax
EC	European Community
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
ECOSOC	United Nations Economic and Social Council
EEA	European Economic Area
EEC	European Economic Community
EEIG	European Economic Interest Grouping
EFTA	European Free Trade Area
EIRF	Expenses Incurred in connection with the Raising of Finance
EMTR	Effective Marginal Tax Rate
EPA	Environmental Protection Agency
ETA	European Tax Analyser
ETR	Effective Tax Rate
EU	European Union
EUR	Euro
EWG	Europäische Wirtschaftsgemeinschaft
FA	Formulary Apportionment
FASB	Financial Accounting Standard Board
FDI	Foreign Direct Investment
FET	Fair and equitable treatment
FHLBB	Federal Home Loan Bank Board
FIFO	First-in first-out
FISC	Financial Information and Service Centre
FoA	Force of Attraction Principle
FoC	Flag of Convenience
FRA	Functional Risk Analysis
FSLIC	Federal Savings and Loan Insurance Corporation
FTC	Foreign Tax Credit
GAAP	General Accepted Accounting Principles
GAARs	General Anti-Avoidance Rules
GDP	Gross Domestic Product
GFA	Global Formulary Apportionment
GG -	Grundgesetz für die Bundesrepublik Deutschlands
GI	Gross Income
GM	Gross Margin
GP-	Gross Profit

GSTT	Generation-Skipping Transfer Tax
HHI	Herfindahl-Hirschman Index
HLWP	High-Level Working Party on Tax Questions
HMAs	Hybrid Mismatch Arrangements
HMRC	Her Majesty's Revenue and Customs
HP	Hybrid deduction
HT	Hybrid Transfer
HTML	Hyper-Text Mark-up Language
HTTP	Hypertext Transfer Protocol
HTVI	Hard-to-value-intangibles
IA	Intangible Asset
IafD	Interest and all Forms of Debt
IAS	International Accounting Standards
IASB	International Accounting Standard Board
IBDF	International Bureau of Fiscal Documentation
ICAEW	Instituted of Charted Accountants in England and Wales
ICC	International Chamber of Commerce
ICSID	International Centre for Settlement of Investment Disputes
IFRIC	International Financial Reporting Interpretation Committee
IFRS	International Financial Reporting Standard
IIM	Indirect Imported Mismatch
ILS	Long Maturity Security
IMF	International Monetary Fund
IMP	Imported Mismatch Payment Made by the Payer
IMR	Imported Mismatch Rule
IOSCO	International Organization of Securities Commission
JTPF	Joint Transfer Pricing Forum
LBO	Leverage Buy-out
LIFO	Last In First Out.
LOB	Limitation of Benefits
M&A	Mergers and Acquisitions
MAP	Mutual Agreement Procedure
MCNs	Mandatory Convertible Notes
MEQRs	Measure having equivalent effect to qualitative restrictions
MFN	Most-favoured Nation
MNEs	Multi-national Enterprises
MOU	Memoranda of Understanding
MSP	Market Support Payments
MSs	Member States
NAFTA	North American Free Trade Agreement
NEMTR	Negative Effective Tax Rate
NIA	National Intervention Agency
NP	Net profit
NPDIR	Neutralized Payment under the Direct Imported Rule

NPSIR	Neutralized Payment under the Structured Imported Rule
NT	National Treatment
OCI	Other Comprehensive Income
OE	Operation expenses
OECD	Organisation for Economic Co-operation and Development
OH	Overhead
PC	Parent Company
PDV	Present discounting value
PE	Permanent Establishment
PEEI	Payments Economically Equivalent to Interest
PER	Price elasticity risks
PPP	Public Private Partnership
PPT	Principle-Purpose-Test
PWC	PricewaterhouseCoopers
R&D	Research and Development
Repo	Repurchase Agreement
RU	Reporting Unit
S&P	Standard & Poor
SAB	Staff Accounting Bulletins
SAC	Standard Advisory Council
SE	Societas Europene
SEC	Secutiries and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SH	Safe Harbor
SHD	Structured Hybrid Deduction
SIM	Structured Imported Mismatch
SME	Small Medium Enterprise
SPV	Special Purpose Vehicle
STR	Statutory Tax Rate
TAIPR	Total Amount of Imported Payment Received
TARHDI	Total Amount of Remaining Hybrid Deductions Incurred
TEC	Treaty Establishing the European Community
TEU	Treaty European Union
TFEU	Treaty on the Functioning of the European Union
TGP	Transfer Pricing Guidelines
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNRIAA	United Nations Report of International Arbitral Awards
URV	Unidade Real de Valor
VAT	Value-added tax
VCLT	Vienna Convention on the Law of the Treaties
VEY	Value at the end of the year

WTO	World Trade Organization
WWTS	World Wide Tax System
XBRL	Extensive Business Reporting Language
XBRL	eXtensible Business Reporting language

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Introduction

Tax[1] law has from the end of the 19th and beginning 20th centuries been applied according to civil law principles, that is, it was considered a branch of private law. In Germany, for example, the change from civil based to a more "economic" based perspective occurred after the First World War with the codification of two Statutes, namely, the Reich Tax Code (*Reichsabgabeordnung*) and the general Administrative Procedure Act (*Verwaltungsverfahrensgesetz*).[2] The area gained notoriety mainly due to the fact that it creates upon individuals duties on private assets by imposing upon persons a payment obligation (*Geldzahlung*) as well as other duties related to the latter (*formallen Pflichten*).[3] Therefore, it is imperative that the relation between State and citizen be well outlined. It is important to delineate beforehand a number of questions and grey areas within the institute of tax law that will not be subjected to a deeper discussion in this study, for instance the historical evolution of tax law, whether tax law should be considered an autonomous discipline, or discussions such as the limits of the State to levy taxes, or other phenomena for example, administrative acts,[4] the relationship between tax law and financial law, [5] the independence of tax law over civil, labour, [6] corporate law [7] etc. Despite its

[1] "[A] tax is a compulsory contribution of the wealth of a person or body of persons for the service of the public powers". Charles F. Bastable. *Public Finance*. 1917. Library of Economics and Liberty. Retrived March 8, 2018, form the world Wide Web: http://www.econlib.org/library/Bastable/bastbPF14.html. III.I.5.

[2] Andrea Amatucci, International Tax Law. (Klumer Law International 2006) 81.

[3] Andrea Amatucci (n 2) 28.

[4] The power to levy taxes is a constitutionally right conferred to the State to advance on the private property of persons upon its triggering event, such as income generation, property ownership, tax on consumption etc. States may also advance or the private property of entities by imposing monetary penalties towards those who have failed to comply with a payment obligation, or a formal obligation. The limits imposed and procedures to claim such rights are properly studied within the field of Administrative Law (*Verwaltungsrecht*). According to *Thomaz von Danwits'* study on European Administrative Law "*In der grundgesetzlichen Verfassungsarchitektur bildet die Zuweisung von Handlungs- und Gestaltungsaufträgen an die Verwaltung durch Parlamentsgesetze eine unverzichtbare Legitimationsgrundlage für das Verwaltungshandeln. Duch sie wird der Legitimationsvorsprung parlamentsgesetzlicher Entscheidung in dem parlamentarischen Regierungssystem des Grundgesetzes praktisch wirksam. (…) Auf normativer Ebene wird die Bindung der vollziehenden Gewalt an Gesetz und Recht aus dem in Art. 20 Abs. 3 3 GG festgeschriebenen* (Grundgesetz für die Bundesrepublik Deutschlands) *Prinzip der Gesetzmäßigkeit der Verwaltung hergeleitet. Dieses Prinzip wird durch zwei Grundsätze konkretisiert: den Vorrang und den Vorbehalt des Gesetzes*." Thomaz von Danwits. *Europäisches Eigenverwaltungsrecht. In: Europäisches Verwaltungsrecht. Enzyklopädie der Rechts- und Staastswissenschaft*. Springer, Berlin, Heidelberg. (2008). Pag. 12.

[5] Financial law governs the public revenue legal framework, and do not represent *per se* a system of similar relationships, but a set of different relationships connected to the activities conducted by the State in relation to the management and creation of money, investments, assets and liabilities regarding public authorities. Tax law, as previously mentioned, is a part of Financial law and acts as a lieu to other areas. Andrea Amatucci (n 2) 66.

[6] The payment of employees generates operational expenses, therefore it may be offset agains the company's profits for the purposes of tax assessment. Nevertheless, should the State allow the deduction of an expense generated by the payment of an allowance made between family members, for example, a spouse? The matter was ruled in 1988 by the German Federal Finance Court, that ultimately denied the deduction. However, the court's decision was challenge and the case was brought upon the German Constitutional Court (*Bundesverfassungsgericht*),that

importance to the study of tax law, it serves no purpose for the present investigation, which intends to maintain a more empirical approach to European and International Taxation. However, some historical background regarding evolution of double taxation, origins of the model conventions etc, will be punctually discussed.

Tax law belongs to the field of Finance Law, and the fact that one can not conduct a rigorous study on the subject without entering into other areas within the law, (Competition Law, Capital Market Law, Criminal Law, Procedural Law, International Law, Administrative Law etc), and also into areas outside the law's common body of knowledge (economics, accounting, political science etc),[8] imposes upon the student an extra effort due to its inevitable multidisciplinary approach. For that matter, tax law is deemed by many as incomprehensible**.** However, this commingled characteristic of tax law with other areas of the law/knowledge is fundamental, if not mandatory, to its instrumentalization, otherwise applicable results would not be possible (public finance Law and administrative law, economics and accounting, for instance, are at the heart of tax law, for "the procedures used by the State to achieve its goals cannot be examined apart from their economic implications").[9] Therefore, conducting an investigation based only on legal aspects of tax law would lead to an empty and ultimately incomplete study, which would, in our view, fail to grasp to a full extent the effects that tax law creates upon society. It is fair to conclude that in no other area of study within the law, is this multidisciplinary approach so necessary and important as it is in tax law. To that end, it is fair to point out that tax law provides to those who wish to *sail such waters* a great intellectual challenge.

When the State levy taxes, it does so in order to finance its activities (security, education, health care etc), nevertheless, one must be attentive of its "extra-fiscal aims". Taxes constitute the very foundation of a system seeking to be fair, just and more importantly, based on the rule of law. The power to levy taxes is a right of the State, granted by the Constitution, that is, the command/order imposed upon the taxpayer need, inevitably, be enacted by the

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reversed Federal Financial Court's opinion. The Federal Financial Court " had refused to recognize civil law structures between spouses with independent tax law considerations (…), whilst the Federal Constitutional Court gives a genuine civil law argument as to the need for recognition. (…) The recognition of the independence of tax law as against civil law is, finally, also impressively (in this case against labour law) by current legislation on the definition of employee in connection with the problem of so-called pretend self-employment. On this, the Federal Finance Court (…) has explicitly stressed once more that, for the evaluation of an activity as self-employed or employed under tax law, the category allocated under social law and under labour law could be significant as an indication, but not binding. For this reason, in particular also the definition under labour law of a 'person similar to an employee' had no impact on the tax law delimitation." Andrea Amatucci (n 2) 95.

[7] The taxation of partnerships and corporations is central to the study of European and international taxation, therefore special attention will be bestowed towards it in other parts of this investigation. Multi-national enterprises (MNEs) may structure their tax schemes in such a way to exploite differences of treatment conferred by domestic legislations (tax arbitrage). In other words, MNEs may abuse such differences to produce the desired tax outcome, namely, tax neutrality, double deductions or artificial tax credits.

[8] Margareth Lamb, Andrew Lymer, Judith Freedman, Simon James. *Taxation. An interdisciplinary Approach to Research*. Ed. Oxford (2005) 4.

[9] Andrea Amatucci (n 2) 10.

law. The ***principle of legality*** prevents the State to advance on the property of its citizens without being properly backed by a previous legislation. Due to its imperative nature and severeness (command/order expressed in a certain Statute to *give something*)[10] it is imperative that constitutional guarantees be strictly observed in order to avoid possible excess and abusive behaviours carried by a State's administration that undoubtedly has the most resources to control and influence the outcome of any legal dispute in which is involved. To that effect, a fair tax system is central to the economic, social, and political development of any State that seeks to achieve the higher possible level of social justice.[11]

From an international perspective taxation provide companies and individuals that conduct cross-border transactions great complexity due to legislation diversity, setting from a practical point of view gargantuan challenges to jurisdictions**.** It is also important to emphasise that it is precisely this complexity that allow MNEs to explored loopholes on the international system in order to reduce tax liability, therefore imposing upon developed as well as on still developing Countries the need for a more organized, coherent, fair and most importantly cooperative system of international taxation.

The BEPS project is an OECD initiative created to deter and correct certain gaps and mismatches in the current international tax system which ultimately causes profits to evaporate without being properly taxed, or being transferred to low tax jurisdictions where little or no economic activity whatsoever occurs.[12] The OECD BEPS initiative acknowledges that investment decisions should not be influenced by tax benefits but for the expectation of profits. Moreover, the fairness, trustworthiness and transparency of a tax system is negatively affected to the extent that the "*government's policy choices influence the allocation of a mobile tax base among regions*"[13] creating an impact on the confidence that citizens have in respect to that government's policies. In 2013 the BEPS project has come up with a number that depicts quite clearly the size of the problem caused by base erosion and profit shifting, concluding that 4-10% of the global corporate income tax (CIT) revenue (100 to 240 billion dollars *per annum*) is not collected.[14]

In order to maintain this investigation more approachable, we have decided to break it into two parts, the first being an introduction to EU principles, legislation, to whom it may apply etc, and the second part, we proceed to cover the operations *per se*, that is, the interaction between EU legislation and

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[10] Andrea Amatucci (n 2) 68.

[11] When referring to the 2016 CCCTB project, the vice-president for the Euro and Social Dialogue Valdis Dombrovskis stated that: "Tax policy should support the EU's goals of economic growth and ***social justice***. Today's proposals aim to boost growth and investment, support enterprise and ensure fairness. The current corporate tax system treats debt financing of companies more favourably than equity financing. Reducing this debt-equity bias in the tax system is an important element of the Capital Markets Union Action Plan and underlines our commitment to deliver on this Project*". Commission proposes major corporate reform for the EU. (2016)* http://europa.eu/rapid/press-release_IP-16-3471_en.htm. Accessed in 21 Sep 2017.

[12] OECD/G20 Base Erosion and Profit Shifting Project. Final Reports. [2015]. http://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf. Accessed in 21 Sep 2017. 3.

[13] John Douglas Wilson, David E Wildasin, *Capital tax competition: bane or boon*, Journal of Public Economics, Volume 88, Issue 6, June 2004. 1067.

[14] OECD/G20 Base Erosion and Profit Shifting Project. Final Reports. (n 12) 3.

its players. A series of graphs will be included in the present investigation, for they are powerful visualization tools in improving the "*intuitive understanding of a functional relationship*".[15]

I. Principles, Concepts, Fundamental Freedoms and EU Legislation

Juris Praecepta Sunt haec: Honeste Vivere, Alterum Non Laedere, Suum Cuique Tribuere[16]

Gnaeus Domitius Annius Ulpianus[17]

A. Introduction

In order to understand the functioning of the EU tax System, we must first study and investigate the principles in which lies its base. This will allow us to construct (brick by brick) a more consistent study. Although these principles are the product of decades of work we understand that discussing its historical background, that is to say, the way in which it reached its present status would be a too herculean task, consequently deviating from the main purpose of the present investigation. Nonetheless, some concepts related to the European integration process must be assessed.

Integration in the broad sense of the word, is bringing together separate pieces into one. Economic integration is the process of abolishing discriminatory measures between economic parties, construed by the absence of discriminatory measures amongst domestic economies.[18] Although there is some connection between ***integration*** and ***cooperation***, both terms present very distinct characteristics. One could say that the road to integration necessarily passes through cooperation. The concept of *cooperation* entails lessening the application of discriminatory measures, whereas *integration* results in the total suppression of such measures.[19] According to *Bela Balassa*, the process of integration should follow five necessary steps in the following order, (1) *free trade area*, (2) *customs union*, (3) *common market*, (4) *economic union* and (5) *economic and monetary union*. Reaching a higher level of economic integration whilst maintain its national identities and sovereignty as States seems to be the

(1) Free Trade Area	**Abolition of tariffs and quantitative restrictions between participating Countries, whereas retaining its own tariffs against non-members.**
(2) Customs Area	Equalization of tariffs with non-members and suppression of discrimination in the movement of commodities.
(3) Common Market	Abolition of trade restrictions as well as mobility factors.[1]
(4) Economic Union	Suppression of the movement of commodities as well as policy factor restrictions, in order to remove regulatory disparities between members.
(5) Economic and Monetary Union	Complete economic integration, by the unification of monetary, social, fiscal and economic policies with one supra-national authority with binding decision privileges.

[15] Robert Cooter and Thomas Unlen. *Law and Economics*. Sixth ed. Addinson-Wesley (2012). 16.
[16] "The principles of the Law: live honestly, do not offend others, give to each person what is due" Gnaeus Domitius Annius Ulpianus
[17] Gnaeus Domitius Annius Ulpianus.
[18] The theory of Economic Integration: An introduction. Bela Balassa. The European Union. Readings on the Theory and Practice of European Integration. Springer (1994) Springer. Pag 173.
[19] Bela Balassa (n 18) 174.

object of great concern amongst EU MS, and a number of challenges need be overcome so that a pure integrated system be achieved. Nonetheless a number of questions are till the present date not clearly answered, such as: *is economic integration really a desirable effect*? **or** *do economic integration enhances the standard of living*? *do economic integration cause taxes to raise?* Well, in order to assess the desirability of economic integration, one must first ascertain whether or not it enhances welfare. Nevertheless, the question of whether economic interation enhances welfare still stirs great debate among scholars, who have different opinions on the matter.[20]

Let us present the following effects of integration: *First*, economic integration will inevitably influence the quantity of commodities produced and consumed within the Common Market due to possible relocation of production factors. Possible inhibiting integration factors are: logistics (geographic distances), language and "man-made barriers" related to state aid. The incorrect application of Union legislation and the existence of a "home-bias", that is, culturally related preferences may also serve as possible barriers. *Second*, economic integration is likely to cause discrimination between foreign and national goods. *Third*, economic integration will reorganize income distribution between *individuals* of different Countries, and *finally*, economic integration will inevitably reorganize income distribution within Member Countries.[21] The European Parliament commissioned a study in order to assess the potential economic gains of a complete economic integration. "*The Cost of a Non-Europe in the Single Market*" (hereinafter *Study*), proceeded to investigate the potential of a full and complete integrated market. The specific topics covered were: free movement of goods structure (183 to 269 billion euro of revenue increase annually), services (338 to 637 billion euro of revenue increase annually – services account for approximately 70% of EU GDP in 2017),[22] digital market (36 to 75 billion euro of revenue increase per annum), public procurement contracts (36 to 66 billion euro of revenue increase annually) and on the influence on the consumer law body over the single market (around 58 billion euros of revenue increase per annum), therefore a "*further deepening of the Single Market could increase EU-28 GDP by an additional 5% to 8.63% equivalent to between 651 billion euros to 1.1 trillion euros of additional economic output per*

[20] Uniformization (integration) reduces uncertainty, thus decreasing compliance expenses, risk of DT, TP issues etc. In the CCCTB Impact Assessment Report, the Commission ***quantified*** and ***qualified*** the effects of a common consolidated corporate tax base in Europe through a number of methodologies, such as the ***European Tax Analyzer*** (ETA) a model which creates a "model company" and simulates the development of that company within the internal market over a 10 year period, "taking into account the relevant provisions of the tax systems in place", ***CORTAX*** model which analyses the information provided by ***ORBIS*** and ***Amadeus*** databases formed by the balance sheets and profit accounts of more than 6700 EU multinationals groups and more than 2000 groups in non-financial sectors, throughout 2002-2005), a PWC case study launched in 2008 and another Delloitte's survey of 2009. Particularly under the ***CORTAX*** analysis it is argued that the implementation of a common consolidated corporate tax base and a formula apportionment creates a positive effect on welfare. Commission Staff Working Document. *Impact Assessment*. Sec (2011) 315 final. 40.

[21] Bela Balassa (n 18) 180.

[22] Proposal for a Directive of the European Parliament and of the Council on the legal and operational framework of the European services e-card introduced by Regulation ....[ESC Regulation]....COM/2016/0823 final – 2016/0402. Explanatory Memorandum 1.

annum."[23] The integration barriers just presented (logistics, language, state aid, incorrect interpretation of EU legislation etc) may be circumvented by reducing legislation gaps and overcoming certain deficits. Here are a number of solutions identified by the *Study*:

- ***Better transposition of Directives*** into domestic legislation by respecting the pre-established (realistic) deadline (the Study suggests that gold plating requirements – term used in project management to projects that are beyond what is realistic or rational for the extra effort – should also be assessed as to whether is generates positive effects) and ***transparency increase*** by the exchange of best practices (mutual evaluation);
- ***Creation of qualitative and quantitative indicators*** to be used as benchmarks for the assessment of the economic effects of application of Single Market rules and ***enhancement on the effectiveness and enforcement*** of Common Market legislation;
- ***Mutual recognition***[24] of regulatory policies between MSs and a more efficient ***proportionality assessment*** targeting discriminatory measures imposed by MSs that are unjustified and disproportionate under a rule of reason analysis.

Nonetheless, further actions may be needed in order to promote "the transition to a fully functional e-procurement regime and the use of e-invoicing in Europe; unlocking the potential of a complete Digital Single Market and the implementation of the euro digital agenda".[25] To conclude the European Community has developed, and enjoys in general a high degree of humanitarian consciousness, freedom, democracy and equality operating under the auspices of the rule of law.[26] We will begin the present investigation by describing the general principles in which the base of EU legislation is build.

1. Supremacy (Primacy of EU Law)

The European Union is basically formed by 7 institutions properly numbered on Article 13 TEU, namely, the European Parliament,[27] the European

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[23] The Cost of a Non-Europe in the Single Market. EPRS. European Parliament Research Service. September (2014). http://www.europarl.europa.eu/RegData/etudes/STUD/2014/510981/EPRS_STU%282014%29510981_REV1_EN.pdf. Accessed in 21 Sep 2017.

[24] The mutual recognition principle was first acknonwledge in the Cassis de Dijon case.

[25] The Cost of a Non-Europe in the Single Market. EPRS. European Parliament Research Service. September (2014) .http://www.europarl.europa.eu/RegData/etudes/STUD/2014/510981/EPRS_STU%282014%29510981_REV1_EN.pdf. Accessed in 21 Sep 2017.

[26] Consolidated Version of the Treaty of the European Union. C [2012] 326/13. http://eur-lex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC_1&format=PDF. Preamble. Accessed in 21 Sep 2017.

[27] The ***European Parliament*** exercise with the Council, legislative and budgetary functions (Article 14 TEU). Its functions are properly described in Articles 223 to 234 TFEU. Among its legislative and budgetary functions, the European Parliament shall elect an Ombusdmann "empowered to receive complaint from any citizen of the Union or any person residing or having its registered office in a Member State concerning instances of maladministration in the activities of the Union Institutions". It shall also allow that "Any citizen of the union, and any natural

Council,[28] the Council,[29] the European Commission,[30] the Court of Justice of the European Union,[31] the European Bank[32] and the Court of Auditors.[33]

As a general rule, organs of a State (courts, administrative bodies etc) are bound to apply norms of a "*national legal order only, that is to say, the law of the State whose organs they are. (…) As an exception to this rule, the law applying organs of this State, especially the courts, are bound to apply norms of another*

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person or legal person residing or having its registered office in a Member State (…) to address (…) a petition to the European Parliament on a matter which comes within the Union's fields of activity or which affects him, her or it directly." 228 TFEU (ex Article 195 TEC). According to *Klaus-Dieter Borchardt,* "(…) ist auch das Recht eines jeden Bürgers order juristischen Person vertraglich abgesichert, Petitionen an das Europäische Parlament zu richten, die von einem ständigen Petitionsausschluss bearbeitet warden. Schließliche hat das Europäiche Parlament von der ihm eingeräumten Möglichkeit Gebrauch gemacht und einen Bürgerbeauftragten (Ombudsmann) ernannt, der Beschwerden über Missstände bei der Tätigkeit der Organe oder Institutionen, ***mit Ausnahme des Gerichtshof***, entgegennimmt." (emphasis added). Klaus-Dieter Borchart. *Das ABC des Rechts der Europäichen Union.* Amt für Veröffentlichungen der Europäischen Union (2010) 57.

[28] Article 15 and 18 TEU (n 26). Article 235 and 236 TFEU.

[29] Article 16 TEU (n 26). Articles 237 to 234 TFEU.

[30] Article 17 TEU (n 26). Article 224 to 250 TFEU.

[31] ***The European Court of Justice*** (Article 19 TEU and Article 251 to 281 TFEU) is formed by: a ***First Instance Court*** (General Court – Article 256 TFEU and Articles 47 to 62b Protocol (No 3) on the Statute of the Court of Justice of the European Union, hereinafter Protocol (No 3)). The *General Court* may *hear and rule* direct actions brought by legal (MSs and undertakings) or natural persons in respect to: (***i***) the legality of legislative acts, recommendations, oppinions etc, by which, the Council, the Commission, the European Central Bank, the European Parliament and the European Council exercises implementing powers (Article 263 TFEU), (***ii***) fail to act of the Council, Parliament, Commission, MSs etc, according to the relevant Treay (Article 265 TFEU), (***iii***) compensation for damages due to *Union's* contractual liability (Article 268 and 340 TFEU), (***iv***) disputes between the Union and its servants, (***iv***) arbitration clauses contained in a contract concluded by or in behalf of the Union (Article 272 TFEU), (***v***) actions regarding intellectual property brought agains the Office for Harmonization in the Internal Market, alternatively, also against the Community Variety Plant Office (*CPVO* – european holder of IP rights in respect to new plant varieties), (***vi***) appeals against decisions of *Specialized Courts* limited to points of law (Article 11 Annex I Protocol (No 3)) and (***vii***) actions brought against decisions of the European Chemicals Agency (*ECHA* – institution focused on implementing public policies related to chemicals within the EU); ***Specialized Courts*** (Article 257 TFEU and Article 62c Protocol (No 3)). *Specialized Courts* are entitled to examine first instance claims in specific areas. So far, only one specialized court have been stablished by the Council, namely, the the Civil Service Tribunal (the court was discontinued in 2016 and its competences were transferred to the General Court); and finally the ***European Court of Justice*** (Article 1 to 46 Protocol (No 3)), which has jurisdiction to hear and rule on ***direct cases***: against MSs that (***i***) failed to fulfill and obligation under relevant Treaties (Article 258 and 259 TFEU), against EU institutions for (***ii***) annulment and for failure to act (annulment - Article 263 TFEU; infringement – Article 265 TFEU), against (***iii***) penalties imposed on undertakings (Article 261 TFEU); cases related to (***iv***) *Euratom* provisions (Treaty establishing the European Atomic Energy Community 2012/C 327/01), and finally, the court shall also have jurisdiction in the actions referred to in Articles 263 and 265 TFEU proposed against the EU Parliament, Council, Commission, European Central Bank etc, upon (***v***) failure to act according Treaty's provisions. In relation to ***indirect cases***, it falls under the EJC's jurisdiction to render a (***i***) preliminary ruling on the interpretation of Union legislation (Article 267 TFEU – ex Article 234 TEC) and to (***ii***) review appeals, limited to points of law in rulings and orders of the General Court (Article 256 (1)). Recommendations to national courts and tribunals in relation to the initiation of preliminary ruling proceedings (2012/C 338/01). Official Journal of the European Union.

[32] Article 282 to 284 TFEU.

[33] Article 285 to 287 TFEU.

legal order, that is to say, the law of another State, to certain cases determine by their own law. These cases are characterized by the fact that they stand in a certain relationship to the territorial or personal sphere of ***validity of a foreign legal order****.*"[34] (*emphasis added*). Now, applying this reasoning to the reality of our investigation, *Kelsen's* idea on the conflict of laws between States, also portrays the friction between domestic legislation with EU legislation, in other words, a certain MS is bound to its own legal framework, but nevertheless, "*as an exception (…) are bound to apply norms of another legal order*", namely, Union Law. Here it is important to present two possible approaches to the application of a foreign legal order by domestic entities, namely, MSs are (***i***) free to choose whether to apply or not such norm ("*choice-of-law*"),[35] and (***ii***) MSs are bound to apply such norm ("*conflict-of-law*").[36] The Supremacy of EU over domestic law (*Vorrang des Gesetzes*) is basically a self-imposed limitation on MSs' sovereignty, that is to say, domestic law can not override Union law. Such understanding was already subjected to the ECJ's rulings in the *Costa v E.N.E.L.* case, where the court declared that "(…) *a subsequent unilateral measure cannot take precedence over community law* (…)."[37] By acknowledging the supremacy of Union law over national law, MSs must adjust their national legislations to the extent of the limitation it previously agreed upon, whether imposed by law (for example, a Directive (*Richtlinie*) – positive harmonization), or by case law (negative integration). Such limitation confer MSs and individuals alike legally enforceable rights.[38] In other words, a ***direct effective provision*** of EU law may be relied upon before national courts of law as well as before national administrative authorities,[39] thus becoming thereafter a part of domestic law, that is, a ***direct applicable provision***.[40]

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[34] *Hans Kelsen*. General Theory of the Law and the State. Cambridge. Massachusetts. Harvard University Press (1946) 243.

[35] Hans Kelsen (n 34) 246.

[36] Hans Kelsen (n 34) 245.

[37] Judgment of the Court of 15 July 1964. Flaminio Costa v E.N.E.L. Reference for a preliminary ruling: Giudice conciliatore di Milano - Italy. Case 6-64. ECLI:EU:C:1964:66.

[38] The direct effect of EU law does not predate the exercise of the MS's discretionay power to apply the provision, that is, it is within the MS's discretion whether or not relying on EU's legislation before the rule has been incorporated into its own legal framework, ***insofar the transitional period has not expired***. In the *Ratti* case, the ECJ ruled that "*1. After the expiration of the period fixed for the implementation of a directive a Member State may not apply its internal law – even if it is provided with penal sanctions – which has not yet been adapted in compliance with the directive, to a person who has complied with the requirements of the Directive*." Judgment of the Court of 5 April 1979. - Criminal proceedings against Tullio Ratti. - Reference for a preliminary ruling: Pretura di Milano - Italy. - Dangerous preparations. - Case 148/78. ECLI:EU:C:1979:110.

[39] "Everyone whose rights and freedoms guarantees by the law of the Union are violated has the right to an effective remedy before a tribunal in compliance with the conditions laid down in this article." Charter of Fundamental Rights of the European Union. OJ (2000/C 364/01) Article 47.

[40] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer. *Introduction to European Tax on Direct Taxation*. 4th Ed. Lind, (2016). Pag. 2.

2. Subsidiarity, Proportionality and Conferral

The principle of Proportionality and Subsidiarity are embedded in Article 5 of the Treaty establishing the European Union. Protocol (No 2)[41] provides guidance on its criteria of applicability. Moreover, it sets limits over community actions, allowing it to act in situations (***i***) which cannot be solved by MSs; to (***ii***) correct competition distortions or to prevent trade restrictions that could hinder a more efficient functioning of the internal market and when, (***iii***) the produced benefits of the action, by reason of scale or effects, supersedes the results had the action been conducted by MSs alone.[42] Article 6 of the Protocol establishes that the Commission's activity should be as "*simple as possible, consistent with satisfactory achievement of the objective of the measure and the need for effective enforcement*",[43] hence proportional. In Community law there is no such thing as an "authorizing statute" (*Ermächtigungsgesetz*), which allows administrative bodies (Commission) to act when special circumstances are present, such as rebellions or economic crisis.[44] The legislative competence vested in such administrative entities is considerably limited. Therefore, it is also important that the Commission's actions pass the "***test of necessity***" and the "***EU value added test***",[45] that is to say, the measured cannot be properly achieved by Member States alone (test of necessity), and the objective of the test is better achieved by action at Union level (EU value added test - the produced benefits of the action, by reason of scale or effects, supersedes the results had the action been conducted by MSs alone). Article 5(2) TEU provides for the ***conferral principle***, that is, the Union may only act within "the limits of the competences conferred upon the Union in the Treaties to attain the objectives set out therein. Competences not conferred upon the Union in the Treaties remain with the Member States".

Actions conducted by MSs that directly or potentially infringes the freedoms established in the Treaty (goods, services, workers, payments and capital) must be *proportionate* in order to be compatible with the internal market.[46] Legal doctrine dictates that three main requirements should be invariably analysed in order to ascertain if a measure that potentially infringes

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[41] Protocol (No 2) on the Application of the Principles of Subsidiarity and Proportionality. Official Journal 115, 09/05/2008 P. 0206 – 0209.

[42] Treaty establishing the European Community (consolidated version) – D. Protocols annexed to the Treaty establishing the European Community – Protocol (n 30) on the application of the principles of subsidiarity and proportionaliy (1997). Official Journal C 321 E, 29/12/2006 P. 0308 – 0311.

[43] "The form of Community action shall be as simple as possible, consistent with satisfactory achievement of the objective of the measure and the need for effective enforcement. The Community shall legislate only to the extent necessary. Other things being equal, directives should be preferred to regulations and framework directives to detailed measures. Directives as provided for in Article 249 of the Treaty, while binding upon each Member State to which they are addressed as to the result to be achieved, shall leave to the national authorities the choice of form and methods." Article 6 Protocol (n 30).

[44] Hans Kelsen (n 34) 271

[45] Denis Weber. *CCCTB Selected Issues*. Klumer Law International BV, The Netherlands (2012) 96.

[46] "Even though a discriminatory measure provision is justified, it may not go beyond what is necessary to achieve its purpose and aim." Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 88.

Union Law is compatible with the Treaty, namely the *appropriateness*;[47] *necessity*[48] and *proportionality,*[49] of the measure.

Public Interest. When MSs take measures not in tune with the Treaty's Freedoms on grounds of public interest,[50]it may only do so respecting the ***compatibility analysis***, that is to say, the appropriateness, necessity and proportionality of the measure. Nevertheless the degree of protection exercised by MSs may vary, meaning that it is at the national authority's discretion to assess the measure's extent. In such a case, the burden falls on the MS's relevant authority to demonstrate that the measure is proportionate, necessary and appropriate. Generally, courts of law accept a lower standard of proof when ruling such cases.[51]

3. Non-discrimination [52]

According to Community Law, where two situations are materially similar, one may not apply differential treatment (double standard), that is to say, a MS may not discriminate by applying a more burdensome tax rule to nationals or non-nationals in same circumstances.[53] The non-discrimination principle is also expressively mentioned by Article 24(1) of the OECD Model

[47] ***Appropriateness***: national measures must be appropriate to reach the desired goal. The *Stopover Tax* case (2009) translates well the appropriateness of national measures. Under Sardinian law, companies without a tax domicile in Sardinia must collect extra taxes for aircrafts and boats that stop in Sardinia. The government applied the tax with the argument that the collected taxes would be used to fight pollution, which was ultimately refused by the court, for the measure lacked appropriateness. Case C-169/08, *Presidente del Consiglio dei Ministri v Regione Sardegna* – Stopover Tax [2009] ECR I-10821.

[48] ***Necessity***: national measures must not go beyond what is necessary to the attainment of the desired objective. If a less restrictive national action accomplishes the goal, the measure cannot be considered as proportionate. Friedl Weiss and Clemens Kaupa. *European Internal Market Law*. Cambridge University Press (2014) 34.

[49] ***Proportionality*** *(proportionality test)*: the court must compare the positive and negative effects of the national measure and evaluate whether the positive result outweighs the negative result. Friedl Weiss and Clemens Kaupa (n 48) 34.

[50] By reason of public morality, policy or security Article 36 TFEU.

[51] "(…) whilst it is true that it is for the Member State which invokes an imperative requirement as justification for the hindrance to free movement of goods to demonstrate that its rules are appropriate and necessary to attain the legitimate objective being pursued, the burden of proof cannot be so extensive as to require the Member State to prove, positively, that no other conceivable measure could enable that objective to be attained under the same conditions". (Case C-110/05, *Commission v Italy – Italian Trailers*, [2009] ECR I-4629, para 44.)

[52] "The advertising campaign to encourage the sale and purchase of Irish products cannot be divorced from its origin as part of the government program, or from its connection with the introduction of the "Guaranteed Irish" symbol and with the organization of the special system for investigating complaints about products bearing that symbol. The establishment of the system for investigating complaints about Irish products provide adequate confirmation of the degree of organization surrounding the "Buy Irish" campaign and of the ***discriminatory nature of the campaign***" Case 249/81 (Commission v Ireland), [1982] ECR 4005.

[53] The intelligence of the ***non-discrimination*** principle is crucial to Union law and its spirit is present in every fundamental freedom. The prohibition of discrimination on grounds of nationality, for instance, must be applied to the four freedoms – goods, capital, services and labour (Article 18 TFEU). The principle is embedded in Article 28 TFEU, prohibiting MSs to impose customs duties on imports and exports on foreign products, and in Articles 45 and 49 TFEU, granting workers or companies the right to established in any country within the Union and be treated as nationals.

Convention Tax Convention. The *Model* provides that no differential treatment should be dispensed to *stateless persons*, [54] *permanent establishments* (branches)[55]and *subsidiaries.*[56]It also states that interests, royalties and other disbursement costs should be tax deductible under the same conditions "*as if they had been paid to a resident*" of that Country, when assessing tax liability.[57] One of the provision's objectives is the elimination of discriminatory measures against non-residents and foreign nationals. Such objective (along with the reduction of withholding tax) is secondary to its main purpose, the ***avoidance of double taxation and the prevention of fiscal evasion***.[58]

4. Territoriality[59]

The principle of territoriality (*Territorialitätsprinzip*) is central to Community law, and is intimately related to each and every fundamental freedom contained in Article 26 (2) TFEU. The notion has great implications on tax related matters due to the wide variety of legal Statutes, each offering different approaches to matters concerning territoriality.[60] Different laws of incorporation, registration places, main seat etc,[61] are some examples of such variety. Being able to move goods, provide services, capital and payments across borders without restrictions, is fundamental to the functional and attainment of a single market. Needless to say, all rules and operations discussed in the present investigation concern ***cross-border element***.

Within its territory, each State may choose its taxation system (imputation or classical), whether it taxes income worldwide (worldwide taxation) or only income derived in its territory (territorial taxation). In other words, the sovereignty principle (*Souveränitätsprinzip*) recognized by international law provides for a supreme authority of the State within the limits of its border's. The problem with sovereignty is that independent players aim to maximize profits and growth in order to enhance welfare (tax competition).

The principle of territoriality has been reshaped by the ECJ and evoked in a number of cases, *Cassis de Dijon* Case C-120/78 (indirect taxation), *Futura* Case C-250/95[62] (direct taxation) where the ECJ concluded that a discriminatory measure denying the carry-forward of a branch's losses not economically linked to the company's operation is compatible with the Treaty and in conformity with the principle of territoriality (rule of reason). Nonetheless, discriminatory measures must be *appropriate* to reach the desired goal, *necessary*, not go beyond what is necessary to the attainment of the desired objective and finally,

[54] OECD Model Convention Article 24 (2).
[55] OECD Model Convention Article 24 (3).
[56] OECD Model Convention Article 24 (5).
[57] OECD Model Convention Article 24 (4).
[58] Andrea Amatucci (n 2) 152.
[59] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 78.
[60] Ben Terra and Peter Wattel. *European Tax Law*. 3rd Ed Klumer Law International (2011) 69.
[61] Friedl Weiss and Clemens Kaupa (n 48) 261.
[62] The fact that the Luxemburg tax authority denied the carry-forward of the branch's losses to non-resindents do not infringe the principles contained in the Treaty (non-discrimination). It is imperative that the losses realized by the associated undertaking be economic related to the income earned by the company (***fiscal territoriality principle)***.

proportional, that is, if a less restrictive national action accomplishes such goal, the measure cannot be considered as proportionate.

5. Legal certainty;

The principle of legal certainty is central to any legal framework, that is, such principle provides *determinacy, predictability*, *non-retroactivity* and *coherence* to the law.[63] Legal Statutes must provide clear, precise and predictable rules in which individuals can rely on. In respect to taxation, the principle of legal certainty provides the taxpayer the possibility to act according to what is permissible by the law, that is, if the State creates a law which imposes an obligation upon an individual, that law may not change the exterior world regarding facts that have already occurred before its enactment (***non-retroactivity principle***). As previously mentioned, a *direct effective provision* of EU law may be relied upon before national courts, that is, the contending parties may take cover under EU's law provided that the cross-border element is present.[64] Nonetheless, it is expected that such provisions be drafted in such a way to reduce to a minimum the possibility of dubious interpretations. Therefore norms must be (***i***) clearly and precisely worded (***determinacy*** and ***predictability***) as well as (***ii***) be unconditional and independent from national implementation measures.[65] However, it is fair to assume that the level of legal certainty that one might expect in a dispute, is highly dependable on the facts that are presented by parties to the court, in other words, the higher the quality of evidence, the higher the court's accuracy. Such reasoning would lead us to the study of the economics of the legal process, consequently deviating our attention from the main topic of discussion of this investigation.[66]

Attached to the legal certainty principle, the ***principle of legitimate expectations*** is "(…) *said to be essential to the EU legal order* (…)" for it undermines the law's predictability. The principle of legitimate expectations is subcategorized under the principle of legal certainty. Both principles (legal certainty and legitimate expectation) are delineated as superior rules of law within the EU's legal system. In the Fintan Duff v Minister for Agriculture and Food,[67] ECJ ruled that "*The first legal principle of Community law to which the plaintiffs in the main proceedings and the Council refer is the principle of the* ***protection of legal expectations****. (…) That principle, which is part of the Community legal order* (…) *is the corollary of the* ***principle of legal certainty****, which requires that legal rules be clear and precise, and aims to ensure that situations and legal relationships governed by Community law remain foreseeable."*[68] Nevertheless, neither fundamental rights nor legal principles can

[63] Aurelien Portuese, Orla Gough, Joseph Tanega. *The principle of Legal certainty as a principle of economic efficiency*. Springer Science+Business Media New York (2014). 136.
[64] Friedl Weiss and Clemens Kaupa (n 48) 29.
[65] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 3.
[66] Further reading on the economics of legal procedure, see Robert Cooter and Thomas Unlen (n 15) 419.
[67] C-63/93 (1996) Fintan Duff v Minister for Agriculture and Food, Ireland.ECLI:EU:C:1996:51
[68] "On the one hand, certainty is associated with uniform treatment, regularity, and predictability: law is certain to the extent that it provides uniform and entrenched generalizations that are relatively blind to the specificity of individual cases. On the other hand, reasonableness is sensitive to particularity and to the concrete form of each case: it tends to admit exceptions to the

unlimited applied. Generally, one has to be quite attentive when applying principles to concrete cases, although they provide the basis for solving legal problems, the sole application of principles may lead to possibly distorted outcomes, that is, one must find the right balance between both the application of a legal principle and positive law so that one does not overcomes the other, consequently deforming completely either the laws' or the principles' spirits.

In the *Kühne & Heitz* case[69] the principle of legal certainty was evoked when a final decision rendered by the Superior Court of the Netherlands was reopened due to a misinterpretation of Union law, that is, had the court in the Netherlands referred the case for a preliminary ruling, according to the wording of Article 267 TFEU, the case would not have been reopened.

Reopening an already ruled case creates a dangerous precedent for it is not that uncommon national courts not referring a case to the ECJ for a preliminary ruling, even on matters still not fully cleared out by the Court.[70] In other countries, such a Brazil, reopening an already judged case on grounds of misinterpretation of the law is as surreal as conferring an administrative body (the internal revenue service, for example) the power to reopen an already ruled case by the Supreme Court (*Kühne & Heitz* case). Nevertheless, we must not lose sight of the fact that Member States imposed against themselves the obligation to comply with EU legislation (primacy of EU law), and cases such as the *Kühne & Heitz* certainly are an exception to the rule. Instead of reopening the case and therefore infringing *res judicata*, the party could file a compensation action on damages against the defendant on grounds of infringement of an essential procedural requirement (Article 267 TFEU), therefore causing less disturbance to the legal order.

6. Unjust enrichment x "Pecunia non olet"

The principle of unjust enrichment has its roots in Roman law (*nemo locupletari potest aliena iactura* or *nemo locupletari debet cum aliena iactura*).[71] Whether under a common law perspective (tort) or under a civil law (theory of harm), if an agent committed an intentional (*absitchlich*) or unintentional (*unabsitchtlich*) act that effectively caused, or has the potential to cause harm to a third entity, that entity will be entiltled to demand the State to provide a remedy.[72] Anyone that had its wealth decreased without the corresponding

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general and uniform rule. While certainty resembles regularity and uniformity, reasonableness strives for adaptability and flexibility. The two then are potentially conflicting and incompatible ideal that cannot be implemented fully at the same time. Since both are considered basic values in the legal order, each has to be weighed against each other (...)".Stefano Bertea. *Certainty, Reasonableness and Argumentation in Law.* Springer (2004), Volume 18, Issue 4, pp 465-478.

[69] Case C-453/00 *Kühne & Heitz v. Productschap voor Pluimvee en Eieren.*

[70] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 9.

[71] No one should benefit at another's expense.

[72] The classification of ***rights***, ***remedies*** and ***procedures*** is worth of some attention. According to W. van Gerven***, rights*** *are legal positions that an* entity *may have, and which can be enforced by that entity through a* ***procedure****, that is, a instrumentalized set of rules of national procedural law, in other words, "an ancilliary body of law, the function of which is to ensure the effective application of substantive law." As for* ***remedies,*** the author subdivides the institute into ***constituent*** and ***executive elements***. ***Rights*** and ***constituent elements*** of ***remedies***, relates to decisions/oppinions of the ECJ. Whereas the ***executive element*** of a remedy relates to MS courts

benefit is able to evoke and seek shelter under the principle, whether public or private entities. On the one hand, private undertakings may challenge tax authorities to the extent that the company paid excess or illegal taxes. There are four situations where the State can be accused of having unjustly enriched on the taxpayer's expense, namely, (*i*) instances where a MS levies tax on behalf of the State, but nevertheless in contravention of Union Law; (*ii*) instances where the National Intervetion Agency (NIA) levies tax on behalf of the EU, although contrary to Union Law; (*iii*) instances where the relevant MS pays unlawfull state aid in breach of Union law, or through the NIA and finally (*iv*) instances where the EU pays out money to an entity in breach Union Law. [73] Nevertheless, in order to be liable, the following conditions must be met:[74] (*i*) the infringed rule confers rights to individuals, (*ii*) the breach must be sufficiently serious, (*iii*) existence of a casual link between the "breach of the State's obligation and the loss and damage suffered by the injured parties". [75] On the other hand, tax authorities may initiate administrative or judicial procedures if has detected that an entity failed to comply with payment obligations (*Geldzahlung*) or formal duties (*formallen Pflichten*). Therefore, anyone that suffered a decrease in value of its property, shall have the right to petition to the relevant court, and in the absence of Community law on the matter, domestic law will determine "the procedural conditions governing actions at law intended to ensure the protection of the rights which citizens have from the direct effect of Community law" (principle of national procedural autonomy).[76] In sum, the "law of unjust enrichment is specially concerned with transfer of value".[77] As a practical note, in order to deny refund of unduly taxes, tax authorities have argued that the charge was "passed down the economic chain so that their economic burden (taxpayer) is borne by third parties and a refund would prompt unjust enrichment of the claiment". Athough such reasoning was accepted by the Court, after being subjected to several conditions it was ultimately "watered down".[78]

The important question here is, to what extent tax legislation should derogate principles coined by private law or any other area for that matter, in the "interest of an economic view"?[79] The matter regarding the distinction between private law and tax law should not be underrated, for the manner in which a certain fact is interpreted, determines how the relevant authority will act upon the fact they have, tax authorities, the constitutional obligation to deal under certain cicumstances (*Polizeigewalt*). Consider the following. A travel

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decisions/oppinions. W. van Gerven. Of Rights, Remedies and Procedures. Common Market Review. Klumer Law International. Netherlands. (2000). Pag. 501.

[73] Rebecca Williams. *Unjust Enrichment and Public Law. A comparative Study of England, France and the EU*. Hart Publishing. (2010) https://lawexplores.com/8-unjust-enrichment-in-national-and-european-law-and-the-remedies-jurisprudence-of-the-ecj/. Accessed in 21 Sep 2017.

[74] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 12.

[75] In the *Francovich* case C- 6/90 and C-9/90, the Court ruled that "it is a principle of Community law that the Member States are obliged to make good loss and damage caused by individulas by breaches of Community law for which they can be held responsible" CJEU, 19 November 1991 Case 6/90 and C-9/90, Francovich. ECLI:EU:C:1991:428. Para. 37. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 12.

[76] The principle of national procedural autonomy is limited by the ***principle of equivalence*** and the ***principle of effectiveness***. Rebecca Williams (n 73).

[77] Rebecca Williams (n 73).

[78] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 11.

[79] Andrea Amatucci (n 2) 86.

agency located in the Brazilian border (next to the Bolivian border) received on a regular basis deposits from various cities. The Brazilian Center for Control of Financial Activities (Conselho de Controle de Atividades Financeiras - COAF) identified that certain amounts paid out to the company did not correspond to amounts that other undertakings operating on the same field and size would receive (COAF was not able to find comparables to the operation, which lead the institution to raise a red flag). The company had very few employees and premises bellow the standards of what is expected of a company operating with such income. After being audited, the company informed the authorities that the deposits received in its bank account originated from the sell package holidays. Finally, after a more thorough investigation, authorities concluded that the operation washed money from income accrued from illicit drugs purchased and transported by the company's employees, which served as tour guides to locations in Bolivia where the drug was produced (more than 100 kilos of cocaine were apprehended in the bags of tour guides and other "tourists" who transported the drugs from Bolivia to Brazil).[80] Now, considering that the income had originated from illicit activities, should the Brazilian tax administration be prevented from taxing such income? No, *pecunia non olet*. The tax legislation in France apply the so called "*tax law realism*", where revenue from illicit activities are treated as if they were lawful obtained, and consenqueltly placed under "whatever income category is appropriated".[81] The Netherlands also tax income from illicit activities, theft, trade in narcotics, bank fraud, bribary etc.[82] Germany, for instance tax illegal income as trade, business or miscellaneous depending on the circunstances.[83] Articles 12 (e) CCCTB,[84] do not allow the deductibility of ***bribes*** and other ***ilegal payments***. Back to the distinction between private law and tax law, note that the transaction's illegality is not relevant in relation to the application of tax provisions, that is, even though such conducts violates a number of statutory principles and good morals. Nevertheless, as far as the author is concerned, the Constitution of the vast majority of industrialized Countries provides no reservation whatsoever, that could result in a departure from such interpretation, in other words, a more economic oriented interpretation of the law.[85]

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[80] III Coletania de Casos Brasileiros de Lavagem de Dinheiro. COAF. Conselho de Controle de Atividades Financeiras. Unidade de Inteligencia Financeira do Brasil. Brasilia/DF. 2015. http://coaf.fazenda.gov.br/menu/pld-ft/publicacoes/coaf_casos-casos-abril2015.pdf. Accessed in 22 Sep 2017. 14.

[81] Income from ***procuring*** (colloquially, perpertrated by "*pimps*" or "*madams*") is placed under commercial profits. Income derived from ***prostitution*** may be placed under wages or non-commercial profits. Hugh J Ault, Brian J. Arnold. *Comparative Income Taxation: A Taxation Structural Analysis*. Klumer Law international. 192.

[82] Hugh J Ault, Brian J. Arnold (n 81) 192.

[83] Hugh J Ault, Brian J. Arnold (n 81) 191.

[84] COM (2016) 685 final Article 12 (e).

[85] *Lerke Osteloh* described other situations where the interpretation of a tax legal relation, as opposed to private law, ultimately renders a complete different and confliting reconfiguration of the fact, for example "in accordance with § 39 II of the Tax Code, merchandise is to be attributed to the 'economic owner', whilst in accordance with §40 of the Tax Code it is 'irrelevant to taxation whether conduct which completely or partly fulfills the provisions of a fiscal statute violates a statutory principle of prohibition or good morals' (*Für die Besteuerung ist es unerheblich, ob ein Verhalten, das den Tatbestand einer Steuergesetzes ganz oder zum Teil erfullt, gegen ein gesetzliches Geot oder Verbot oder gegen die guten Sitten verstößt. §40 Gesetz – oder sittenwidriges*

7. Ability-To-Pay Principle

The four *Smithian* taxation cannons are: ***cannon of certainty*** ("The tax which each individual is bound to pay ought to be certain and not arbitrary. The form of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person"), ***cannon of convenience*** ("Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it"), ***cannon of economy*** ("Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State") and the ***cannon of equality*** ("The subjects of every State ought to contribute towards the support of the government as nearly as possible in *proportion to their respective abilities*—that is, in proportion to the revenue which they respectively enjoy under the protection of the State" [86] (*tax equity*). The fact of the matter is that the ability-to-pay principle requires that "any two taxpayers with equal ability to pay in terms of the relevant tax base should be taxed equally, whereas taxpayers in different conditions of ability to pay should be taxed to a greater or lesser extent corresponding to their higher or lower capacity. The former rule is reffered to as horizontal and the later as vertical equity".[87] Note that the *tax equity* concept is essentially enshrined in EU principles such as subsidiarity, proportionality, non-discrimination, legal certainty, unjust enrichment, case law and it is most definetly a legitimate and obligatory constraint to governamental taxing powers.[88]

Handel. Abgabenordnung (AO)), and in accordance with §41 of the Tax Code, the ineffectiveness of a legal transaction 'is irrelevant for taxation where those concerned let the economic outcome of this legal transaction occur and remain' *((1) Ist ein Rechtsgeschäft unwirksam oder wird es unwirksam, so ist dies für die Besteuerung unerheblich, soweit und solange die Beteiligten das wirtschaftliche Ergebnis dieses Rechtsgeschäfts gleichwohl eintreten und bestehen lassen. Dies gilt nicht, soweit sich aus den Steuergesetzen etwas anderes ergibt. (2) Scheingeschäfte und Scheinhandlungen sind für die Besteuerung unerheblich. Wird durch ein Scheingeschäft ein anderes Rechtsgeschäft verdeckt, so ist das verdeckte Rechtsgeschäft für die Besteuerung maßgebend. § 41 Unwirksame Rechtsgeschäfte. Abgabenordnung (AO)*), and finally, in accordance with § 42 of the Tax Code: 'It is not possible to ***circumvent tax law by misusing ways available to shape the law***. If a violation has been committed, ***the fiscal claim arises in the same way as in the case of a legal form suitable to the economic events*** *((1) Durch Missbrauch von Gestaltungsmöglichkeiten des Rechts kann das Steuergesetz nicht umgangen werden. Ist der Tatbestand einer Regelung in einem Einzelsteuergesetz erfüllt, die der Verhinderung von Steuerumgehungen dient, so bestimmen sich die Rechtsfolgen nach jener Vorschrift. Anderenfalls entsteht der Steueranspruch beim Vorliegen eines Missbrauchs im Sinne des Absatzes 2 so, wie er bei einer den wirtschaftlichen Vorgängen angemessenen rechtlichen Gestaltung entsteht.(2) Ein Missbrauch liegt vor, wenn eine unangemessene rechtliche Gestaltung gewählt wird, die beim Steuerpflichtigen oder einem Dritten im Vergleich zu einer angemessenen Gestaltung zu einem gesetzlich nicht vorgesehenen Steuervorteil führt. Dies gilt nicht, wenn der Steuerpflichtige für die gewählte Gestaltung außersteuerliche Gründe nachweist, die nach dem Gesamtbild der Verhältnisse beachtlich sind. § 42 Missbrauch von rechtlichen Gestaltungsmöglichkeiten. Abganenordnung (AO)*)." Andrea Amatucci (n 2) 86.

[86] Adam Smith. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Edwin Cannan, Ed 1904. Library of Economics and Liberty. June 2018. http://www.econlib.org/library/Smith/smWN.html. 347.

[87] Andrea Amatucci (n 2) 257.

[88] For further discussion on the ability-to-pay principle see "A European legal tax order based on ability to pay". Andrea Amatucci (n 2) 252 – 335.

8. Union Loyalty (Art. 4(3) TFEU)

Being loyal is being cooperative, devoted, attached and consistent with a relationship, pact, or promise previously agreed upon. Being loyal, from a legal perspective, is also having good faith to the legal relation that parties to an agreement chose to enter into (*pacta sunt servanda*). The importance of the principle of union loyalty is as fundamental as other principles such as supremacy, subsidiarity, proportionality, non-discrimination, territoriality, legal certainty, unjust enrichment, cooperation, effectiveness, enforcement and equivalence, for it provides the foundation for trust amongst members, that all parties to a relationship will play by what was previously agreed to. Union loyalty provides cohesion, solidity and consistency to the EU. According to such principle, MSs must (*i*) actively, and "in full mutual respect, assist each other in carrying out tasks which flow from the Treaties", (*ii*) ensure the "fulfillment of the obligations arising out of the Treaties" by taking appropriate measures in order to attain such objectives and lastly (*iii*) cease and refrain from conducting any act that could contribute negatively to "the attaintment of the Union's objectives."[89] Loyaltry has been brought as a central argument in various cases before the ECJ,[90] nevertheless the case bellow (*Hurd* case)[91] depicts the application of the principle in relation to tax law.

Case C-44/84 Hurd v Kenneth Jones (Her Majesty's Inspector of Taxes)

1- After the installation of the European Coal and Steel Community (ECSC) institutions in Luxembourg 1953, the officials of such institutions saw as appropriate to provide their children education in their mother tongues. The teachers of those institutions would receive their salaries paid by their respective MSs, and a supplement would be paid by the European school. The teachers therefore would pay income tax in their respective countries (source deduction).[92] The supplement paid by the European school would not be taxed, thus should "a Member State tax the European supplement, the school would refund the tax by means of a differencial allowance, which may itself be taxed nationaly".[93] The UK authorities proceeded to tax a British teacher in the European School at Culham, situated in the UK on the supplement and other allowences. Having regard to this dispute, the Special Commissioners decided to refer the case to the Court for a preliminary ruling.
2- Question: Should the UK give effect in its national law to the decision taken by the European School (which later became the Statute of the European School and a protocol on the setting up of European Schools) that determine all staff be exempt from tax on their salaries and allowances?

[89] Article 4(3) TEU (n 26).
[90] Marcus Klamert. *The Principle of Union Loyalty in the EU*. Oxford University Press (2014) 289.
[91] Derrick Guy Edmund Hurd v Kenneth Jones (Her Majesty's Inspector of Taxes). Reference for a preliminary ruling: Special Commissioners of Income Tax - United Kingdom. European school - Liability to domestic taxation of the salaries of the teaching staff. Case 44/84. *European Court Reports* 1986 -00029. ECLI identifier: ECLI:EU:C:1986:2.
[92] Source deduction.
[93] Marcus Klamert (n 91) 289.

3- Yes.
4- According to the Court's ruling "the duty of genuine cooperation (*Loyalty*) and assistance which Member States owe the Community and which finds expression in the obligation laid down in Article 5 of the EEC Treaty to facilitate the achievement of the Community's tasks and to refrain from jeorpardizing the attaintment of the objectives of the Treaty, Member States are prohibited from subjecting to domestic taxation the salaries paid by the European Schools to their teachers, where the burden of such taxation is borne by the Community budget".

Note that by evoking the "duty of genuine cooperation and assistance" and "the burden of such taxation (…) by the Community budget" the Court based its argument on *loyalty* and on the obligation imposed upon MSs by ex Article 5 EEC, that Member States must "refrain from any unilateral measure that would interfere with the system adopted for financing the Community and apportioning financial burdens between Member States."[94]

9. Enhanced Cooperation

The Principle of Enhanced Cooperation is fundamental within the internal market. The increase of taxpayer's mobility, the internationalization of financial instruments, the growing difficulty of States to properly assess taxes in order to deter evasion/avoidance, has created great concern within the international community as a whole, thus a mutual effort system was seem as indispensable in tackling such problems. For that matter, mutual agreement procedures on the exchange of financial information and tax recovery, aiming at enhancing the administrative cooperation between MSs, were created. Instruments such as automatic exchange of information, notifications, administrative enquiries etc, passed along a secure electronic system accessed by tax authorities are also products of such cooperation actions. These actions, were incorporated on Union's legislation, namely, Administrative Cooperation Directive 2011/16/EU, Exchange of Financial Account Information Directive 2014/107/EU, Council Directive 2012/2376 on the mandatory automatic exchange of information in the field of taxation, Cross-border Tax Rulings and Advance Pricing Arrangement Directive[95], and will be properly studied in this investigation. These Statutes indicate the Commission's measures in order to reach of a pure internal market, which would prove to be impossible without such cooperation schemes. Articles 25 – 27 of The OECD Model Tax Convention provide for such assistance.[96]

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[94] Hurd v Kenneth Jones (Her Majesty's Inspector of Taxes). *Para 48.*

[95] APA (Advanced Pricing Agreements). The court found that the IRS abused its discretion in cancelling two unilateral advanced pricing agreements (APAs) covering the transfer of certain products, the license of intangible property, and the cost sharing between Eaton's subsidiaries and foreign subsidiaries. *US Tax Court determines IRS abused its discretion in cancelling two APAs with Eaton* (2017). http://www.internationaltaxreview.com/Article/3739387/Compliance-Management/US-Tax-Court-determines-IRS-abused-its-discretion-in-cancelling-two-APAs-with-Eaton.html.

[96] Article 25 OECD Tax Model provides for **Mutual Agreement Procedure**; Article 26 OECD Tax Model provides for **Exchange of Information**; Article 27 OECD Tax Model provides for **Assistance in the Collection of Taxes**.

10. Effectiveness and Enforcement[97]

According to *Kelsen*, the effectiveness of a norm is highly dependable on its validity, that is, if the relevant norm does not have any practical applicability it cannot be deemed as valid. Here lies the principle of effectiveness of international law, under such understanding, if a norm cannot be enforced it cannot be effective. The Charter of Fundamental Rights, grants "[A]ny citizen of the Union and any legal person residing or having its registered office in a Member State (…) the right to petition the European Parliament".[98] Article 47 of the same Statute states that "[E]veryone whose rights and freedoms guaranteed by the law of the Union are violated has the right to an effective remedy ***before a tribunal*** (…)" (emphasis added). The tribunal that the text refers to, comprises all jurisdictional levels from a ***domestic perspective*** (national level) to a ***supra-national perspective*** (EU level). From a *domestic perspective*, if a national of another MS had its right somehow violated (for example, a tax authority denies deduction benefits for a national of another MS), he may initiate judicial or administrative procedures in national courts of that MS on grounds of EU legislation. However, when provoked, national courts are not obliged to render an opinion making direct reference to EU legislation, that is, where national law is in tune EU law, the court may rule the case according to national law, as long as it is compatible with Union's legal framework. Moreover, if the "(…) *EC provision in question has already been interpreted by the court*" or the applicability of the relevant EU norm is "(…) *so obvious as to leave no scope for reasonable doubts*", courts are permitted to ruled the case under the *acte clair* and *acte éclairé* doctrine,[99] in other words, courts are allowed *not* to refer the case to the ECJ for a preliminary rulings. The *acte clair* and *acte éclairé* doctrine was construed by the ECJ in the *CILFIT* case. Nevertheless, if there is doubt over as to the right interpretation of Union law, courts (whether a 1st degree court or Superior National Courts), must refer the case to the CJEU for a ***preliminary ruling*** before it renders its final opinion (Article 267 TFEU).[100] Although requesting the ECJ a preliminary ruling ensures the correct interpretation of Union legislation, such procedure is likely to delay the litigation's result (some cases can take up to five years for a decision).[101]

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[97] The efficacy and the validity of the law is regimented by a coercion element, that is to say, the idea of a sole moral "*psychic compulsion*" alone do not validate its command, but the expected punishment or reward consequences. In reality the former expectation (punishment) plays a far more significant role when compared to the latter. The reason for this is of a historical and sociological nature, for fear, accredited mainly by religion, imposes upon transgressors sanctions of a transcendental and metaphysical order. *"(…) The hope of reward has only a secondary significance. (…) even in more highly developed religions, where divine retribution is no longer or not only realized here, but in the hereafter, the idea of a punishment to be expected after death holds first place. In the actual beliefs of mankind, fear of hell is much more alive, and the picture of a place of punishment is much more concrete, that the usually very vague hope of a future paradise where our virtue shall find its reward.*" Hans Kelsen (n 34) 18.

[98] Charter of Fundamental Rights of the European Union (n 39) Article 44.

[99] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 8.

[100] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 8.

[101] *Britain could be subject to European Court rulings until 2027, it emerges*. (2017) http://www.telegraph.co.uk/news/2017/08/20/britain-could-subject-european-court-rulings-2027-emerges/. Accessed in 22 Sep 2017.

Case C-283/81 CILFIT v. Ministry of Health

5- Textile firms have paid a levy of LIT 700 per quintal of imported wool until the entry into force of law No. 1238 which amended the levy, reducing the levy paid by the plaitiffs to 70 LIT. The District Court (Tribunal di Roma) had dismissed the case. Consequently, the plaintiffs appealed the court's decision on grounds that Law No. 1968 was "inapplicable as a result of adoption of Regulation (EEC) No 827/68 (…) on the common organization of the market in certain products listed in Annex II". The case was also rejected by the Court of Appeals, *for wool was not included in Annex II EEC of the Treaty*. The plaintiffs then proceeded to appeal to the Court of Cassation, which agreed the to the Ministry of Health's view that "the factual ciscumstances are so obvious as to rule out the possibility of their being capable of any other interpretation and that obviates the need to refer the matter for a preliminary ruling to the Court of Justoce of the European Community". Nevertheless, the Court of Cassation in 1981 submitted the case for a preliminary ruling.
6- Is it mandatory for national court to comply with the obligation in sending a case for a preliminary ruling over provisions that have already been interpreted by the ECJ?
7- No.
8- National courts are under no obligation to do so if it has established that, the problem "raised is irrelevant" or when the "provision in question has already been interpreted by the Court of Justice" or when the "correct application of Community law is so obvious as to leave no scope for any reasonable doubt."[102]

It is important to consider that, notwithstanding the time factor, which is clearly a negative side to it, not referring cases for a preliminary ruling when necessary, can be even more detrimental to the parties involved, specially in cases related to direct taxation.[103] Now, from a ***supra-national perspective,*** proceedings against infringements to EU legislation may be initiated by any person that had its rights offended (whether a natural person, private or public

[102] Urteil des Gerichtshofes vom 6. Oktober 1982. Srl CILFIT und Lanificio di Gavardo SpA gegen Ministero della Sanità. Ersuchen um Vorabentscheidung: Corte suprema di Cassazione - Italien. Vorlagepflicht. Rechtssache 283/81. ECLI:EU:C:1982:335.

[103] According to Ana Paula Dourado "(…) there are many doubts as to whether national courts in the different Member States correctly apply Art. 234 (3) EU EC Treaty (…) although the ECJ decisions normally refers to the previous case law, thus creating a system of precedent, the predictability of the results of the subsequent related cases is not as high as it could be expected to be, which may lead us to the conclusion that unless a case on direct tax issues is identical to a previous one (acte éclairé in the sense of *Da Costa*), a national law court should always refer a case, contrary to what the ECJ recommend in the *CILFIT*, in order to avoid inconsistencies regarding the interpretation of the fundamental freedoms (…)". Ana Paula Dourado. *The Acte Clair in EC Direct Tax Law*. Sample excerpt. https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Sample_ActeClair.pdf. Accessed in 22 Sep 2017.

undertaking - MSs[104] and the Union incorporated by the Commission). If the Commission concludes that EU law was breached, it will proceed to notify the concerned entity that can either comply with the Commission's observations (in which case the proceeding is ended) or provide proper a defence. After the Commission renders its opinion, the relevant entity may than challenge the Commission's opinion to the ECJ.[105] Nevertheless, in case EU law is infringed, and there is no procedural rules established by the Union, the case may be conducted under the procedural law of the relevant MS. Such measure operates under the ***principle of national procedural autonomy***, which states that "(…) in the absence of Community legislation governing a matter, it is for each Member State to lay down detailed procedural rules governing legal actions for safeguarding rights which individuals derive from Community law (…)".[106] However, there are two relevant limitations to such principle, namely, (***i***) procedural rules must be ***equivalent***[107] to the rules applied under similar circumstances in respect to domestic claims and the (***ii***) national procedure must not be applied in such a manner which prevents the party from obtaining reparation of its right, that is, inhibiting the ***effectiveness***[108] of the procedure.[109]

20. In the Marks and Spencer case the ECJ mitigated the application of such principle, namely, effectiveness, under the understanding that although limiting the period for a company to require reimbursement of unduly paid VAT sums violates Community law, "transitional arrangements allowing an adequate period of enactment of the legislation for lodging the claims of repayment which persons were entitled to submit under the original legislation (…) are necessary where the immediate application to those claims of a limitation period shorter than that which was previously in force would have the effect of retroactively depriving some individulas of their repayment, or of allowing them too short a period for assessing that right. (…) by way of exception to that principle, fixing a reasonable period for claiming repayment is compatible with Community law

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[104] (MS against MS). Although it has never been put to use, such procedure can definitely serve as a negative harmonization instrument.

[105] Article 260 (1) "If the Court of Justice of the European Union finds that a Member State has failed to fulfill an obligation under the Treaties, the State shall be required to take the necessary measures to comply with the judgement of the Court." and 260 (2) TFEU "If the Commission considers that the Member State concerned has not taken the necessary measures to comply with the judgment of the Court, it may bring the case before the Court after giving that State the opportunity to submit its observations." The exact required procedure to be followed in ***Preliminary Rulings*** as in ***Direct*** *Actions* instances are properly delineated in the Recommendations to national courts and tribunals in relation to the initiation of preliminary ruling proceedings. Recommendation 2012/C 338/01 (n 31).

[106] *Edilizia Industriale Siderurgica Srl (Edis) v Ministero delle Finanze*. Reference for a preliminary ruling: Tribunale di Genova - Italy. Case C-231/96 ECLI:EU:C:1998:401.

[107] "4. (…) In the absence of any Community legislation, it is in accordance with the rules of national law on liability that the State must make relaration for the consequences of loss and damage caused. Nevertheless, the relevant substantive and procedural conditions laid down by the national law of the Member States must ***not be less favourable*** than those relating to similar domestic claims and must not be so framed as to make it virtually ***impossible or excessively difficult to obtain reparation***." (emphasis added) CJEU, 19 November 1991 Case 6/90 and C-9/90, Francovich. ECLI:EU:C:1991:428.

[108] See previous citation.

[109] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 9.

(…). However, in order to serve their purpose of ensuring legal certainty limitations periods must be fixed in advance"[110]

11. Equivalence[111]

National courts may not apply less favourable procedural rules for the compensation of losses and/or damages, "time limits, rules on burden of proof"[112] etc, to cases concerning community law, than they would apply to domestic claims of a ***similar nature***. This principle was already subjected to analysis by the ECJ in the *Marks & Spencer I* Case. According to the Court, "a legislative amendment retroactively depriving a taxable person of a right to deduction (…) is incompatible with the principle of ***legitimate expectations*** (…)". Such principle, namely, legitimate expectations, "forms part of the Community legal order and must be observed by Member States when they exercise the powers conferred on them by Community directives (…)" (***principle of conferral***), therefore, it is essential to the proper functioning of the EU's internal market, that the measures conducted by MSs be ***equivalent*** to those applied in domestic actions.

B. Fundamental Freedoms. Introduction

According to Article 26 (2) TFEU[113], it falls under the Union's duties to ensure and to conduct measures that contribute to the better functioning of the internal market, abolishing to that respect, obstacles that may prevent (in)directly the free movement of *goods*, *services*, *persons* and *capital*. Needless to say, taxation (whether direct or indirect), may hinder or prevent the attainment such objectives. These four above mentioned freedoms are based on two specific foundations: the right of ***cross-border*** circulation, and the ***constraint of discriminatory actions*** carried out by MSs due to origin or nationality.[114] The meaning of discriminatory actions stands for differential treatment in relation to persons or goods.[115]

35. *Cross-Border Element.* The cross-border element is fundamental in respect to all the Treaty's freedoms. Such rule prevents the applicability of Union legislation to domestic matters on its absence. Therefore it is imperative the following circumstances be present: (***i***) *crossing goods* (from MS "A" to MS "B"), (***ii***) *services* provided by a resident of MS "A" to another resident of MS "B" (whether virtually or not), (***iii***) *workers* applying and taking jobs in other States

[110] Judgment of the Court (Fifth Chamber) of 11 July 2002. - Marks & Spencer plc v Commissioners of Customs & Excise. - Reference for a preliminary ruling: Court of Appeal (England & Wales) (Civil Division) - United Kingdom. - Sixth VAT directive - National legislation retroactively curtailing a limitation period for repayment of sums unduly paid - Compatibility with the principles of effectiveness and of the protection of legitimate expectations. - Case C-62/00. Para 38/39.

[111] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 9.

[112] Marjaana Helminen. *EU Tax Law: Direct Taxation*. IBDF (2011) 339.

[113] "The internal market shall comprise an area without internal frontiers in which the free movement of good, persons, services and capital is ensured in accordance with the provisions of the Treaties." Article 26 (2) TFEU.

[114] Ben Terra and Peter Wattel (n 60) 30.

[115] Ibid.

of the Union, regardless maintaining a dual resident status (residing and working in two or more MSs), (***iv***) *self-employed* persons establishing themselves or a company in another MS, (***v***) *union citizens* entering and residing in another State (retirees, students etc) and finally, (***vi***) *capital and payments* wired from one MS to another MS.[116] Under such situations, entities may evoke Union law.

Constraining Discriminatory Measures. Discriminatory measures may explicitly place individuals in a disadvantageous position (direct discrimination), or create negative effects to individuals which may result on an unbalanced position between nationals and non-nationals of a MS (indirect discrimination tents to put non-nationals on a disadvantageous position).[117] Nevertheless, as we shall study in other parts of this investigation, discriminatory measures may be justified on certain grounds, such as *public policy*, *public security* and *public health*.[118] Although not tax related, the *Dassonville* case shaped the institute in EU law.

Case C- 8/74 Dassonville v. Procureur du Roi [119]

1- Gustav Dassonville and his son, Benoît Dassonville imported to Belgian a consignment bought in France of "Johhnnie Walker" and "Vat 69" which Gustav Dassonville had purchased in France. According to Belgian law, the spirits imported for sale bearing a designation of origin must be accompanied by an official document envisaged by the Royal Decree No. 57 of 1934 certifying such designation to be lawfull. The matter is that French Law did not require such certificate of designation, therefore the batch was legally imported to France. Nevertheless, the Public Prosecutor instituted criminal proceedings against the Dassonvilles on grounds of "forgery or assisted therein in affixing to the bottels the aforementioned labels, with fraudulent intent to induce belief that they were in possession, *quod non*, of an official document certifying the origin of the whiskey".[120]
2- Does the Royal Decree No. 57 of 1934 which requires spirits to bear a certificate of designation accompanied by the product itself constitutes a measure having equivalent effect to quatitative restrictions?[121]
3- Yes.
4- According to the ruling of the Court "a trader, wishing to import into Belgium whiskey which is already in free circulation in France, can obtain such a certificate only with great difficulty, unlike the importer who imports directly from the producer country. (…) All trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community Trade are to be considered as measures having an effect equivalent to quantitative restrictions". Therefore, "[S]ince only the

[116] Friedl Weiss and Clemens Kaupa (n 48) 30.
[117] Ibid 31.
[118] Ibid 32.
[119] Urteil des Gerichtshofes vom 11. Juli 1974. Procureur du Roi gegen Benoît und Gustave Dassonville. Ersuchen um Vorabentscheidung: Tribunal de première instance de Bruxelles - Belgien. Rechtssache 8-74. *European Court Reports 1974 -00837. ECLI:EU:C:1974:82.*
[120] Dassonville v. Procureur du Roi. Para.3.
[121] Friedl Weiss and Clemens Kaupa (n 48) 55.

> authorities of countries of origin have the power to certify the right to a designation of origin, there can be no question of a disguised restriction or arbitrary discrimination" (Dassonville Formula).

Rule of Reason. Member States may apply discriminatory measures to the extent that the *rule of rea*son is observed.[122] The criteria need to be applied according the formula established by the ECJ in the *Gebhard* case, i.e (*i*) the national measure must not be applied in a non-discriminatory manner, (*ii*) general interest must imperatively exist, (*iii*) the measure must be suitable for securing the attainment of such objective and (*iv*) the measure must not go beyond what is necessary in order to achieve the relevant action.[123]

1. Free movement of Goods. Article 28 TFEU

Under the freedom to move goods across borders, MSs are forbidden to create barriers (tariffs or other duties that have that effect). Discrimination on grounds of protecting domestic production, financing the drawing of statistics or advertising products with the intention of achieving *"the substitution of imported domestic products for domestic products",*[124] affecting thus the volume of trade between Members States, are not allowed. [125] Article 28 TFEU states that customs duties and charges that have that same effect, shall be prohibited. The range of application of this freedom, namely, movement of goods, has been subjected to the rulings to the ECJ on a number of cases,[126] and its importance can not pass unmentioned. Nonetheless, each MS may choose the more appropriate tax policy according to their preference, under the condition that they comply with Union's legislation.[127]

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[122] Ben Terra and Peter Wattel (n 60) 33.

[123] A advertising campaign to encourage the sale and purchase of Irish products cannot be divorced from its origin as part of the government program, or from its connection with the introduction of the "Guaranteed Irish" symbol and with the organization of the special system for investigating complaints about products bearing that symbol. The establishment of the system for investigating complaints about Irish products provide adequate confirmation of the degree of organization surrounding the "Buy Irish" campaign and of the ***discriminatory nature of the campaign*.** Case 249/81 (Commission v Ireland), [1982] ECR 4005.

[124] In this case, the propaganda conducted by the Irish Government, which proceeded to label Irish products with a "*Guaranteed Irish*" symbol, failed to "*fulfil its obligations under the Treaty*". Case 249/81 (Commission v Ireland), [1982] ECR 4005.

[125] Ben Terra and Peter Wattel (n 60) 30.

[126] For sake of the argument, we here present two cases de that sculpt such understanding: "(…) all trading rules enacted by Members States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade." C-8/74 (Dassonville), [1974] ECR 837. "Consequently, any pecuniary charge, however small and whatever its designation and mode of application, which s imposed unilaterally on domestic of foreign goods by reason of the fact that they cross a frontier, which is not a customs duty in the strict sense, constitutes a charge having equivalent effect within the meaning of Articles 9,12,13 and 16 of the Treaty" C-24/68 (Commission v Italy) [1969] ECR 193.

[127] Cécile Remeur. *Tax Policy in the EU. Issues and Policies*. European Parliamentary Research Service (2015) http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/549001/EPRS_IDA(2015)549001_EN.pdf. 6.

a. Similar Goods (Article 110 (1) TFEU)

The wording of Article 110 (1) TFEU precludes MSs from levying taxes on similar products from other MSs.[128] The question of what is to be considered a similar product was answered by case law, where the court considered products to be similar if they "*have similar characteristics and meet the same need from the view point of the consumers*".[129] To that respect, bellow we list some products that the court found to be of a similar nature:

- Fruit wines and wine made of grapes;[130]
- Used cars sold in MSs are similar to imported second-hand cars;[131]

On the other hand, some products were found not to be similar;

- Whiskey and fruit liquor;[132]
- Wine and beer.[133]

b. Competing Goods (Article 110 (2) TFEU)

Article 110 (2) TFEU states that MSs are forbidden to impose "*on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products*". Contrary to Article 110 (1), the wording this paragraph refers to goods that have different characteristics, that is to say, not similar. Nevertheless, three conditions must be met before evoking this article. (*i*) a competitive connection must be established between the relevant products,[134] (*ii*) the non-domestic product must be replaceable in certain aspects[135] and (*iii*) the action conducted by the Member State's authority is that of a protective nature.[136]

Members States are permitted to apply restrictions on the free movement of goods, persons, services and capital on grounds of public policy, public security or public health. In short, the TFEU provides two main possible

[128] Friedl Weiss and Clemens Kaupa (n 48) 88.
[129] Case 168/78, Commission v France – Spirits [1980] ECR 347, para. 5.
[130] The court ruled that fruit wines and wine made of grapes have "*the same kind of basic product*" for they "*meet the same needs from the point of view of consumers, as they can be consumed in the same way, namely to quench thirst, as refreshments and as meals*" Case 106/84, *Commission v Denmark*, [1986] ECR 833. Para 14-15.
[131] Tax levied on used cars cannot put them in a disadvantageous position when compared to new cars. The depreciation of the asset must be taken into account, making the price of the used imported car higher than that sold in the MS. Case C-345/93, *Nunes Tadeu* [1995] ECR I-479 para. 20. Friedl Weiss and Clemens Kaupa (n 48) 88.
[132] Whisky and fruit liquor were not considered similar by the court, for they are based on different agricultural products and chemical production (fermentation x distillation). Case 243/84, Jonnie Walker [1986] ECR 875. Friedl Weiss and Clemens Kaupa (n 48) 88.
[133] Although not similar, beer and wine, whisky and fruit liquor, compete with each other. Therefore, they fall under Article 110 (2) TFEU.
[134] Case 170/78, Commission v United Kindom [1983] ECR 2265, para 12
[135] Idem.
[136] Friedl Weiss and Clemens Kaupa (n 48) 90.

justifications to discriminatory and restrictive actions, namely, (a) Article 36 TFEU, and (b) *Rule of Reason* test.[137]

c. Article 36 TFEU[138] (Ex Article 30 TEC)

Under this legal provision, Member States are permitted to impose restrictions and discriminate upon imported and exported products, insofar the measure is justifiable on grounds of public morality, policy or security, protecting the health or life of humans, animals or plants as well as national treasures (of an artistic value) or protecting the industrial and commercial property. [139] The ECJ applies the Article in its most strict definition. Justifications such as the absence of harmonization to take account of differeces between national tax rules, the fact that a non-resident have avoided the discrimination by setting up a subsidiary company rather than a branch, economic aims or the protection of tax revenue, the absence of reciprocity, or the existence of discretionary or equitable procedures to ensure appropriate fiscal treatment, for example, are not accepted as viable justifications.[140]

d. Rule of Reason

The *Rule of Reason* is applied under the assumption that justifications in relation to differential treatment conducted by relevant authorities, may be accepted on grounds of public interest.[141] The Rule of Reason is applicable to all Treaty's Freedoms,[142] nevertheless, ***under the free movement of goods***, the measure may be justified only if the following six questions are answered accordingly: (*i*) has the protection been harmonized within the Union? (MSs are not allowed to act upon already harmonized areas),[143] (*ii*) does the measure differentiate domestic products from imported ones? (discrimination between national and imported goods falls under Article 36 TFEU, failing thus the test),[144] (*iii*) does the legal statute of the MS of origin protects the relevant public interest? (if that is true, the importing MS may apply different measures that may hinder such freedom),[145] (*iv*) does the protected public interest justifies the

[137] The Rule of Reason Doctrine was shaped by the ECJ on case C-120/78 (*Rewe Zentrale AG v Bundesmonopolverwaltung für Branntwein* – Cassis de Dijon).
[138] "*The provisions of Articles 34 and 35 shall not preclude prohibitions or restrictions on imports, exports or goods in transit justified on grounds of public morality, public policy or public security; the protection of health and life of humans, animals or plants; the protection of national treasures possessing artistic, historic or archaeological value; or the protection of industrial and commercial property. Such prohibitions or restrictions shall not, however, constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States.*" Article 36 TFEU.
[139] Ben Terra and Peter Wattel (n 60) 31.
[140] Commission Staff Working Paper: *Company Taxation in the Internal Market*. SEC (2001) 1681. COM (2001) 582 final. 311.
[141] Public interest may also be read as: consumer protection, prevention of unfair competition, protection of the environment, improvement of working conditions, protection of public health, product safety, promotion of culture. Ben Terra and Peter Wattel (n 60) 31.
[142] Ibid 33.
[143] Ibid 32.
[144] Ibid 32.
[145] Ibid 32.

overriding the treaty's freedom?[146] (Public interest in relation to direct taxation, can also be understood as: *effectiveness of fiscal supervision*,[147] *the maintenance on the integrity of the tax system (fiscal coherence),*[148]*the prevention of possible abuses*,[149] *territoriality*,[150] *balanced allocation of taxation rights*,[151] and *as tax neutralization in other States,*[152] (v) is the measure appropriate for the protection

[146] Friedl Weiss and Clemens Kaupa (n 48) 33.

[147] Admitted first in the *Cassis de Dijon* Case (indirect taxation), and then applied in the *Futura* Case (direct taxation), the ***effectiveness of fiscal supervision*** defense, was used by Luxembourg authorities that required a French company (*Futura*) to provide a separate accounting, which met the Luxembourg's fiscal legislation. Keeping double accounts in order to be allowed to carry-over losses from a previous year was, according to Futura, against the spirit of the Treaty, that is an impediment to the freedom of establishment. Luxembourg permitted that the branch's profits be assessed under the Profit Split Method (applied to transactions that are so interrelated to each other, so that it becomes difficult to ascertain the contribution that each company allocated on the product's value of creation - R&D>Manufacturing>Marketing>Sales>Distribution>Support – TP), which requires the weighting of the dispensed cost, so that the operation's proper profit/loss assessment of the can be reached. In sum, Luxembourg permitted a *profit allocation* of the basis of such method, recognizing thus the foreign accounts, but nevertheless demanding a separate accounting for *loss allocation*. Such measure, taken by the Luxembourg tax authority, was ultimately not accepted by the Court, which ruled the conduct as ***not proportional***.

[148] Under the *Bachmann* Case, the Belgium Government was able to persuade the Court that the discrimination measure of not granting a German national tax deduction benefit over insurance premiums paid in Germany, would fall under the category of exempted restrictions. The convincing argument follows: in order to maintain a level o legal coherence of its national tax system (***integrity of the tax system***), a direct link between the deductibility of the contributions and the possibility of taxation of future pensions, annuities and capital sums, was absent, which ultimately would lead to a loss of tax revenue. Belgium authorities would not able to levy tax on benefits paid by foreign insures abroad. Thus fiscal coherence could not be secured. *Rule of Reason* successfully applied. Ben Terra and Peter Wattel (n 60) 67.

[149] In order to justify discriminatory domestic provisions with an "***anti-abuse argument***" it is mandatory the tax administration to demonstrate that: (*i*) the relevant tax-payer created the possibility of enjoying tax benefits that would otherwise be impossible to benefit from had the national provision been applied, (*ii*) the national provision applied to the relevant case serves as a protection of the State against abusive or fraudulent conducts, and (*iii*) the provision was explicitly designed to discriminate exclusively abusive behaviours. A national legal provision *that in a general manner denies "benefits in cross-border situations cannot be justified by the anti-abuse argument*". Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 80.

[150] The ***fiscal territoriality principle***, was acknowledged by the Court in the *Futura* case where tax rules limiting loss compensation to losses economically connected to Luxemburg income was not againt the Treaty's spirit. Ben Terra and Peter Wattel (n 60) 78.

[151] The ***balanced allocation of taxation rights*** was applied in the *Marks & Spencer* case (Case C - 446/03) and in the *X Holding* case (Case C-337/08), but only in the latter the justification sufficed in itself. The Court accepted the justification proposed by the Netherland's tax authority on not allowing the integration of foreign companies into the group's taxation system, which would allow the group to deduct its losses/profits. In this particular case, the possibility to freely choose a jurisdiction, according to the court, would unbalance the power to levy taxes among MS. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 79.

[152] The ***neutralization of taxing rights in other State***, is based on the assumption that MSs may apply discriminatory measures other than those previously mentioned in this study (effectiveness of fiscal supervision, the maintenance on the integrity of the tax system, abuse prevention, territoriality and balanced allocation of taxation rights). Nonetheless, there are three limitations to this discrimination: (*i*) the tax credit generated due to cross-border operations must be based on a DTC, (*ii*) the amount of the credit may not surpass the amount that would have been paid in the resident State, and finally (*iii*) the amount must be credited in full. Partial credits do not fulfill the requirement. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 84.

of the relevant public interest?,[153] and (vi) does the measure obey the principle of proportionality? (are there other less restrictive measures that could be applied?).[154]

Case C- 120/78 Rewe-Zentral Ag (Cassis de Dijon) v. Bundesmonopolverwaltung für Branntwein [155]

1- Rewe-Zentral is a cooperative company importer of goods from other MSs of the Union. In 1976 the undertaking requested authorization for the *Bundesmonopolverwaltung* to import a spirit called "Cassis de Dijon" (a liquor used in cocktails such as Kir Royal, wine cocktails as well as in crème de cassis). According to the *Bundesmonopolverwaltung* the Cassis de Dijon could not be sold in the FDR, "since Article 100 (3) of the *Branntweinnmonopolegesetz* provides that only potato spirits having a wine-spirit content of at least 32% may be marketed in that country". Ultimately the Finanzgericht request a preliminary ruling on the matter.
2- Is the fixing of a "minimum wine-spirit content come within the concept of 'discrimination regarding the conditions under which goods are procured and marketed … between nationals nad Member States' contained in Article 37 of the EEC treaty?" [156] In other words, does such prohibition constitutes a measure having equivalent effect to quatitative restrictions (MEQRs)?[157]
3- Yes.
4- The fact that the German authority established that only spirits with a certain alcoholic content could be marketed in that Country constitute a MEQR. Nonetheless, discriminatory measures that have the potential to hinder cross-border operations within the Internal Market, may be compatible with the Treaty "in so far those provisions may be recognized as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of the fiscal supervision, the protection of public health, the fairness pf commercial transactions and the defence of the consumer".[158] The *public health defence* was raised by the German authority, claiming that "the fixing of a lower limit for the alcohol content of certain liquoers is designed to protect the consumer against unfair practices on the part of producers and distributors of alcoholic beverages". [159] However, this

[153] Ben Terra and Peter Wattel (n 60) 32.
[154] Ben Terra and Peter Wattel (n 60) 33.
[155] Friedl Weiss and Clemens Kaupa (n 48) 68.
[156] Para. 1 Article 37 reads "Member States shall adjust any State monopolies of commencial character so as to ensure that no discrimination regarding the conditions under whch goods are produred and marketed exeists between national of Member States". Para. 2 Article 37 reads "***Member States shall refrain from introducing any new measure which is contrary to the principles laid down in paragraph 1*** or whch restricts the scope of the articles dealing with the prohibition of customs duties and ***quantitative restrictions*** between Member States." (*emphasis added*) Treaty establishing the European Community (Nice consolidated version) - Part Three: Community policies - Title I: Free movement of goods - Chapter 2: Prohibition of quantitative restrictions between the Member States - Article 31 - Article 37 - EC Treaty (Maastricht consolidated version) - Article 37 - EEC Treaty.
[157] Friedl Weiss and Clemens Kaupa (n 48) 55.
[158] Rewe-Zentral Ag (*Cassis de Dijon*) v. Bundesmonopolverwaltung für Branntwein. Para. 8.
[159] Ibid Para.12.

> argument was not accepted by the court, concluding that there were "no valid reason why, provided that they have been lawfully produced and marketed in one of the Member States, alcoholic beverages should not be introduced into any other member State".[160] (*Mutual recognition principle*).

Some measures, although considered of a *non-discriminatory*[161] nature, are liable to hinder or make less attractive cross-border operations. These measures may impose obstacles on the free movement of goods throughout the Union, and are normally referred to as *restrictions*.[162] Nevertheless, in the area of direct taxation, discrimination occurs normally in relation to non-nationals (indirect discrimination) and restrictions usually on *exit tax*[163] cases, where the latter is justified under the *Rule of Reason* and the former on grounds of public morality, public policy or public security according to the wording of Article 36 TFEU.[164]

45. Another important point is that ***disparities between legal systems do not serve as a viable negative integration argument***, although it creates restrictions and obstacles to the functioning of the internal market. An undertaking that has subsidies in various MSs across the Union cannot demand a tax refund in its home State due to higher tax differences paid in other jurisdictions.[165]

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[160] Rewe-Zentral Ag (*Cassis de Dijon*) v. Bundesmonopolverwaltung für Branntwein. Para.14.

[161] Discrimination provisions are classified as Direct and Indirect. *Direct Discrimination* places nationals or products of other MSs at a disadvantaged position due to their nationality status. On the other hand, *Indirect Discrimination* apply the discriminatory provision irrespectively to non-nationals and nationals alike. Friedl Weiss and Clemens Kaupa (n 48) 30.

[162] The current legal doctrine treats *Indirect Discriminatory Measures* and *Restriction Measures* (restriction of imports for example) in the same manner, thus a deeper discussions on its differences has little or no importance. Friedl Weiss and Clemens Kaupa (n 48) 32.

[163] The *Bachmann* case is an important mark in relation to tax payer mobility. The "*claw-back tax rules*" (exit and recapturing tax deferral), and the right to tax unrealized assets are dangerous hindrances to the freedoms contained in the Treaty. In order to tackle the problem, tax authorities demand that the relevant expatriate pay the outstanding tax debt, or pay a tax according to the present market value of the assets, before emigration. Countries that apply the EET (exemption exemption taxation), where the tax payer deducts contribution payments made out from pension funds (pension's earnings tax exempted) may suffer a loss of tax income if the retiree decides to enjoy his retirement in other MS meaning that the ***integrity of the tax system*** might be compromised. In order to solve the problem, *Ben Terra* and *Peter Wattel* proposed the following: A possible solution "(…) would be to adopt a Directive providing for the transfer of claim from the exit State to the influx State, and for a macro-clearing system. The exit State could sell its claim on the emigrating taxpayer or asset to the influx State for a discounted value, taking into account the money value of the effluxion of time and the possibility that the claim may never be realized (e.g. if a retired person dies, the pension fund will stop paying). At the end of each fiscal year the Member State could aggregate their sales and purchases of exit claims, match them bilaterally and clear the balance (…)". Ben Terra and Peter Wattel (n 60) 67.

[164] Ibid 43.

[165] Ibid 44.

2. Free movement of persons, services and capital. Articles 18–25, 45-48 TFEU.

Union law grants the possibility to Union's citizens to move freely and reside within the internal market as if nationals of that MS.[166] Discrimination on grounds of sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation" is expressively prohibited according to Article 19 TFEU (ex Article 13 TEC). Natural persons as well as companies have the right to move freely and establish residence in any MS of the Union. According to a recent study on "Social Mobility in the EU"[167] the increased inequality of income and of social standards within the Union, has been one of the main reasons why individuals migrate to other MSs. Economic stagnation within the internal market resulted in a massive number of unemployed work force (especially amongt young people) who ultimately increased the "social fluidity"[168] of such MSs. One of the main goals of having an internal free market is to reduce inequalities amongst its members, granting therefore an ***equal opportunity*** to all those citizens to generate income and ultimately increase their living stardards. In the field of taxation, the freedom of Union Citizenship was already been subjected to the ECJ's rulings, for instance, in the *Schwarz and Gootjes-Schwarz* case, the German tax authority denied the tax deduction for school fees paid to a school not located in Germany in 1998 and 1999, on grounds that the amount paid by the *Schwarzes* was "significantly higher than that changed by private schools established in Germany",[169] and that German legislation excluded the possibility for "german taxpayers of deducting from their taxable income part of the school fees linked to sending their children to a private school located in another Member State" due to the fact that only fees paid to "private schools approved by that State (Germany), or authorized or recognized by the law of the relevant land" were deductible, which indirectly, created impediment deductions for fees paid out to schools located outside of Germany (***indirect discrimination***). Before rendering its argument, the court made reference to the fact that the reduction of tax revenue does ***NOT*** configure a *public interest* issue, therefore under that reasoning, it should fail the Rule of Reason test. The argument that the *Schwarzes* paid a higher fee than they would have paid in Germany was not accepted by the Court, for the financial burden impose on that school in particular (*Cademuir International School*, a private school for exceptionally gifted children located in Schotland) was greater than the ones recognized by German legislation, that is to say, they had to charge higher school fees in order to survive (the fact the the school is no longer operational since 2006 due to financial difficulties, confirms that the ECJ rightly evaluated the matter). Moreover, "a citizen of the Union must be granted in all Member States the same treatment in law as that accorded to nationals of those Member States who find themselves in the same situation, it would be incompatible with the right to freedom of movement were a citizen to

[166] "Every citizen of the Union should have the right to move and reside freely within theterritory on the Members States, subjected to the limitations and conditions laid down in the Treaties and by the measue adopted to give them effect" Article 21 TFEU.
[167] *Eurofond. Social Mobility in the EU.* Publications Office of the European Union, Luxembourg (2017).
[168] Eurofond (n 167).
[169] *Schwarz and Gootjes-Schwarz* case. Para 42.

receive in the Member State of which he is a national treatment less favourable than he would enjoy if he had not availed himself of the ***opportunities offered by the EC Treaty*** in relation to freedom of movement (…)." [170] (emphasis added)

Rule of Reason. As previoulsy stated, the rule of reason is applied to all Treaty's Freedoms,[171] nevertheless, in the *Gebhard* case, the ECJ ruled that MSs may impose discriminatory measures capable of hindering or making the exercise of fundamental freedoms less attractive, insofar the following criteria is observed, namely (*i*) the measure must be applied in a non-discrimatory manner, (*ii*) the measure must be justified as an action of general interest, (*iii*) the measure must be suitable for securing the attaintment of the relevant objective and finally (*iv*) the measure must not go beyond what is necessary to achieve the relevant objective.[172]

3. Free movement of workers[173] Articles 45-48 TFEU

During the first decades of the European Economic Community - EEC (*Europäische Wirtschaftsgemeinschaft - EWG*), Europe experienced a great number of immigration movements thoughout the path in its economic integration process. From the years 1958 to 1973, approximately 2.184 million workers mostly from Italy, Greece, Spain, Portugal, Turkey and Yoguslavia moved to Countries such as France and Germany (till 1973 only Belgium, Germany, France, Italy, Luxembourg, Denmark and Ireland formed the Union),[174] due to European economic expansion (1950 - 1980).[175] Nevertheless, the oil shocks of 1973 and 1979 caused European Countries to restrict immigration in order to protect its labour market.[176]

When individuals move across borders within the EU to establish residence and work in another MS, the process of transferring their fiscal residence does not present great difficulties, for the State where the person earns income will be the one entitled to taxing rights. The matter gains another level of complexity when the person lives in one MS and works in another. Moreover "particular frontier workers who work and reside in different Member States" may also be confronted with some tax disadvantages.[177] In such a case, the home State will most definitely apply a double taxation relief (exemption or credit method). Nevertheless, which State should be entitled to the benefit of taxation, the source or the resident State? Moreover, does the relief method applied by the relevant Country result in a Treaty incompatibility, that is, is there

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[170] *Schwarz and Gootjes-Schwarz* case. Para 88.
[171] Except for the free movement of goods which consists of six steps.
[172] Ben Terra and Peter Wattel (n 60) 33.
[173] A worker is an individual in an employment relationship. In order to be consider a worker, it is necessary the individual to receive remuneration and be supervised. The concept of a worker has been subjected to the ECJ in the *Hoekstra* Case C-75/63, ruling that if interpreted differently, it would "eliminate at will the protection afforded by the Treaty to certain categories of persons", such as a migrant worker. The Court created a ***supranational*** meaning to the term, by harmonizing union law negatively.
[174] Friedl Weiss and Clemens Kaupa (n 48) 146.
[175] Geoffrey G. Jones. *European economic expansion between the 50s and the 80s.* Harvard Business School. Working Knowledge. 22 Aug 2005. https://hbswk.hbs.edu/item/restoring-a-global-economy-19501980. Accessed in 22 Sep 2017.
[176] Friedl Weiss and Clemens Kaupa (n 48) 146.
[177] Friedl Weiss and Clemens Kaupa (n 48) 185.

a discrimination between residents and non-residents upon application of the relevant double taxation relief method? How does one assess such compatibility? [178] In order to answer those questions, it is important to differentiate the types of tax benefits one could rely on, namely, *objective tax benefits - source State* (income related - deductions of expenses, refunds, tax credits connected to dividend etc) from *personal tax benefits – home State* (related to personal conditions – allowances, splitting of income within a family, family related tax deductions such as marital status, number of children, age, sickness etc).[179] ***Objective tax benefits***, according to case law, must be granted equally to residents and to non-residents. For instance, a Belgian resident employed in Germany, must be allowed to deducted from its *income tax expenses* paid in Germany travel expenses, expenses with professional literature, clothing etc, as a German resident on an equal footing (*Schumacker* C-279/93). In the *Biehl* Case, a German citizen employed in Luxembourg was also granted the benefit tax deduction, under the condition that such employee resided in Luxembourg at least 9 months (Contrary to Schumacker, Klaus Biehl lived and worked in Luxembourg for more than ten years and moved back to Germany – *Biehl* C-175/88). [180] ***Personal tax benefits***, contrary to income-related tax benefits, are related to the taxpayer's personal conditions (age, number of children, sickness, marital status etc). The main aim of granting personal tax benefits is to balance the taxpayer ***ability to pay*** against his personal conditions (a household with 5 children will definitely generate more expenses than other with 1 child, or a person who has to submit himself/herself to a special treatment due to illness etc), therefore, personal tax benefits are attached to the State where the situation occurs and it can be granted only once, for instance, the relevant State may allow the person with the especial condition be placed on a different tax bracket,[181] thus, the tax benefit will only be granted once, for contrary to income-related tax benefits, which can be deducted according to the individual variable expenses (travel expenses, clothing etc), personal tax benefits are not concerned with the variable expenses, but with the circumstance that lead the individual to apply for such benefit.[182] However, within the internal market, an individual may work in one MS and live in other MS of the Union, moreover, the individual may also live in the frontier between two MSs. According to international tax law system and principles, "it is the home State which should take into account the taxpayer's personal situation, and that the source State objectively taxes the income sourced within its territory".[183] Such principle is also provisioned in the OECD Model. [184] Although the Treaty expressively forbid discriminatory measures towards EU citizens, non-residends are not in the same situation as residents concerning ***personal tax benefits***.

[178] Ben Terra and Peter Wattel (n 60) 48.
[179] Ibid 50.
[180] Ibid 50.
[181] Tax brackets in the U.S, for instance, are based on the filing status of the taxpayer (single filing, married filing, head of household filing etc).
[182] Ben Terra and Peter Wattel (n 60) 50.
[183] Ibid 50.
[184] Such reasoning is also backed up by common sense, for the State where the individual earns his income, will be able to ascertain and assess the taxpayers ability to pay according to his/her earnings in that MS, whereas, the State where the individual lives will be able to properly assess his/her personal circunstances.

Consider the following example. If an individual earns income in a certain MS, and resides in another MS, that person may not be granted full personal tax benefits in both States, where he/she generates income, and where he/she resides, for it "be an anomaly (an unjustified advantage) to give them two sets of personal tax benefits, one on each side of the border".[185] As previoulsy mentioned, MSs may are allowed to apply discriminatory measures on grounds of public interest (***legal coherence of its national tax system***, ***integrity of the tax system*** – *rule of reason*). In other words, if absent a direct link between tax deductibility and tax revenue, MSs are
likely to deny the benefit (*Schumacker* C-279/93 – see case bellow).

Under the *freedom of workers*, an early test must be applied, namely, the ***Treaty Access Test***. The test operates under the assumption that, in order to evoke the benefits of the Treaty, it is necessary the existence of a *cross-border element/situation and* the person is required to possess *treaty status*. Article 18 TFEU (ex Article 12 TEC) prevents the application of the Treaty's benefits to domestic situations. The Article reads: "Within the scope of application of the Treaties (*1*), and without prejudice to any special provisions contained therein (*2*), any discrimination on grounds of nationality shall be prohibited (*3*)".[186] *The first part of the Article* ("Within the scope of application of the Treaties") restricts the application of the Treaty to cross-border instances, whether related to an economic activity (employment, self-employment, establishment of companies and associated companies, provision and purchase of services etc), or non-economical activities (social, cultural, scientific, environmental etc),[187] may seek cover under the Treaty's provisions. However, "a situation lacking some kind of cross-border economic (or non-economical)[188] activity will be regarded as purely internal (domestic), thus leading to the inapplicability of the Treaty (Freedoms)."[189] *The second part of the Article* ("and without prejudice to any special provisions contained therein") recognizes preference of other specific provisions contained in the Treaty regarding the four freedoms (free movement of persons, goods, services and capital).[190] Finally, *the third part of the Article* ("any discrimination on grounds of nationality shall be prohibited") prevents MSs from imposing discriminatory measures towards nationals of other MSs, although the measure may be justified under the *Gebhard Formula* (Rule of reason).

Treaty Access Test
1. ***Cross-border element.***
2. ***Treaty Status***

Gebhard Formula
A restriction on the Treaty's freedoms in order to be valid must: (*1*) be applied in a non-discriminatory manner; (*2*) be justified by imperative requirements in the general interest (public interest), (*3*) be suitable for securing the attainment of the objective which they pursue (proportional) and (*4*) not go beyond what is necessary in order to attain the objective.

[185] Ben Terra and Peter Wattel (n 60) 50.
[186] Articles 18 TFEU.
[187] Ben Terra and Peter Wattel (n 60) 24.
[188] Cross-border non-economical situations may also fall under Article 18 TFEU, situations where retirees choose to move to other MSs to enjoy their retirement lacks economic activity. Ibid 24.
[189] Ibid 24.
[190] Ibid 23.

Case C- 279/93 Schumacker v. Finanzamt Köln Altstadt[191]

1- Roland Schumacker, a resident of Belgian earned his entire income in Germany, therefore he paid no income tax in Belgian. Nonetheless, Mr. Schumacker applied in for a splitting tax regime[192] in Germany, which would allow he and his wife the benefits of a lower bracket. Following the German tax authority refuse in granting him the benefit, the *Bundesfinanzhof* remitted the case to the ECJ for a preliminary ruling.
2- Is a provision that subjects a non-resident to higher taxation than a resident worker contrary to Art. 45 TFEU (Art. 39 EC), considering that he receives *his entire income* is that State?
3- Yes.
4- According to the Court's ruling "national rules (…) under which a distinction is drawn on the basis of residence in that non-residents are denied certain benefits which are, conversely, granted to persons residing within national territory, are liable to operate mainly to the detriment of nationals of other member Stats, non-residents are in the majority of cases foreigners. In those circumstances, tax benefits granted only to residents of a member State may constitute indirect discrimination by reason of nationality. It is (…) settled law that discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations. In relation to direct taxes, the situation of residents and non-residents are not, as a rule, comparable (…) The situation of a resident is different in so far as the major part of his income is normally concentrated in the State of residence. Moreover, that State generally has available all information needed to assess the taxpayer's overall *ability to pay*, taking account of his personal and family circumstances. Consequently, the fact that a member State does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayers are not in a comparable situation".[193]

The Schumacker doctrine coined by the ECJ can be resumed as the acceptance by the Court of a "general principle of international tax law, embodied in the OECD Model Convention, according to which personal and family circumstances have to be taken into account in the State of residence applying worldwide taxation" *and that* "exceptions to this principle must be made when the non-resident taxpayers undertakes significant economic activity in the Member States. In this case he is deemed to be in a situation comparable to that of the taxpayers resident of that State if he derives his income ***entirely or almost exclusively*** from the economic activity which he performs in that State"

[191] Friedl Weiss and Clemens Kaupa (n 48) 185.
[192] According to German law, married residents are allow to apply for a splitting tax system, that is, the income of the couple is added and divided by two for purposes of of selecting the appropriate bracket, thefore placing the household's income at a lower bracket (***progressive tax system***).
[193] *Schumacker v. Finanzamt Köln-Altstadt. Case C- 279/93* Paras 28 and 34;.

[194] (emphasis added). After Schumacker, Germany had changed its legislation "in order to adapt the income tax system for non-residents to the law (…), a married taxable person who has neither permanent residence nor usual abode in Germany and who is a national of one of the Member States of the European Communities Area may now, under Paragraph 1a(1), point 2, of the EStG, apply for the joint assessment under the splitting procedure, where that person's spouse resides in one of those States".[195] However, the ECJ's position was refined in the *Gschwind* case.[196]

Case C-391/97 Gschwind v. Finanzamt Aachen-Außenstadt

1- Frans Gschwind a Dutch national lived in the Netherlands but worked in Germany. The family's income derived from his work, which amounted to 58% of the family's total income (Germany), and the difference of 42% was earned by his wife (The Netherlands). Mr. Gschwind applied for the splitting benefit in Germany. The German tax authority ultimately denied to splitting income benefit for he did not earn at least 90% of his income in Germany. Mr. Gschwind proceded to challenge the tax administration's decision. The Finanzgericht Köln referred the case to the ECJ for a preliminary ruling under Article 267 TFEU (ex Article 234 TEC).
2- "Is it contrary to Article 48 of the EC Treaty for Paragraph 1(3), second sentence, in conjunction with Paragraph 1.a.1.2 of the *Eikomensteuergesetz*" denying a Netherland's national splitting income tax benefits considering that the household earns less than 90% in Germany?
3- No.
4- "In the present case, given that nearly 42% of the total income of the Gschwinds is received in their state of residence, that state is in a position to take into account Mr Gschwind's personal and family circumstances according to the rules laid down by the legislation of that state, since the tax base is sufficient there to enable them to be taken into account (…)". Nonetheless, "[A]rticle 48(2) of the Treaty (…) is to be interpreted as not precluding the application of a Member State's legislation under which resident married couples are granted favourable tax treatment (…) whilst the same treatment of non-resident married couples is made subject to the condition that at least 90% of their total income must be subjected to tax in that Member State".[197]

In sum, the free movement of workers imposes upon MSs the duty of removing any obstacles that would prevent a worker from moving and working in another MS within the Union.

[194] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa. *The Impact of Rulings of the European Court of Justice in the area of direct taxation*. Brussels, European Union, (2011). 25.
[195] Gschwind v. Finanzamt Aachen-Außenstadt. Case C-391/97 Para. 6.
[196] Friedl Weiss and Clemens Kaupa (n 48) 186.
[197] Gschwind v. Finanzamt Aachen-Außenstadt. Case C-391/97.

4. Right of establishment[198] Articles 49-55 TFEU.

The freedom of establishment is central to the EU's market integration, for it allows a "national to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom, so contributing to economic and social interpretation within the Union in the sphere of activities (…)".[199] Article 49 TFEU provides that nationals of Member States may pursue activities as self-employed, set up agencies, branches - PEs or subsidiaries, in other MSs where any measure, whether direct or indirect that creates obstacles to such freedom, shall be deemed as incompatible with the Treaty. Such obstacles include the creation of "administrative procedures, or practices"[200] towards nationals of other MSs treating such entities less favourably than resident entities (minimum tax base applied to foreign undertakings operating in Belgium were deemed as incompatible with the Treaty by the ECJ).[201] Member States are also prohibited from treating branches and subsidiaries on non-resident EU companies less favourably than resident companies "as to the right to interest on restitution of overpaid tax or to a tax deduction of research expenses carried out in other Member States".[202]

Article 54 (1) grants the right to firms or companies incorporated in accordance with the law of the Member State and having their registered office in that MS, central administration or principal place of business within the Union to be treated in the same way as natural persons who are nationals of Member States, that is, if a certain company operates in a MS through a PE (branch), that in turn receives dividends (income) from other associated companies within and outside the EU, the non-resident company can not be discriminated under the laws of that MS on grounds that the tax relief system accorded with the third-country (DTC) grants the tax benefit only to companies submitted to a ***full tax liability regime*** (unlimited tax liability).

Measures that restrict the freedom of establishment are justified under Articles 51 and 52 TFEU as well as under overriding reasons of public interest.[203] For instance, numerous cases were subjected to the ECJ for a preliminary ruling regarding the transfer of the company seat to another MS.[204] In *Daily Mail case*,[205] a UK holding company quoted on the London stock exchange,[206] organized a tax scheme intended to avoid taxation on capital gains concerning its shares, that is, in order to change its seat to The Netherlands, the company proposed to buy its own shares, and upon arrival in The Netherlands, the company "would have to draw up an opening balance sheet for tax purposes on which its holdings would enter at current market value. If these holdings were to

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198 Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 20.
199 Gebhard [1995] Case C-55/94, ECR I-4165, para. 25.
200 Article 50 (2) (c) TFEU.
201 After the ECJ ruled the *Talotta* case C-383/05, Belgium uniformed its legislation so that resident taxpayers were also subject to taxation on a minimum basis. Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 25.
202 Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 8.
203 Friedl Weiss and Clemens Kaupa (n 48) 208.
204 Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 101.
205 *Daily Mail* Case C 81/87.
206 Ben Terra and Peter Wattel (n 60) 68.

be sold immediately afterwards, them no capital gain for the Netherlands corporate tax purposes would be ensue".[207] The ECJ considered that the case should be ruled under company law principles rather than tax law,[208] providing that "Articles 52 and 58 of the Treaty, (…) ***confers no right*** on a company incorporated under the legislation of a Member State and having its registered office there to transfer its central management and control to another Member State" [209] (emphasis added). In other words, the ruling prevented *Daily Mail* from leaving the Country without collecting its due tax on "uncrystallized"[210] capital gains, therefore, the court concluded that UK tax administration measure did not violate the Treaty's right of establishment.[211] The fact of the matter is that the UK tax authorities would not allow *Daily Mail* to leave the Country *free of charge*, consequently would not grant the company its approval to change the company's seat to the Netherlands. The *Daily Mail* case relates to exit taxation, which has as its ultimate *ratio* the maintenance of Country's tax system integrity. Exit taxation will be properly studied in other parts of this investigation (exit taxation as an avoidance measure).

Now, imposing upon a company the cost of liquidation to achieve the transfer of seat was deemed as disproportionate by the ECJ (*Cartesio* C-210/06),[212] for there are, according to the Court, less restrictive national measures to safeguard public interest. The change of seat between companies located within the common market is a prerogative granted by the freedom of

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[207] Ibid 68.

[208] According UK's tax administration, "The fact that the central management and control of a company is located in a Member State does not itself necessarily imply any genuine and effective economic activity on the territory of that Member State and cannot therefore be regarded as establishment within the meaning of Article 52 of the Treaty." *Daily Mail* case C 81/87. Para 13.

[209] *Daily Mail* case C 81/87.

[210] Ben Terra and Peter Wattel (n 60) 69.

[211] According to Terra/Wattel, "The requirement of final settlement of deffered tax and of uncrystallized capital gains upon emigration of the tax-connecting factor from the tax jurisdiction of the State holding the tax claim is not directly or indirectly discriminatory. It applies equally to residents emigrating as to non-residents winding up a local permanent establishment. Even if one would argue that although there may be no discrimination, there is still a serious restriction to emigration, the answer, in our view, is that such restriction is justified under the ***fiscal cohesion justification***, provided that it does not go any further than necessary to realize a domestic tax claim on the undertaking." (emphasis added). Ben Terra and Peter Wattel (n 60) 70.

[212] In *Cartesio*, the ECJ ruled that "a Member State has the power to define both the connecting factor required of a company if it is to be regarded as incorporated under the law of that Member State and, as such, capable of enjoying the right of establishment, and that required if the company is to be able subsequently to maintain that status. That power includes the possibility for that Member State not to permit a company governed by its law to retain that status if the company intends to reorganise itself in another Member State by moving its seat to the territory of the latter, thereby breaking the connecting factor required under the national law of the Member State of incorporation. (...) the power referred to in paragraph 110 above, far from implying that national legislation on the incorporation and winding-up of companies enjoys any form of immunity from the rules of the EC Treaty on freedom of establishment, ***cannot, in particular, justify the Member State of incorporation, by requiring the winding-up or liquidation of the company***, in preventing that company from converting itself into a company governed by the law of the other Member State, to the extent that it is permitted under that law to do so. (...) Articles 43 EC and 48 EC are to be interpreted as not precluding legislation of a Member State under which a company incorporated under the law of that Member State may not transfer its seat to another Member State whilst retaining its status as a company governed by the law of the Member State of incorporation." (emphasis added). *Cartesio* C-210/06. Para. 110 and 112.

establishment, therefore, if a company transfers its seat to another MS, that MS must recognize such change, insofar the company has maintained its "***legal personality under the law of their State of origin".***[213] Moreover, a measure that prevents or creates a higher administrative burden to EU entities to change their seats is likely to be incompatible with the Treaty.

In the Marks & Spencer case, the Court ruled that the rejection for a relief claim related to losses incurred by a resident as well by a non-resident subsidiaries, infringed the freedom of establishment in light of Article 49 TFEU. However, the discriminatory measure, namely, not allowing a tax relief to non-resident subsidiaries, were justified on grounds of public interest (*balanced allocation of taxation rights*).[214]

Case C- 446/03 Marks & Spencer v. David Halsey (Her's Majesty's Inspector of Taxes)

1- Marks & Spencer Group incorporated within the UK, established a number of associated companies (subsidiaries) within the UK and throughout the EU. The group claimed in the UK tax relief due to losses realized by other subsidiaries across the Union (Belgium, France and Germany). Ultimately rejected by the UK tax administration on grounds that only losses realized by subsidiaries within UK territory may be set off, Marks & Spencer challenged such decision to the Higher Court of that Country. Ultimately the case was referred to the ECJ for preliminary ruling in order to ascertain whether denying the deduction of losses realized by subsidiaries located in other MS (non-resident subsidiaries), infringed EU's provisions on the freedom of establishment.
2- Does the restriction imposed by the UK tax administration to the group's tax relief claim, infringes EU law regarding the freedom of establishment?
3- No.
4- According to the ECJ's opinion, the fact that the State's revenue is reduced, due to the deductions of losses realized non-resident subsidiaries, "cannot be regarded as an overriding reason in the public interests which may be relied on to justify a measure which is principle contrary to a fundamental freedom (…).[215] Nonetheless, (…) the preservations of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses. In effect, to give the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a *balance allocation of the power to impose taxes* between Member States, as a taxable basis would be increase in the first State and reduced in the second to the extent of the loses transferred."[216] (emphasis added)

[213] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 103.
[214] Se citation 228.
[215] ***Loss of tax revenue*** "has never been accepted by the Court as an overriding reason in the public interest that may justify a discriminatory national provision." Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 86.
[216] Judgment of the Court (Grand Chamber) of 13 December 2005.Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes).Reference for a preliminary ruling: High Court of

The ***Treaty Access Test*** must also be applied to the right of establishment when justifying discriminatory or restrictive measures. Exit taxes are a conspicuous impediment in relation to the freedom of establishment. Nonetheless in the *Daily* and *Bachmann* case, the ECJ provided that exit taxes were allowed to the extent that such taxes are mandatory in realizing tax claims that would otherwise be certainly lost in future revenue (***integrity of the tax system***).[217] Although not tax related, the *Gebhard* case was one of the key cases that contributed to the freedom of establishment's concept evolution within the EU.

Case C-55/94 Gebhard v. Consiglio Dell'Ordine Degli Avvocati e Procuratori di Milano

1- Reinhard Gebhard, a German national worked as a lawyer in Germany. Mr. Gebhard moved to Italy in 1978 with his wife, an Italian citizen. In Milan he worked as a collaborator (*con un rapporto di libera collaborazione*) in a law firm till 1980, when he began to work as an associated member (*associato*) till 1989. In 1989 he opened his own firm. Mr. Gebhard assisted mainly Germans and Austrians citizens in non-contentious matters. The fact that he used the titled of *avvocato* lead practitioners of that MS to request the Milan Bar to initiate administrative proceedings in order to prevent Mr. Gebhard to work as a lawyer in that MS for he "had contravened his obligations under Law No 31/82 by pursuing a professional activity in Italy on a permanent basis in chambers set up by himself whilst using the title *avvocato*."[218] According to Italian law (No 31/82 Article 2) "[Nationals of Member States authorized to practice as lawyers in the Member State from which they come] shall be permitted to pursue lawyers' professional activities on a temporary basis (con carattere di temporaneità) in contentious and non-contentious matters in accordance with the detailed rules lays down in this title. For the purpose of pursuit of the professional activities referred to in the preceding paragraph, the establishment on the territory of the Republic *either chambers or of a principal or branch office is not permitted*" [219] (emphasis added). After Mr. Gebhard's appeal against the Consiglio Nazionale Forense, the case was ultimately referred to the ECJ for a preliminary ruling.
2- Is Article 49 TFEU (Right to establishment) valid even if Italian law expressively forbids the establishment of either chambers or branch office by a foreign lawyer not properly registered in the Italian BAR?[220]
3- Yes.
4- The court held that the "concept of establishment within the meaning of the Treaty is (…) very broad (…), allowing a Community national to participate, on

Justice (England & Wales), Chancery Division - United Kingdom.Articles 43 EC and 48 EC - Corporation tax- Groups of companies - Tax relief - Profits of parent companies - Deduction of losses incurred by a resident subsidiary- Allowed - Deduction of losses incurred in another Member State by a non-resident subsidiary - Not included.Case C-446/03. Para.45.

[217] Ben Terra and Peter Wattel (n 60) 430.

[218] *C-55/94* Para. 9.

[219] *C-55/94* Para 17.

[220] British Accreditation Regency (BAR association).

a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom, so contributing to the economic and social interpretation within the Community in the sphere of activities as self-employed persons".[221] Nonetheless, the Court did point that MSs are competent to provide the necessary regulations for self employment for the "pursuit of certain self-employed activities may be conditional on complying with certain provisions laid down by law, regulation or administrative action justified by the general good, such as rules relating to organization, qualifications, professional ethics, supervision and liability".[222] However, a restriction on the Treaty's freedoms must "*fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it*" [223] (*Gebhard Formula*)(emphasis added).

Recently, in the X AB case, the ECJ ruled that the denying deduction on capital loss due to currency variations after the realization of shares owned by a Swedish Holding located in the UK, did not infringe the freedom of establishment within the meaning of the Treaty. The case bellow (*Avoir Fiscal*) was the first case where the "need to prevent tax avoidance was put forward by a Members State".[224] In fact, it was the "first direct-taxation case ever to reach the Court".[225] France applied the imputation system (see section xx), therefore when a shareholder receives a dividend, the same shareholder also receives a tax credit, which may be used against hit tax income or CIT. Nonetheless, the tax administration of that Country granted an imputation credit (avoir fiscal) only to resident shareholders and "depending on concessions made by a treaty partner, under bilateral tax treaties also to certain foreign shareholders".[226] French tax authorities denied the avoir fiscal to German subsidiaries of certain insurer companies, whereas other French-based insurers were granted the credit (had the German insurers invested through a subsidiary incorporate in France or were the German subsidiaries effectively managed in France, then those subsidiaries would be entitled to such credit). [227] According to French tax authorities, "foreign companies insuring French risks were wholly free to maintain their mandatory technical reserves through a locally incorporated subsidiary, which, being resident, would be entitled to the avoir fiscal. This argument ignores the fact that imputation affected the insurance sector in particular, because insurance companies were required to maintain minimum technical reserves (portifolio investments) to cover for risks insured. Meeting these requirements was easier through direct investment (branches) than through "compartmentalization" of their reserves into numerous separately

[221] C-55/94 Para 25.
[222] C-55/94 Para 35.
[223] C-55/94 Para 37.
[224] Ben Terra and Peter Wattel (n 60) 78.
[225] Ibid 78.
[226] Ibid 78.
[227] Ibid 78.

incorporated local subsidiaries".[228] French also argued that "investing through a branch, legally being part of a non-resident company, is not the same thing, taxwise, as investing through a local subsidiary, which is a legally separate and resident entity".[229] Lack of harmonization was also raised by that tax jurisdiction therefore, in their view only positive harmonization could solve the matter.[230] Those arguments were not sufficient to convince the Court as we shall see bellow.

Case C-1986/83 Commission of the European Communities v. French Republic

1- The Commission brought upon the Franch Republic infringement proceedings related to French branches (PEs) of non-residents (German Insurance companies) which owned shares in French listed (quoted) companies. France operates under an integration system, therefore companies are taxed on their profits (French legislation levied a 50% tax rate on CIT), and upon distribution of those profits to its shareholders. In order to "reduce the effects of the cumulative taxation of profits distributed by companies caused by the fact that such profits are liable first to corporation tax in the hands of the company distributing the dividends and then to income tax or corporation tax in the hands of the recipient of those dividends, Article 158 bis of the *Code Général des imposts* provides for a tax credit called 'avoir fiscal' which is granted to the recipients of dividens distributed by French companies and is equal to half the amount actually paid by those companies". [231] However, France denied crediting the German branches whereas branches of other French companies could ultimately benefit from such credits. According to French law, had the "German insures invested in France through locally incorporated subsidiaries (or German incorporate subsidiaries effectively managed in France), then these subsidiaries would have been French residens and would therefore have been eligible for avoir fiscal"[232]
2- Is not granting the non-resident German insurance companies a tax credit upon receiving dividends from listed companies in France a discriminatory measure within the meaning of Article 52 EEC (Article 43 EC – Article 49 TFEU)?
3- Yes.
4- According to the ruling of the Court, the "freedom of establishment (…) grant (…) nationals of another Member State (…) the right of companies or firms formed in accordance with the law of the Member State and having their registered office, central administration or principal place of business within the Community to pursue their activities in the Member State concerned through a branch or agency. With regard to companies (…) it is their registered office (…) that serves as the connecting factor with the legal system of a particular State, like nationality in the case of natural persons."

[228] Ben Terra and Peter Wattel (n 60) 78.
[229] Ibid 79.
[230] Ibid 79.
[231] Avoir Fiscal. Para. 3.
[232] Andrea Amatucci (n 2) 78.

> The Court went further to assume that "different treatment solely by reason of the fact that its registered office is situated in another Member State would be thus deprive that provision of all meaning".[233] It concluded that the rules which were applied to France companies incorporated in France and branches situated in France of companies whose registered offices are abroad "on the same footing for the purposes of taxing their profits, those rules, cannot, without giving rise to discrimination, treat them differently in regard to the grant of an advantage related to taxation, such as taxholders' tax credits".[234]

The rule of reason test was not applied in the *avoir fiscal* case, for the Court only interpreted whether "the freedom of establishment could be restricted for anti-abuse purposes".[235]

5. Right to provide services. Articles 56-62 TFEU.

The service market represent more than 2/3 of the Union's GDP,[236] therefore the proper regulation of such affairs was taken as a necessary step in order to secure a "*sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.*"[237] The proper definition and classification of services are properly established by the Services Directive.[238] The provisions on the free movement of services will only be applied if the provisions on the free movement of goods, capital and persons are not used (Article 57 TFEU). It is therefore a freedom placed on a subsidiary position in relation to all other freedoms.[239]

The freedom to provide services grants the right to service providers to enter another MS and be treated as a national of that MS,[240] operating under *market access* and *equality* assumptions. For that matter, two cases are worth mentioning, the *Eurowings*[241] case and the *Waypoint Aviation*[242] case. The former case, relates to the German *Gewerbesteuer,* that had as its ultimate goal the prevention of double taxation in relation to assets leased from other business (the yield generated by the asset could only once be taxed), under the condition that the leasing operation occurred within Germany. The court ultimately found that circumscribing the possibility of a tax relief only to leasing operations within German territory amounted to a restriction to provide services within the

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[233] Avoir Fiscal. Para. 18.
[234] Avoir Fiscal. Para. 20.
[235] Andrea Amatucci (n 2) 80.
[236] Friedl Weiss and Clemens Kaupa (n 48) 276.
[237] Article 3(3) TEU (n 26).
[238] Business Services: advertisement, consultancy, agency recruitment etc. Services provided to business and to consumers: legal and tax consultancy, construction, car rental, real states services etc. Consume services: tourism, leisure etc. Household support: services for elderly people. Directive 2006/123/EC. Preamble, recital 33.
[239] Ben Terra and Peter Wattel (n 60) 36.
[240] Ben Terra and Peter Wattel (n 60) 36.
[241] Eurowings Luftverkehrs Case C-294/97 *AG* ECR I-7447.
[242] Waypoint Aviation Case C-9/11 [2011] ECR I-9697

meaning of the Treaty. The fact that the Irish company (lessor to the assets - airplanes) was under a more favorable tax regime (tax authority's defense) did not justify, according to the court, a less favorable tax regime in Germany.[243] In sum, *disparities* between legal systems do not serve as a viable negative integration argument, even though it creates restrictions and obstacles to intra community trade. The latter and more recent case, *i.e. Waypoint Aviation,* concerned a more favorable tax regime to revenue accrued from loans financing the purchase of assets (airplanes) contracted by undertakings established in national territory.[244] In this particular case, the Belgium government purchased aircrafts from *Airbus* (French company), leasing them to *Air France*. Belgium authorities denied tax benefits on income derived from the financed asset. The measure was found to be in direct violation of Article 56 TFEU. Although not tax related, the *Säger* case is an important example that helped shaping the freedom to provide services within the Internal Market as we shall see below.

Case C-76/*90 Säger v. Dennemeyr & Co. Ltd*[245]

5- A firm established in the UK provided consulting services for patent renewal services, that is, it informed its clients of patents expiration dates, dues etc. The company paid the necessary dues upon authorization of its clients. Manfred Säger, a lawyer established in Munich argued that the business practice conducted by the UK company (Dennemeyr & Co. Ltd) infringed the *Rechtberatungsgesetz* (German legislation that authorized such services only to licenced lawers).
6- May a company incorporated under English law be required to obtain a permit in order to maintain or renew IP rights whose owners are established in Germany?
7- No.
8- According to the court, Article 59 of the Treaty "requires not only the elimination of all discrimination against a person providing services on the ground of his nationality but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those Member Statates, when it is liable to prohibit of otherwise impede the activities of a provider of services established in another Memebr State where he lawfully provides similar services".[246] The court also concluded that "national legislation which makes the provision of certain services on the national territory by an undertaking established in another Member State subject to the issue of an administrative licence for which the possession of certain qualifications is required constitutes a restriction on the freedom to provide services within the meaning of Article 59 of the Treaty".[247]

[243] "Any tax advantage resulting for providers of services from the low taxation to which they are subjected in the Member State in which they are established cannot be used by another Member States to justify less favourable treatment in tax matters given to recipients of services established in the latter State (...)". Eurowings Luftverkehrs *AG*, Case C-294/97 ECR I-7447.
[244] Friedl Weiss and Clemens Kaupa (n 48) 270.
[245] Friedl Weiss and Clemens Kaupa (n 48) 32.
[246] Säger. Para. 12.
[247] Säger. Para. 14.

Discrimination and *Restriction exemptions* are also applicable to the right to provide services under Articles 62 and 52 TFEU, where discriminatory measures may be justified on grounds of public policy, public security, public health and security.[248]

Case C- 294/97 Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna[249]

1- Eurowings Luftverkerhrs leased assets from other companies within Germany and other MSs. The German tax administration granted a tax relief for revenue accrued from assets that have been leased from other undertakings. The relief was ultimately granted in order to avoid double taxation with both lessee and lessor.[250] However, according Paragraph 2 of the Trade Tax Law of March 1991 (BGBI. I, p. 814) *Gewerbesteuer* (regional tax on business yield and assets), "any business currently operating in Germany is subjected to trade tax on capital and earnings. (…) Trade earnings are the amount determined in accordance with the provisions of the Income Tax Law or the Corporation Tax Law, plus the add-backs[251] required by Paragraph 8 of the Treade Law Tax and minus the deductions provided for in Paragraph 9 thereof. The purpose of the add-backs and deductions is to enable the objective earnings of the business to be determined regardless of whether they arise on the investment of own or outside capital".[252] Eurowings leased its assets (aircrafts) from a company established in Irland, which were subjected to a more favourable tax regime (10%).[253] Ultimately, the German tax authority did not grant the deduction benefit to Eurowings concerning lease payment made out to the Irish company.
2- Does Article 59 of the Treaty precludes national legislation from imposing trade tax?
3- Yes.

[248] In the *SIAT* Case, although the measure applied by the Belgium government was unsound with the provision of Article 56 TFEU, the court stated that the deductibility of business expenses made to a non-domestic supplier, can be unobtainable if "*by virtue of the legislation of the country of establishment, is not subject there* (the non-domestic supplier) *to a tax on income or is subject there to a tax regime which is appreciably more advantageous than the applicable tax regime in Belgium, unless the taxpayers proves, by any legal means, that such payments relate to genuine and proper transactions and do not exceed the normal limits*". Justification intended to avoid tax evasion and ensuring the ***effectiveness of legal supervision.*** *SIAT* Case (C-318/10 [2012].

[249] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 51.

[250] Ibid 20.

[250] Ben Terra and Peter Wattel (n 60) 81.

[251] According to Paragraph 8, point 7 of the Gewerbesteuer, "entitled 'Add-backs' (…) that must be added to the earnings of the business: 'half of the rental payments made for the use of fixed business assets, other than real estate, owned by another person. This does not apply where the payments are to be taken into account for the purposes of trade tax on the lessor's earnings, unless the lease is of an undertakings or part of an undertaking and the rental payments exceed DEM 250 000. The amount to be taken into account is that which the lessee has to a lessor for use of business assets which he does not own in the business establishment within the municipality. (…). The Finanzgericht points out that the add-back provisions relating to trade tax reflect the intention of the legislature to ensure that the assets of business established in Germany are taxed only once, regardless of whether the assets are financed by own or outside investment and how the business capital is owned for the purposes of civil law." Eurowings. Paras. 7 and 9.

[252] Eurowings. Para 6.

[253] Ben Terra and Peter Wattel (n 60) 81.

4- The fact that Eurowings used a lessor subjected to a lower tax rate was not considered as an abusive behavior by the Court, which ruled that "Any tax advantage resulting for providers of services from the low taxation which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State (see, as regards Article 52 of the EC Treaty (now, after amendment, Article 43 EC), Commission v France, paragraph 21, and Asscher, paragraph 53 (…)".[254] The Court concluded that "[C]ontrary to what was argued by the Finanzamt, that difference of treatment can also not be justified by the fact that the lessor established in another Member State is subjected to lower taxation (…) therefore (…) Article 59 of the Treaty precludes national legislation on trade tax such as that at issue in the main action."[255]

It is clear to us that the Court it not inclined to consider tax differences between jurisdictions, even if there is a special and more favourable regime in the other jurisdiction, as an abuse behaviour.

a. Market's "bitization"

The internet has changed the configuration in which services are rendered, where everything seems to be "*becoming bits*".[256] Action 1 of the OECD BEPS Project (Addressing the Tax Challenges of the Digital Economy)[257] is the result of such bitization. The evolution of information and communication technology (ICT) brought prices of ICT products almost to a "zero marginal cost".[258] *Stell dir vor*, 3D printers that can be programmed to produce an infinite variety of products such as jewelry, airplane parts, cars or even human protheses at a speed and quantities "that would have been unheard of half century ago",[259] education being also provided at almost zero marginal cost (Coursera, edX)[260] forming the so-called Massive Open Online Courses (MOOCs), free energy being produced by the "harvesting power of renewable energy technology" (solar and wind – analysts forecast that in 15 years the technology for solar and small wind power will be as cheap as cell phones and laptops,[261] the democratization of the banking system through virtual currencies "cryptocurrencies" (numerous cryptocurrencies are availabled, such as Litecoin, Namecoin, Swiftcoin, Peercoin, Bitcoin etc), all possible due to the Internet of Things (IoT),[262] that is, a smart-infrastructure which "will connect every machine, business, residence, and

[254] Eurowings. Para 44.
[255] Eurowings Paras 43 and 46.
[256] Ben Terra and Peter Wattel (n 60) 36.
[257] *Addressing the Tax Challenges of the Digital Economy*, Action 1 – 2015 Final Report. OECD. https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en. Accessed in 22 Sep 2017
[258] Jeremy Rifkin. *The Zero Marginal Cost Society.* Palgrave Maccmillan. St. Martin's Press LLC. New York. New York. (2014) 86.
[259] Jeremy Rifkin (n 258) 89.
[260] Non-profit consortium formed by Harvard and MIT.
[261] Jeremy Rifkin (n 258) 81.
[262] The term was coined by Kevin Ashton, founder of the MIT Auto ID Center in 1995. Jeremy Rifkin (n 258) 74.

vehicle in an intelligent network comprised of a Comunications Internet, Energy Internet and Logistics Internet, all embedded in a single operating system".[263] Therefore, it is fair to assume that allocating profits based on the ***concept of economic allegiance***,[264] which is founded "on factors aimed at measuring the existence and extent of the economic relationships between a particular state and the income or person to be taxed" may no longer provide a proper solution to the allocation of taxing on difficulties created by transfer princing for instance HTVI.

6. Capital and Payments. Articles 63-66 TFEU

After WW II between 1950-1973 particularly, the world economy experienced a smooth growth with an average of 5%. The United State's dollar, turn out to be the most important currency in the world and US companies became leading players in the world's economy. Asian and Europe had a hard time rebuilding their Countries' structures (legal, social, economical and political) and experienced a massive loss of lives for they fought in their territory, contrary to the USA. In 1971 the USA also ended by *forceps* the American dollar convertibility into gold [265] (*Nixon shock*). Capital flows nevertheless were still restricted by most Countries, that "systematic discourage wholly owned FDI (…) and restricted it to a low level"[266] which was a reflect of over the growing concern that Countries had in respect to their balance of payments and the Bretton Woods system which provided for *fixed exchange rates*.[267] In 1958 most European States adopted the so-called "non-resident-convertibility, which permitted foreigners to move funds for current accounts purposes freely from one country to another", leading to a great inflow of USA's FDI into Europe,[268] nevertheless it was only after the "collapse of the Bretton Woods system of fixed exchange rates in the early 1970s that the controls over capital movements began to be slowly dismantled".[269] The flow of FDI continued to grow from a $60 billion dollar figure to $500 billion dollars by 1980. Moreover the USA FDI share decreased substantially during such period, that is, between

[263] Jeremy Rifkin (n 258) 73.
[264] Factors comprising ***economic allegiance***: (i) origin of walth or income, (ii) situs of wealth or income, (iii) enforcement of the rights to wealth or income, and (iv) place of residence or domicile of the person entitled to dispose of the wealth or income. Addressing the Tax Challenges of the Digital Economy (n 257) 25.
[265] Between the years of 1944 and 1971, ***Bretton Woods*** recognised the the American dollar as the world's reserve currenty, and all major currencies were "pegged" to the dollar, wheras the dollar was "pegged" to gold (Gold Standard).
[266] Geoffrey G. Jones (n 175).
[267] The ***Bretton Woods system*** (named after where the agreement was signed in 1944, Bretton Woods in New Hampshire) was a monetary agreement entered into by the USA, Western Europe, Japan, Australia and Canada. The agreement created the International Monetary Fund (IMF) and the World Bank. Nonetheless, after the USA abandoned unilaterally the convertability of its currency to gold in 1971 (*Nixon shock*), many currencies became floating- currencies, that is, their value was not fixed according to a certain standard, but floated according to market forces (balance of payments). See citation 1233 (currency variations).
[268] Geoffrey G. Jones (n 175).
[269] Geoffrey G. Jones (n 175).

the years of 1945 to mid 1960s, US FDI represented almost 85% of capital flows and by 1980, its contribution was reduced by less than half (40%).[270]

The free movement of capital within the EU was introduced by Directive 88/361/EEC, backed by Article 56 Treaty of Maastricht, which provided for full liberalization.[271] According to Article 63 (1) (2), any restriction that prevents the free movement of capital and payments among MS and third countries are forbidden.[272] The possibility to operate payments throughout the EU is parallel to the other four freedoms (goods, services, persons and capital).[273] It seems only logical that if a worker is prevented from transferring his income from the source MS country to the resident MS, his freedom to move across the Union would be compromised. The freedom to freely move capital within the Common Market has already been subjected to the rulings of the ECJ. In the *Test Claiments in the FII Group Litigation* case, the court held that a domestic legislation intended to "apply to those shareholdings acquired solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking must be examined exclusively in light of the free movement of capital".[274] The "*fiscal gravitational effects*"[275] generated by the liberalization of capital flows have been largely debated among scholars. Such studies called out for the necessity of capital control programs so that countries would be able to defend themselves from sudden capital flights that could cause currency fluctuations, causing therefore negative economic effects such as inflation pushed by currency devalorisation, and therefore influence the relevant economy negatively.[276] Moreover, over the last two decades Nations worldwide are more concerned in preventing the product of corruption moving across borders (money laundering). The financing of terrorist groups throughout the globe[277] is also a matter of great concern.[278]

46 *Rule of Reason.* As previoulsy stated, the rule of reason is applied to all Treaty's Freedoms (see m.nos 43 et seq.),[279] nevertheless, the ECJ ruled that MSs

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[270] Geoffrey G. Jones (n 175).

[271] Ben Terra and Peter Wattel (n 60) 452.

[272] "*Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and third countries shall be prohibited. (2) Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and third countries shall be prohibited*" Article 63 (1) (2) TFEU

[273] Ben Terra and Peter Wattel (n 60) 39.

[274] Test Claimants in the FII Group Litigation, C-35/11, EU:C:2012:707, paragraph 92.

[275] Ben Terra and Peter Wattel (n 60) 40.

[276] John B. Goodman, Louis W. Pauly. *The Obsolescence of Capital Controls?: Economic Management in an Age of Global Markets*. World Politics, Volume 46, Issue 1 (Oct., 1993), 50-82. 55.

[277] In Europe the EU Parliament and the Commission already proceeded with the enactment of a fourth Directive on the subject. Directive 2015/849 on the Prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

[278] In 2014 in Brazil (after the so called Lava Jato "*car wash*" operation started, the Brazilian federal policy, with the cooperation of other countries, such as Switzerland, Austria, USA etc, exchanged information on the transferring of proceeds of illicit activities to those countries. Private undertakings (builders, meet processors etc) paid congressman in order to have special benefits with public banks (loans with subsidized rates) and on the passing of tax laws which granted rebates or the possibility to adhere to instalment plans over long periods of time over unpaid tax. Such operation would never have been possible without the close cooperation of public authorities.

[279] Except for the free movement of goods which consists of six steps.

may impose discriminatory measures capable of hindering or making the exercise of fundamental freedoms less attractive, insofar the criteria established in the *Gebhard* case is followed.[280]

7. Other provisions[281]

There are a number of other provisions throughout the Treaty that are relevant as far as taxation policies are concerned, for instance, MSs may grant a tax exemption in order to enhance economic activities. Article 107 TFEU provides that "any aid granted by a Member State or through State resources in any form whatsoever which distors or threatens to distord competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Members States, be incompatible with the internal market." The problem of State Air will be properly addressed to in other parts of this investigation. Articles 110 to 113 TFEU precludes MSs imposing directly or indirectly taxes on similar products from other MSs as well as levying taxes that renders a indirect protection of domestic products. The matter was already subjected to discussion in this investigation (free movement of goods. Articles 114 to 118 TFEU provides for an approximation of laws as a means of achieving legislation harmonization. According to Article 115 TFEU "tax harmonization can be realized through directives only".[282] Article 179 (1) and 179 (2) TFEU create also implications to tax law, stating that the Union shall strengthen technological and scientific research by "permitting researches to cooperate freely across borders and at enabling undertakings to exploit the internal market potential to the full, in particular through the opening-up of national public contracts, the definition of common standards and the ***removal of legal and fiscal obstacles to that cooperation***"(emphasis added). Articles 191 and 192 TFEU imposes upon the Union the obligation to pursue responsible environmental policies of a preventive nature, under the maxim that any "environmental damage should as a priority be rectified at source and that the polluter should pay" (***polutter pays principle***).[283] Directive 2003/87/EC[284] is a result of such policies, that is, companies undertaking activities listed in the Directive (energy activities,[285]

[280] Ben Terra and Peter Wattel (n 60) 33.
[281] Ben Terra and Peter Wattel (n 60) 12.
[282] Cécile Remeur (n 127) 7.
[283] Ben Terra and Peter Wattel (n 60) 13.
[284] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (Text with EEA relevance).
[285] Within the energy industry (energy extractive industry), mineral oil refineries generate substantial amounts of greenhouse gas. Such refineries "convert natural raw material such as crude oil and natural gas into usable saleable products" such as fuel for cars, aeroplanes, ships, combustion fuel for generating heat and power to commercial and domestic use, materials for chemical and petrochemical insdustries, parafins, lubricatings oils energy in the form of heat (steam) and power (electricity). *Best Available Techniques (BAT). Reference Document for the Refining of Mineral Oil and Gas.* Industrial Emissions Directive (Integrated Pollution and Control). JRC Science and Policy Reports. Institute for Prospective Technological Studies. (2015) http://eippcb.jrc.ec.europa.eu/reference/BREF/REF_BREF_2015.pdf. (Accessed in 23 Sep 2017). Pag. 1.

production and processing of ferrous metals,[286]mineral industry,[287] and other activities such as industrial plants for production of paper, pulp from timber, fibrous materials etc), may not function "unless its operator holds a permit issued by a competent authority".[288] In sum, taxation is an important instrument for promotion and control of environmental policies. Initiatives such as the "The Green Fund Scheme" in The Netherlands provides companies that undertake environmental friendly initiatives lower interest rates on green projects (project that generate positive effects on nature and environment - *green money*),[289] tax incentives (exemption) on capital gains on green bonds etc.[290] A number of EU members also grant other types of subsidies, tax credits, tax deductions, exemptions etc, as environmental promotion tools. [291] The provisions on enhanced cooperation (Articles 326 to 334 TFEU) improved the effectiveness, transparency and enforcement of Union law. It is fair to say that tackling unilaterally tax avoidance and evasion, would ultimately lead to a complete failure of such public policies, for the truth is that the problems confronted by authorities surpasses the MSs' ordinary abilities in addressing such instances. For example, the use of hybrid mismatches operated by MNEs in order to avoid taxation would prove to be impossible, for it is under this grey area, this legal vacumm, this lack of cooperation and coordination in the international tax system, that such groups are able to manipulate, twist and exploit legislation differences to their benefit, and the result of such exploitation is very clear, revenue reduction, negative impact on competition, efficiency, transparency and fairness.

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[286] The production and processing of ferrous metals such as *metal ore* (aggregating mineral containing ferrous metals – iron, and non-ferrous metals – Copper, Nickel, Zinc, Aluminium, Gold, Silver, Uranium etc), *pig iron* (semi-finished, pig resemblance, metal produced from iron before further refined into steel), or *steel* (carbon, structural, stainless, ferritic, austenitic, and alloy types), generate great quantities of greehouse gas, therefore a permit to explore such activities is necessary. *Environmental data centre on natural resources.* http://ec.europa.eu/eurostat/web/environmental-data-centre-on-natural-resources/natural-resources/raw-materials/metal-ores. Accessed in 23 Sep 2017.

[287] Non-energy extractive industries are divided in three main groups, namely, *construction minerals* (sand, gravel and crushed natural stone), *industrial minerals* (baryters, kaolin, salt, magnesite, fluorspar, potash) and *metallic minerals* (see citation above). The cement industry is responsible for 5% of the total amount of carbon dioxide released into the atmosphere (337 million metric tons of carbon in 2007 – *Fact sheet. National Ready Mixed Concrete Association*), therefore, a permit is also required in order to explore such activity. *Minerals and non-energy extractive industries.* https://ec.europa.eu/growth/sectors/raw-materials/industries/minerals_en Accessed in 23 Sep 2017.

[288] Article 4. Directive 2003/87/EC.

[289] The fund finances agricultural projects, projects on sustainable mobility (cycle paths and parks, green engines), energy (wind turbines, solar cells, hydropower, etc), green homes projects (homes constructed with environmental friendly material and that involve water savings) etc. *The Green Funds Scheme. A success story in the making*. NL Agency. Ministry of Housing, Spatial Planning and the Environment (2010).https://www.rvo.nl/sites/default/files/bijlagen/SEN040%20DOW%20A4%20Greenfunds_tcm24-119449.pdf. Accessed in 23 Sep 2017. 7.

[290] The Green Funds Scheme. (n 289) 3.

[291] Green policies in the EU: A review. EC-IILS joint discussion paper series. No. 14. International Labour Organization. International Institute for Labour Studies. (2011) 11.

C. EU Legislation. Introduction

The number of direct taxation legislations within the internal market is scarce. A reason for this failure in producing a more harmonized direct tax legislation resides on the *subsidiarity principle*, previously studied in this investigation (see m. no. 5 et seq.). Moreover, Directives are only adopted on the ***unanimity basis,***[292] which makes even more difficult harmonization of direct taxation.[293] Direct taxes[294] are a useful tool in regulating the economy as well as public policies, therefore each MS retain the right to defend direct tax policies "*as if it were their virginity*".[295] The Parent-Subsidiary, Interest-Royalty and Merger Directives confirms the importance, necessity as well as the Commission's concern on the enactment of a clear corporate cross-border regulation to create a true internal market, where its players can properly and rightfully compete. For that matter, a proper policy on cross-border operations and a functional cooperation between MSs is imperative to the attainment of such objective. Despite its importance, notoriously a very limited number of harmonized rules in relation to direct taxation have been approved.

Positive Harmonization x Negative Harmonization. The harmonization on direct taxation rules within the internal market contributes positively to its proper functioning, making the tax system more transparent, eliminating obstacles to cross-border capital flows, double taxation and creating a more favourable business environment for small and medium-sized enterprises.[296] Such harmonization may be accomplished in common agreement (*Positive Harmonization*) or on an *ad hoc*/case-by-case basis,[297] that is to say, by the ECJ's rulings (*Negative Harmonization*). [298] The cost of achieving negative harmonization is generally higher when compared to its counterpart.

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[292] "(...) *All rules and conditions relating to the taxation of Members or former Members* ***shall require unanimity*** *within the Council*." (emphasis added) Article 223 TFEU.

[293] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 14.

[294] According to *J.S. Mill* "[T]axes are either direct or indirect. A direct tax is one, which is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another: such as the excise of customs. The producer or importer of a commodity is called upon to pay a tax on it, not with the intention to levy a peculiar contribution upon him, but to tax through him the comsumers of the commodity, from whom it is supposed that he will recover the amount by means of an advance in price. Direct taxes are either on income, or on expenditure. Most taxes on expenditure are indirect, but some are direct, being imposed not on the producer or seller of an article, but immediately on the consumer. A house-tax, for example, is a direct tax on expenditure, if levied, as it usually is, on the occupier of the house. If levied on the builder or owner, it would be an indirect tax. A window-tax is a direct tax on expenditure; so are the taxes on horses and carriages, and the rest of what are called the assessed taxes." John Stuart Mill. *Principles of Political Economy with some of their Applications to Social Philosophy*. William J. Ashley, ed. 1909. Library of Economics and Liberty: http://www.econlib.org/library/Mill/mlP65.html. Accessed in 8 March 2018.

[295] Ben Terra and Peter Wattel (n 60) 152.

[296] Ibid 151.

[297] Ibid 152.

[298] Without full harmonization of national direct tax policies, it is impossible to reach full capital movement neutrality. Case law plays an important role in such process, even though it conducts negative harmonization (more costly). Achieving capital move neutrality without a harmonized environment seems very unlikely.

The lack of action by the Legislative power imposes upon the Judiciary the duty and the necessity to act on matters that must not be left unsolved, for many times the good functioning of the society demands it. Is such cases, the Judiciary advances the red light, exercising the so undesired "*judicial activism*".[299] It is important to point out that judicial activism does not constitute in an overlapping of powers or competences in our opinion, but the strict respect and obedience of principles of law such as *inherent Jurisdiction* and *Non Liquet*. Generally, the ECJ does not solve situations that were up to the Council to regulate. The institute of "*Judicial Activism*" is used only (or at least it should) to lift restrictions and discriminations[300] on a case-by-case-basis on the event of a legal *vacuum*.[301] The ECJ must always operate under the "*Rule of Reason*" and leave the policy making process to the Council.

Primary and Secondary Legislation. One can also classify Primary and Secondary Legislation as ***hard law*** instruments, that is to say, statutes that impose a set of rights and obligations upon community members.[302] In sum, *Primary Law* consists mainly of the Treaty of the European Union (TEU),[303] Treaty on the Functioning of the European Union (TFEU)[304] and the EU Charter of Fundamental Rights.[305] The *Charter* as well as both treaties are the product of decades of historical, political, economic developments and reforms. The

[299] The problem of usurpating the enactment of laws attributed to the Legislative by the Judiciary power was subjected to a deep and extent examination by *Jose Carlos Nicola Ricci*, who analysed its positive and negative results on Brazilian Courts. According to the author "[T]he proper functionality of constitutional guarantees (…) raises the power of the Judiciary in relation to its overseeing duties towards public sector administrative acts [positive or negative acts] (…). To that respect, the broadening of such function do not necessarily represents an inappropriate overlapping of powers (…) but the effective control and proper function of the State." Jose Carlos Nicola Ricci. *O exame do merito administrative pelo judiciario.* Marilia, SP (2013) 81.

[300] Ben Terra and Peter Wattel (n 60) 23.

[301] When analysing the Legislative Function of the Chief of the Executive Department, *Hans Kelsen* defends the idea that there is no such thing as a legal *vacuum,* therefore if there is no obliging legal order, the individual, in theory, is "*legally free*". Thus the coercion of an individual without a pre-defined legal order is an illegality in itself. "Insofar as the legal order is silent it constitutes a sphere of individual liberty". Hans Kelsen (n 34) 271.

[302] In The General Theory of Law and State, *Hans Kelsen* recognizes that the law is in principle a "specific social technique of a coercive order", where its effectiveness is conditioned upon the "evil applied to the violator of the order when the sanction (….) socially organized consists in a deprivation of possessions – life, health, freedom or property." Hans Kelsen (n 34) 18.

[303] Treaty of the European Union (TEU) (n 26).

[304] Treaty on the Functioning of the European Union (TFEU).

[305] ***EU Charter of Fundamental Rights*** is a relatively new statute enacted in 2000, which entered into force in 2009. The charter has the same value as other EU treaties (TEU and TFEU). Nonetheless it does not contain provisions on direct taxation. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 15.

Secondary Law statutes include Directives,[306] Regulations[307] and the Arbitration Convention. Such Statues are of a ***legally binding to MSs***.[308]

Tax Coordination Instruments, also referred to as ***soft law***, such as recommendations, [309] communications, [310] international agreements, [311]

[306] There are two groups of ***Directives*** in force. First Group: (1) *Obstacles Removing Directives* (Parent-Subsidiary Directive, Merger Directive, and Interest and Royalties Directive). Second Group: (2) *Cooperation Enhancing Directives* (Mutual Assistance Directive, Recovery Assistance Directive and Savings Directive). Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 19.

[307] Although ***Regulations*** are an important source of hard secondary law, till the present day not a single direct tax regulation was issued. Although not directly tax related, two important Regulation Statutes are worth mentioning, namely *SE* and *SCE* Regulations.

[308] In order to exercise the Union's competences, the institutions may adopt regulations, directives, decisions, recommendations and opinions. Article 288 TFEU.

[309] In 1993 the Commission issued two ***Recommendations*** on the *taxation or certain items of income received by non-residents in a Member State other than that in which they are resident* (94/79/EC) and on the *tax treatment of SME* (94/390/EC). The **former** "*advised*" MSs to treat non-resident individuals as residents for income tax purposes (to the extent that they earn at least 75% of their income in that State. *Article 2.1* and *2*). The recommendation also provides for deduction/credit benefits to non-residents and covers only active income (income derived out of employment relations, sale of goods and services etc - Article 3). Although non-binding, recommendations have great influence on tax authorities actions and are most definitely used by courts of law, especially the ECJ (nevertheless they avoid referring to its text as a legal source). Landmark judgments such as the *Schumacker* and *Wielockx* cases are examples of the recommendation's effect. In *Schumacker* the ECJ ruled that "*1. Article 48 of the EEC Treaty must be interpreted as being capable of limiting the right of a Member State to lay down conditions concerning the liability to taxation of a national of another Member State and the manner in which tax is to be levied on the income received by him within its territory (...) to treat a national of another Member State employed in the territory of the first State in the exercise of his right of freedom of movement less favourably than one of its own nationals in the same situation.*" Note that the recommendation's wording is not expressively mentioned, nonetheless its spirit is most definitely noticeable. *Finanzamt Köln-Altstadt* v. *Schumacker* Case C-279/93. As for the **latter,** namely Recommendation 94/390/EC, provides for non-incorporated businesses subjected to progressive tax on income (*partnerships*) therefore enduring a higher income tax when compared to incorporated companies. SMEs are clearly in an unfavorable position when competing against large undertakings for various reasons. Ilan Goldfajn (current president of the Brazilian's Central Bank), while commenting on the possibility of the enactment of a new "system segmentation regulation" in the banking sector [***more complex rules to more complex banking structures such as multi-purpose banks (investment, financing, retail etc) and less complex rules to simpler structures such as factoring***] aiming at fighting the current and evident oligopolistic Brazilian financial market, which is likely to harm consumer welfare, raise prices, degrade the quality of products and services, limit innovation and deprive consumers of choice, said recently in an interview given to a major Brazilian television network that "*the level of complexity applied to small companies should be lower in relation to the one applicable to large enterprises*". The European Commission, which has a fundamental role in developing secondary law measures in relation to the Treaty's freedoms, as well as overseeing the application of Union's law (Article 17 (1)(2) TEU), added four possible growth problems encountered by SMEs Recommendation 94/390/EC, namely: (i) administrative complexity and compliance costs, (ii) inability in producing guarantees in order to raise capital, (iii) continuation problems (death of a partnership owned by a single natural person) and (iv) difficulties in conducting cross-border operations. *The improvement of the fiscal environment of small and medium sized enterprises. The proper tackling of such limitations certainly enhances the survival chances of SME, to the ultimate benefit of the EC as a whole*. Communication from the Commission to the Council and the European Parliament. Com (94) 206 final. http://aei.pitt.edu/4741/1/4741.pdf. Accessed in 23 Sep 2017.

[310] ***Communications*** are basically explaining notes written by the Commission, describing to the general public current EU policies (policies on human rights, State aid, competition etc). In

conventions, codes of conduct,[312] action plans, explanatory notes, consultations etc, although ***not legally binding*** (with the exception of the Arbitration Convention), furnishes intelligence which transcends the capabilities of MS were

relation to tax law, the Commission has in 2010, issued a communication on the promotion of good governance in tax matters. Its main goal was to recommend MSs to protect the EU's financial system from non-transparent, non-cooperative and loosely regulated jurisdictions, including offshore centers, thus tackling avoidance and evasion. Although the Commission refers to the 2008 economic crises and the increasing economic integration process (globalization) as the main reasons for its concern, there was (and still is) a growing security concern amongst developed Nations to be solved. Non-transparent, non-cooperative and loosely regulated jurisdictions are not only problematic due to difficulties in tax related matters, but also due to a lack of cooperation on other fronts such as money laundering and terrorism. Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee. Tax and Development. Cooperating with Developing Countries on Promoting Good Governance in Tax Matters. COM (2010) 163 final. https://ec.europa.eu/europeaid/sites/devco/files/communication-good-governance-tax-matters-com2010163-20100421_en.pdf. Accessed in 23 Sep 2017.

[311] ***International Agreements*** are understandings between the EU and third-States. Important examples of such agreements are the *European Free Trade Area* (EFTA), currently formed by Norway, Lichtenstein, Iceland and Switzerland and the *European Economic Area* (EEA), formed by Norway, Lichtenstein and Iceland (the agreement was rejected by Switzerland in 1992). Both EFTA and EEA (the last created to involve the participant States in Europe's economic integration) are considerably similar the TFEU. Provisions on the discrimination on grounds of nationality, fundamental freedoms, State aid and on competition are included in such Treaties. Nonetheless, the rulings of the ECJ as well as primary and secondary law, do not bind the participant States. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 23.

[312] ***Codes of Conduct*** have no binding power over MSs whatsoever. Such legal instruments serves mainly as a gentleman's agreement, that is to say, a political commitment in which MSs "ought comply". Examples of Codes of Conduct are: *Code of Conduct on Business Taxation* – Conclusions of the ECOFIN Council Meeting on 1 December concerning taxation policy (98/C 2/01), and two codes produced by the EU Joint Transfer Princing Forum (JTPF) – advisory group to the Commission on transfer pricing -, the *Revised Code of Conduct on the elimination of Double Taxation* – Revised Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (2009/C 322/01) - and the *Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union* [COM(2005) 543 final]. The first code, namely, *Code of Conduct on Business Taxation,* requires MSs to "***rollback***" on already existing harmful tax measures and abstaining (***standstill***) from introducing new measures that have a potential detrimental effect on the internal market. According to the document, measures should be deemed as harmful when: (1) tax advantages are granted only to non-residents, or in respect of transactions conducted by non-residents, (2) ring-fenced advantages are granted in relation to the relevant domestic activity (ring-fenced advantages prevent the erosion of the domestic tax base, nevertheless it erodes other States' bases - *beggar thy neighbour* – (*I drink your milkshake!*), (3) tax benefits are granted without any substantial economic advantage, (4) lack of arm's length prices are observed, that is, contrary to international rules (OECD rules on the determination and allocation of profits) and finally (5) lack of transparency is notably observed (relaxation of tax rules at an administrative sphere in a non-transparent and discriminatory manner. The second mentioned code, prepared by the EU Joint Transfer Pricing Forum (JTPF), was named as *Revised Code of Conduct on the elimination of Double Taxation.* The Council, acknowledging the importance on the proper interpretation of the *Arbitration Convention*, adopted such *code* in order to provide MSs' tax authorities guidance on matters regarding transfer pricing issues such as penalties, interests charged or credited by tax authorities. The JTPF proposed that such arbitral proceedings be concluded within a three-year period. As for the third code, namely, *Code of Conduct on Transfer Pricing Documentation for Associated Enterprises,* have standardized the process of providing TP documentation, in order to reduce compliance costs.

they to act uncoordinated, therefore these instruments contribute to the better functioning of the EU's direct tax system.[313]

1.Parent/Subsidiary Directive

The EU Parent-Subsidiary Directive was first proposed in 1969 with the purpose of eliminating cross-border disincentives towards undertakings conducting business across the EU, such as double taxation on profit distribution of profits[314]. The first draft provided some situations that no longer make part of the present directive, such as transition rules, the prohibition of dividend withholding tax etc. Article 1 of the Directive uses of the term "***distributions of profits***". The term should be read in a broad manner, that is to say, whichever benefit that a subsidiary, PE etc of a MS receives from a parent company, subsidiary or PE located in another MS,[315] shall benefit from the Directive's wording (provided that the prerequisites for its application are are met – *listed in the Annex*, *resident* and *subjected to corporate tax*). In other words, the Directive exempts intra-group cross-border dividend payments from withholding taxes, through the use of two relief methods, either by full exemption, or by granting a full tax credit.[316] Article 2 of the Directive states that, in order to be considered a company of a MS and benefit from the Directive's tax exemption, the entity must meet ***cumulatively*** the following requirements: (i) *be listed in the Annex of the Directive,*[317] (ii) *be a resident of that MS*[318] *and* (iii) *be subjected to corporate taxes*.[319] A proper interpretation and application of the Parent-Subsidiary Directive is a fundamental factor in the Internal Market's harmonization process, and the incorrect application of such legislation has been defined as one of the main impediments against a true and pure harmonized system. Here, the ECJ plays also an important role, for is up to the Court to clarify important concepts regarding the Directive's wording. For

[313] Cécile Remeur (n 127) 6.

[314] The term "*distribution of profits*" should be read extensively, that is to say, it should include any form of payment or transfer of benefits from a qualifying PE/Subsidiary to its parent company. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 140.

[315] COM (2001) 582 final 316.

[316] Ben Terra and Peter Wattel (n 60) 337.

[317] The *Annex* lists in general Limited Companies and Limited Liability Companies (*Aktiengesellschaft* (AG) respectively, *Gesellschaft mit beschräkter Haftung* (BmbH)). Ben Terra and Peter Wattel (n 60) 338.

[318] In order to benefit from the Directive, the company must be a resident under treaty and domestic law (treaty access test). If the company is considered to be a resident of both contracting States the tie-breaker rule must be applied, that is to say, the State where the company effectively manage its business breaks the tie (Art 4(3) OECD Model). Being a resident of both contracting States means ***that the company is a tax-resident in both jurisdictions under the relevant multi-lateral or DTC***. The ***dual-residence approach*** is not permitted for it allows companies to organized their corporate structure in such a way to avoid taxation, that is to say, the company could benefit from the Directive as well as obtain other tax benefits in jurisdictions outside the internal market. Nevertheless, if both companies are residents for tax purposes of two MSs, the group will not be excluded from the Directive's benefits. The same applies to dual-resident companies that are resident for tax purposes under jurisdictions without a DTC contracted, for there is nothing to prevent the tax administration of a MS to apply full statutory tax rate (STR) in its absence. Ben Terra and Peter Wattel (n 60) 339.

[319] The Directive lists corporate tax nomenclature throughout the Union. The second part of paragraph (iii) prohibits MSs to substitute CIT for any other tax with the same effect.

example, the term "***exemption***" was analysed by the court in the *Cobelfret* case, "***withholding tax***" in the *Epson Europe*, *Athinaiki Zithopoïaa* and *Oce van der Grinten* cases, "***ownership of the shareholding***" in the *Vergers du Vieux Tauves* case, "***listed companies***" in the *Gaz de France* case and "***holding period***" in the *Denkavit and other* cases.[320]

Case C- 170/05 Denkavit Internationaal v. Ministre de L'Economie[321]

1- Denkavit Internationaal, a company specialized in the feed for young animals (veal calves, breeding calves, piglets, lambs etc) owned 50% of the capital of Denkavit France and 99% of Agro Finances. Agro Finances owned the other half of Denkavit France. Between 1987 and 1989, Denkavit France and Agro Finances merged and paid a total of FRF 14 5000 000 to Denkavit Internationaal resident in the Netherlands. The fact of the matter is that the French tax administration applied the Franco-Netherlands DTC which grants France limited taxation rights (5% on distributed dividens considering a control higer than 25%), which amounted to FRF 725 000. Denkavit Internationaal followed all procedural instances and the case was ultimately referred to the ECJ for a preliminary ruling under Article 267 TFEU.
2- "Is a provision which imposes the burden of taxation on a parent company in receipt of dividends which is not resident in France, while relieving parent companies which are residents in France of a similar burden, open to challenge in the light of the principle of freedom of establishment (…)"[322] even though the relevant Franco-Netherlands DTC grants the source limited taxation rights upon dividend distribution?
3- Yes.
4- The principle of supremacy of EU legislation provides for the overriding of international legislation contrary to Union Laws, therefore it cannot be relied upon as to impose upon residents and non-resindents differential treatment (discrimination). As the ECJ rightly stated "(…) in the absence of harmonizing measures at Community level and of conventions concluded between all the Member States for the purposes of the second indent of Article 293 EC, the Member State retain the competence for determining the criteria for taxation on income with a view to eliminating double taxation by means, inter alia, of international conventions. In those circumstances, the Member State remain at liberty to determine the connecting factors for the allocation of fiscal jurisdiction by means if bilateral agreements (…). The fact remains that, as far as the exercise of the power of taxation so allocated is concerned, the Member States may not (…) disregard Community rules (…). In particular, such an allocation of fiscal jurisdiction does not permit Member States to introduce discriminatory measures which are contrary to the Community rules. (…)",[323] therefore "imposing a liability to tax on dividends paid to a non-resident parent company and allowing resident parent companies

[320] Denkavit International v Bundesamt für Finanzen, ECR I-5063. ECJ C-283/94, C 291/94 and 292/94,
[321] Denkavit Internationaal v. Ministre de L'Economie, Case C- 170/05 ECR I-11949.
[322] Denkavit. Case C- 170/05 Para. 16.
[323] Denkavit Case C- 170/05. Paras. 43 and 44.

almost full exemption from such tax, *constitutes a distriminatory restriction on freedom of establishment*"[324] (emphasis added).

a. Company of a MS (Parent Company - PC)

The definition of Parent Company (PC) is a particularly important to tax law. Article 3(1)(a) of the Parent-Company Directive states that, "***the status of parent company shall be attributed****: (i)* at least to a company of a Member State which fulfills the conditions set out in Article 2[325] and has a minimum holding[326] of 10% in the capital of a company of another Member State fulfilling the same conditions; (ii) under the same conditions, to a company of a Member State which has a minimum holding of 10% in the capital of a company of the same Member State, held in whole or in part by a permanent establishment of the former company situated in another Member State" (emphasis added). Important concepts of the above rule, namely, holding in the capital of the company of another MS (and others such as period of holdings),[327] have been subjected to the ECJ for a preliminary ruling. In the *Les Vergers du Vieux Tauves SA* case, the court held that the definition of holding to include the holding of shares in usufruct.[328] As for the latter, namely, holding period requirements, the court clarified that dividends paid by German subsidiary to its PC in the Netherlands were not covered by the directive due to the fact that the dividends were paid before the 12-month holding period.[329]

b. Subsidiary

A subsidiary company is a separate entity, independent from its PC. Such entity maintain a separate status in relation to its parent. Contrary to PEs, the vast majority of MSs do not permit cross-border loss relief for subsidiaries. Only Denmark, France, Austria and Italy, allow cross-border loss relief regimes under certain conditions under deduction/reintegration method. ***Tax-connecting factor*** adopted by Union Law is the ***residence criteria***, which is expressively mentioned on the Directive's wording.[330]

c. Permanent establishment - PE (Branch).

When an undertaking resident of a MS, makes an investment decision of initiating operations in other MS, a start-up business, for instance, the investor may opt for fixing a permanent-establishment (PE). Permanent Establishments can be defined as a fixed place of business located in a MS through which the

[324] Case C- 170/05 Denkavit. Paras. 41.
[325] Must be listed in the directive, must be a resident of a MS for tax purposes, be subjected to tax according to the directive's list without being exempt.
[326] Contrary to the Interest and Royalties Directive, which provides for direct and indirect holdings, the Parent-Subsidiary Directive do not differentiate direct from indirect holdings.
[327] Parent-Subsidiary Directive Article 3(2)(b).
[328] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 137.
[329] CJEU, 17 October 1996, Joined Cases. C-283/94, C-291/94 and C-292/94, Denkavit, VITIC and Voormeer, ECLI:EU:C:1996:387.
[330] Ben Terra and Peter Wattel (n 60) 70.

activities of a company of another MS is conducted. [331] Permanent-establishments (branches) are not separate/independent entities and its liabilities are connected to the parent company. A threshold of 10% of capital holdings is imposed by the Direcive in order for the parent company to be eligible to its benefit.[332] The vast majority of MSs allow PE's losses to be relieved under a credit, exemption or deduction/reintegration method. Such methods will be properly analyzed in other parts of this investigation. The OECD Model defines a PE as "*(…) a fixed place of business through which the business of an enterprise is wholly or partly carried on."* [333] As previously mentioned, the Parent-Subsidiary Directive requires a minimum holding threshold of 10%. Most MS apply a ***dual-approach*** in relation to holding thresholds, in other words, a Company of a MS may detain either the minimum required amount of "*capital*" or "*voting rights*". Objective temporal requirements such as the necessity of maintaining the associated company status for a minimum period of time (2 years) is also mandatory.[334] Contrary to the Royalties Directive, the Parent-Subsidiary Directive and ***do consider indirect holding partnerships eligible to benefit from the Directive's exemption***.

2. Interest and Royalty Directive

The Interest and Royalties Directive[335] provides source State tax exemption for interest and royalty payments made out by a company or a PE located within the internal market, to an associated company or another PE resident in another MS. In order to be covered by the Directive, undertakings must meet ***cumulatively***, the following requirements: (i) be listed in Directive's *Annex,*[336] (ii) be resident for tax purposes and (iii) be subject to tax conditions.[337]

Being a resident for tax purposes. If the company is not a resident for tax purposes, it will not be able to benefit from the Directive's exemption. An interesting situation is considered by *Dimitar Hristov* regarding partnerships (unincorporated tax-transparent companies) as to whether or not "may benefit and fall within the scope of the Interest and Royalty Directive".[338] According to

[331] Council Directive 2003/49/EC of June 2003 on a common system of taxation to interest and royalty payments made between associated companies of different Member States. Article 3 (c).
[332] Directive 2011/96/EU. Article 3 1 (a) (i) (ii).
[333] The term establishment may also be understood as: (a) place of management; (b) branch; (c) office; (d) factory; (e) workshop and a (f) mine, oil or gas well, a quarry or any other place of extraction of natural resources. OECD Tax Model Article 5(2).
[334] Parent-Subsidiary Directive Article 3(2)(b).
[335] Council Directive 2003/49/EC of June 2003 on a common system of taxation to interest and royalty payments made between associated companies of different Member States. Article 3 (c).
[336] The Annex presents an exhaustive list of companies, whereas the companies not listed, may not enjoy the Directive's benefits. The SE and SCE, although not yet listed will be included shortly in the Directive. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 187.
[337] The company must be subjected to one of the taxes listed in Article 3(a) (iii) and not be exempt from such tax. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 189.
[338] **Partnerships** were the first Community legal corporate form agreed amongst MS. In 1985 the Council adopted Regulation 2137/85/EEC on the European Economic Interest Grouping (EEIG). The regulation versed over possible cooperation schemes between companies or professionals of different MSs. Such partnerships, according to the Regulation's wording, have no legal personality, must have a limited number of employees (500 employees permitted) and its members are also liable for its obligations. Moreover, the EEIG's activities must be ancillary in relation to the activities of its members. The goal of this entity form was to facilitate the

the author, the Directive is applicable regardless, that is to say, even though the statute of some MSs do not treat partnerships as taxable entities, to deny such entities the Directive's benefits infringes Article 3(a)(i) Interest and Royalty Directive. Moreover, denying such benefits to partnerships, infringes the Treaty's spirit as well as fundamental freedoms such as the free movement of capital and payments and freedom of establishment.

Subjected to tax conditions. The company must collect the tax listed in Article 3 (a)(iii) "or (…) a tax which is identical or substantially similar and which is imposed after the date of entry into force of the Interest and Royalty Directive in addition to, or in of, the taxes listed in Art. 3(a)(iii)" and not be exempt.[339] The term "*without being exempt*" makes reference to the company itself and not the income *per se*. However, it is argued whether the term "*subject to tax contitions"* relates to company itself as being personally tax exempt (subjective requirement) or whether the company's income being tax exempt (objective requirement). [340] According to *Dimitar Hristov,* "it is clear that the subject-to-tax requirement is a subjective one. This interpretation can be inferred from the wording of the introductory sentence of Art. 3 (a) in conjuction with Art. 3 (a) (iii), which defines the term 'company of a Member State' as 'any company which is subjected to tax to one of the following taxes without being exempt'".[341]

Contrary the Parent-Subsidiary Directive,[342] the holding threshold of the Interest and Royalty Directive is currently[343] at 25%. Most MSs apply a dual-approach in relation to holding thresholds, in other words, a Company of a MS may detain either the minimum required amount of "*capital*" or "*voting rights*" (25% according to Article 3 (b) Interest and Royalty Directive). Objective temporal requirements such as the necessity of maintaining the associated

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improvement of the economic activities of its members and not to improve its results. Such partnerships cannot hold shares of other undertakings. [Ben Terra and Peter Wattel (n 60) 423]. The EEIG is transparent for accounting purposes, that is, the entity is not liable to taxation but its members, in other words, "***they are not taxable entities but used for the purpose of computing taxable income to be attributed to the partners***". Partnerships are generally formed (or at least should) by lawyers, architects, accountants etc. Generally, ***partnerships*** are economic entities formed by one partner with unlimited liability. There are several definitions to partnerships throughout Union such as: (**i**) *civil law partnerships* (group of people not organized in a specific legal form that generates income, for instance, lawyers, doctors etc), (**ii**) *general or ordinary partnerships* (one or more entrepreneurs with unlimited liability), (**iii**) *limited partnerships* (some partners have unlimited and others limited liability. The limited liability partner may be a limited liability company in some countries), (**iv**) *silent partnerships* (the company does not conduct its activities as a partnership properly, nonetheless one of the partners will have unlimited liability whereas other partners may have limited or underlimited liability), (**v**) *sleeping partnerships* (a partner that is not made known to contractors). Some jurisdictions treat partnerships as "taxable units" and in some cases as companies (OECD Commentaries pag 45) therefore attracting tax liability to such entities instead to its partners. COM (2001) 582 final 301.

[339] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 189.

[340] Ibid 189.

[341] Ibid 189.

[342] Holding threshold of 10% is required.

[343] A pending amendment proposal intends to change the 25% threshold rule to 10% as well as extending the benefits to indirect holdings. Proposal for a Council Directive on a common system of Taxation applicable to interest and royalty payments made between associated companies of different Member States. COM(2011) 714.

company status for a minimum period of time (2 years) are also mandatory.[344] Again, contrary the Parent-Subsidiary Directive, the Interest and Royalties Directive ***do not consider*** indirect holding partnerships eligible to benefit from the Directive's exemptions.[345] According to the Parent-Subsidiary Directive dividends paid from a subsidiary to a parent company are exempt, in so far the minimum holding control threshold is respected. The 25% control (Directive 90/435/EEC) was lowered to 10%, according to the present amended version (Directive 2011/96/EU), which has been beneficial to undertakings.

3. Merger Directive

The matter of business reorganizations has stirred great debate among the European Community. Directive 90/434 EEC 1990, (amended by directive 2005/19 EC) created a uniformed tax system to be applied in mergers, transfer of assets, divisions of undertakings and exchange of company shares to cross-border transactions, therefore ***domestic reorganizations are not covered by the Directive***.[346] In order to be eligible and benefit from the Directive's exemptions and deferrals, the same three Parent-Subsidiary and Interest and Royalty Directives' main requirements are here also mandatory, namely, (i) *be listed in the* Directive's *Annex*, (ii) *be a resident for tax purposes* and (iii) *be liable to those taxes listed in the* Directive's *Annex*. Nevertheless, contrary to the Interest and Royalty[347] and Parent-Subsidiary Directives,[348] "*the Directive* (Merger) ***does not require that these three conditions be met within one and the same national tax jurisdiction***."[349]

According to Article 2 Merger Directive, only the following operations are covered by the Statute: *mergers*, *total divisions*, *partial divisions*, *transfer of assets*, *exchange of shares* and *transfer of the registered office of a SE or SCE from a MS to another*. This operation list is exhaustive, that is to say, non-listed operations are excluded from the Directive's exemption/deferral benefits.[350] Note that in most restructurings there is no movement of assets between MSs. Generally in corporate restructurings, tangibles and intangibles remain in the relevant MS, that is, only the ownership of those assets is transferred. The Directive's scope of application has already been subjected to the ECJ for a preliminary ruling in the *Andersen og Jensen, Leur-Bloem* and others.[351]

Legal Mergers. Mergers can be defined as corporate restructuring operations where one company transfers the totality of its assets and liabilities to another company, whereas the ***transferor is dissolved without being liquidated***. The transferee, in exchange for the received assets issues shares to

[344] Interest and Royalties Directive Article 1(10).
[345] An example of such indirect holdings is given by *Dimitar Hristov*: "*(...) if a parent company is holding a participation in a subsidiary company through an intermediary (non-transparent) partnership or if a grandparent company is holding a participation in a sub-sub-subsidiary through an intermediary company*." Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 191.
[346] COM (2001) 582 final 224.
[347] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 187.
[348] Ibid 135.
[349] Ben Terra and Peter Wattel (n 60) 384.
[350] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 160.
[351] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 20.

the transferor's shareholders. [352] Article 2(a) provides for three different forms of mergers, namely, when (i) *one or more companies merger into a pre-existent company*, or when (ii) *two or more companies merge forming ultimately a new company* and (iii) *quasi-liquidation (up-stream merger) instances*.[353] Additional 10% cash pay-out "*boot"* is allowed by the Directive.

Partial and Total Divisions. Total and partial division restructurings are covered by Article 2(b) and (c) of the Directive. In *Total division* restructurings, one company transfer all its assets[354] and liabilities to two or more new or already existing undertakings in exchange for shares and ultimately ceases to exist[355] (without being liquidated). *Partial divisions* were not covered by the original version of the Directive and it was added in 2005 under the wording of Article 2(c), which defines the operation as a transfer of one or more branches of activity[356] to one or more existing or new companies, without being dissolved and leaving at least one operating branch in the transferor's independent operation. In this situation, the transferred company do not ceases to exist. Such restructuring is often referred to as *split-off*.[357] Additional 10% "*boot"* allowed.

Transfer of Assets is covered by Article 2(d) of the Directive. Here, a company transfers all or one of its branches to another existing or newly established company, without dissolution or ceasing to exist.[358] In return, the company receives shares of the transferee (in this situation, it is not the shareholders who receive the transferee's shares, but the transferor company itself). Such operation consists essentially in the transfer of branches of the relevant company's activities "in exchange for the transfer of securities representing the capital of the company receiving the transfer", thus ***NO*** additional cash pay-out "boot" is permitted. Member States have the discretionary power whether or not to allow cash payments on transfer of assets restructurings.[359]

Share Exchange. When acquirer issues shares from its own capital to the shareholders of the acquiree (target company) so that they become shareholders of the acquirer, and consequently turning the acquired company into a

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[352] Ben Terra and Peter Wattel (n 60) 377.

[353] Despite the fact that Article 2 (a) (i) (ii) requires the issue of new shares, the rule should be read extensively, allowing thus the transferring of existing shares in exchange of assets. Ben Terra and Peter Wattel (n 60) 378.

[354] The term "*transfer of assets*" refers only to related assets. Unrelated assets are not covered by the Directive. Ben Terra and Peter Wattel (n 60) 378.

[355] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 161.

[356] According to Article 2 (j) Merger Directive, a "branch of activity" must be considered as an independent and functional business, therefore the transfer of one single asset, do not constitute a "*branch*" *per se*. The above "*functional business*" definition does not provide a complete and unambiguous understanding of *"branch"*. For instance, questions such as: can a company that conducts operations of a passive nature (holdings, investments portfolio) be referred to as a branch within the meaning of the Directive? Or is it mandatory that the *"branch"* be a manufacturer or distributer, that is to say, consumer orientated? The answer to both questions is: both approaches are possible. The Directive does not make such distinction. Nevertheless, if the authority of the relevant MS identifies an abuse bias, it may deny or withdraw benefits. The anti-abuse rule (GAARs) will be properly studied on other parts of the investigation Accessed in 23 Sep 2017.

[357] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 161.

[358] Ibid 162.

[359] Ben Terra and Peter Wattel (n 60) 381.

subsidiary. This restructuring corporate operation is called *Share Exchange*.[360] The share exchange provision is conditional upon the fulfillment of the majority voting rights rule, regardless if it is a one share swap operation or an increase from 51% to 100% of holding.[361] Additional 10% "*boot*" allowed.

Transfer of Registered Office of an SE and SCE. A proper and complete study *of* Societas Europea *SE* and Societas Cooperative Europea *SCE,* would certainly fall outside the main objective of this investigation. In sum, the transfer of the registered office of *SE* or *SCE* from one MS to another is also possible according to Article 12(1)(a)(b) Merger Directive and shall "not give rise to any taxation of capital gains, calculated in accordance with Article 4(1)".

Additional 10% "Boot". As previously discussed, a merger consists of a fusion between two or more undertakings into a pre-existent or new company or when the subsidiary is simply incorporated (up-stream merger). Generally, such operations are performed by dividing, partially dividing or exchanging shares. Nevertheless, the share value of the acquirer company do not always matches the share value of the acquiree. Such value differences may prevent corporate restructurings within the single market from occurring. For that matter, the Directive provides for an additional cash payment to the acquiree's shareholders up to 10% of the nominal share's value at the time of the restructuring. According to *Wattel/Terra* "[A]dditional cash payments are allowed only in ***legal merger***, ***legal divisions*** and ***share exchange operations***. For an *assets transfer* to qualify under the Directive, the consideration for the transferred branch of activity may solely consist of 'securities representing the capital of the receiving company'. Therefore, in order to secure the Directive's benefits, no cash payment must be made in the case of an asset transfer (unless a Member State chooses to give the Directive a wider scope in its implementation legislation than required".[362] The Directive does not provide for whether the 10% "boot" can be unevenly distributed among the shareholders, which could "be used to buy out an unwelcomed minority shareholder in the transferring/acquired company".[363] To conclude, any supplementary cash payment may be taxed and no "tax deferral relief applies (…), because there is no need for deferral: the cash has been actually received, and tax can therefore be paid out".[364]

4. Mutual Assistance Directive

The first text on mutual cooperation in relation to the tax information came into force in 1977, with the main objective of improving and strengthening the data exchange between tax authorities. The Directive provided that MS are required to exchange any information which appeared to the relevant for the proper assessment of direct (income or capital) or indirect (value added and excise duties) taxes.[365] According to the Directive's original wording, the

[360] Merger Directive Article 2(e).
[361] Ben Terra and Peter Wattel (n 60) 379.
[362] Ibid 381.
[363] Ibid 382.
[364] Ben Terra and Peter Wattel (n 60) 381.
[365] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation and taxation of insurance premiums. OJ L 336 of 27.12.1977.

automatic exchange of information was based on a consultation procedure, where the involved tax authorities formed a Committee in order to conduct a proper tax assessment on a case-by-case basis, insofar the matter in question was of a ***common*** and ***bilateral interest***.[366] After this first draft, the Directive was amended 6 times.[367] The Directive was certainly an important step on the Union's tax harmonization process. In 2009 a new Directive on mutual assistance was drafted by the Commission (Directive 2011/16/EU), which was also amended numerous times, being 2016/2258[368] the last amendment to the Directive.

The "new" Information Exchange Directive[369] redesigned the previous Directive by including three main information exchange groups, namely, (i) ***automatic mandatory exchange*** (income and capital,[370] financial account data[371] and to cross-border tax rulings), (ii) ***spontaneous exchange of***

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[366] Article 9(1) provided that the consultation, or the exchange of information, between the competent tax authorities was mandatory "*(…) in so far the matters involved are not solely of bilateral interest*". In our understanding, it was the legislator's intention to protect not only the interests of the MSs involved, but also the Union's, thus respecting Community's principles such as Union Loyalty. Article 4(3) TEU (n 26).

[367] Directive 77/799/EEC followed the subsequent chronology: (***1***) Directive 79/1070/EEC changed some of Directive's 77/799/EEC wording. (***2***) Directive 92/12/EEC extend its scope to cover excise duties. (***3***) Directive 2003/93/EC extended the scope of mutual assistance Directive covering taxes on insurance premiums, properly referred to in Directive 76/308/EEC. The purpose of this amendment was to provide better protection to MSs' financial interests. Then (***4***) Directive 2004/56/EC was enacted to speed up the flow of intelligence between national tax authorities and to update some of the directive's weaknesses on the exchange of information regarding direct taxation (income tax, company tax and capital gains tax), along with taxes on insurance premiums. This amendment allowed MSs to coordinate investigative actions against cross-border tax fraud. After that, (***5***) Directive 2004/106/EC was drafted to cover administrative cooperation in relation to Council's excise duties Regulation 2073/2004 and lastly by (***6***) Directive 2006/98/EC, which required the adaptation of Directive 77/799/EEC and amendments, by reason of accession of Bulgaria and Romania (2007) to the EU.

[368] Amendment 2016/2258 included paragraph (1a) to Article 22. According to the amending Directive, MSs must by 1 January 2018 implement and adopt the Directive's rules. The paragraph reads: "*For the purpose of the implementation and enforcement of the laws of the Member States giving effect to this Directive and to ensure the functioning of the administrative cooperation it establishes, Member States shall provide by law for access by tax authorities to the mechanisms, procedures, documents and information referred to in Articles 13, 30, 31 and 40 of Directive (EU) 2015/849 of the European Parliament and of the Council*".

[369] Council Directive 2011/16/EU of February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64 of 11 March 2011.

[370] According to Article's 8 (1)(b), MSs are required to automatically provide information to any other MS over the following categories of income and capital: *income from employment*, *Director's fees*, *pensions*, *life insurance products, income* (or ownership) *of immovable property*, *dividends*, *capital gains* and *royalties*. The information must also be provided "*at least once a year, within six months following the end of the tax year of the Member State (…)*" Article 8 (6) Directive 2011/16/EU.

[371] The ***exchange of financial account information Directive*** (2014/107/EU) was introduced in late December 2014, in order to enhance the cooperation between tax authorities in relation to taxation. According to the Directive, MSs are required to provide information on an annual basis, within nine months following the end of the fiscal year, on the total interest, dividends or any other income deposited in the relevant account (whether custodial or depositary account). The financial institution will provide such information to the competent tax authority according to the Directive's wording. ***Reportable persons'*** financial information (resident of another MS) will have to provide ***Financial Report*** according to the Directive's requirements (name, State of residence, account number and balance etc) Annex I Section I General Reporting Requirements.

information[372] and finally (ii) ***exchange on request***.[373] Nevertheless, MSs may refuse to provide financial information if any of the five situations of Article 17 is verified. MSs may deny cooperation if: (i) the requesting State did not exhaust all possible resources in order to obtain the relevant financial information,[374] (ii) the disclosure of the requested information infringes national legal provision,[375] (iii) the requesting MS failed to provide information to similar circumstances,[376] (iv) the sensibility of the information is such that could eventually compromise industrial, commercial or profession secret[377] and (v) the disclosure of the information has the potential to jeopardize public policy.[378] Such refusal is only

[372] The ***spontaneous information exchange*** is not a faculty, but an obligation imposed upon MSs that shall provide to other MSs relevant tax information. If any of the five cases provided in Article 9(1) of the Directive are present, MSs ***MUST*** inform other MSs. Article 9(1) circumscribe the following situations: (**i**) possible tax loss of another State (reasonable doubt is enough, that is, not necessary that the loss be actually proved), (**ii**) obtaining a tax reduction/exemption which could lead to a reduction on the tax credit generated by the source State, thus increasing the liability in the resident State, (**iii**) business transaction between persons located in two or more MSs conducted in such a way in order to avoid tax (tax planning or avoidance), (**iv**) artificial transfer of profits between group members and (**v**) if a MS A obtained information which could be usefull/relevant for the MS B. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 223.

[373] The system of information exchange "***on Request***" was operated in the same manner stated in Article 9 (1)(2) of the repealed Directive 77/799/EEC. The information must be provided on a case-by-case basis and its relevance, its purpose, must be informed. If both requirements are met, the MS must comply by passing on the requested taxpayer's information. Under this information exchange category, MSs may not request "*group data*", for example, requesting information on specific sectors of the economy is not allowed. Currently, Article 5 of Directive 2011/16/EU provides for such situation.

[374] Ascertaining whether a tax authority exhausted all its sources can be difficult to the required MS. We understand that the main objective of the provision is to prevent that MSs require information that could easily be obtained domestically. Nevertheless, the exhaustion of sources raises questions over whether tax authorities may impose upon taxpayers a higher procedural burden in relation to cross-border operations. Recently the ECJ ruled that increasing *formallen Pflichten* for cross border obligations does not constitute as a discriminatory measure. CJEU. C-318/07 ECLI:EU:C:2009:33, paras 63 e seq. *Persche*, and joint cases C-436/08 and C-437/08, *Haribo and Österreichische Salinen*, ECLI:EU:C:2009:17, paragraphs 95 e seq. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 227.

[375] Within the meaning of this provision, refusal to provide financial information on grounds of bank secrecy is not permitted. "*In no case shall Article 17(2) and (4) be construed as permitting a requested authority of a Member State to decline to supply information solely because this information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person*."Article 18(2) Directive 2011/16/EU.

[376] The denial on grounds of lack of ***reciprocity*** is possible not only in relation to bilateral situations, but on a collective basis. (If State *A* refused to provide information to State *B*, consequently, not only State *B* would be able to deny future financial information, but also other MSs). Directive 2011/16/EU Article 17 (3).

[377] The aim of this provision is to protect possible violation to intellectual property, industrial or professional secrets. Banking secrets are not covered by this limitation.

[378] Under Article 17(4), MSs may deny to provide information contrary to public policy (*Ordre public).* Illegally acquired information is generally contrary to public policy (principles written or unwritten, on which society laws are based). Most Jurisdictions apply the "*fruit of the poisonous tree*" doctrine, that is to say, neither criminal, nor civil claims may be filed if the information/proof sustaining the petition was illegally obtained. However, is it mandatory that tax authorities, when in possession of illegally acquired data, provide such information to other MSs in light of the Mutual Assistance Directive? Can tax authorities initiate administrative/criminal/civil procedures with illegally acquired information? The answer to

possible to *exchange on request* category and in *mandatory spontaneous exchange* instances. ***Member States are not allowed to deny assistance over a taxpayer's financial information to other MSs over automatic mandatory exchange requests.***[379]It is also important to point out that the refusal to provide taxpayer's financial information on grounds of lack of domestic interest, or on national bank secrecy, is not possible. The latter was a valid under Directive 77/799/EEC, and ultimately excluded by Directive 2011/16/EC.

The rules governing mandatory automatic information exchange on ***cross-border tax rulings*** and ***advanced pricing arrangement information*** were included through an amendment to the information exchange Directive.[380] This amendment constitutes an important step in achieving a more harmonized and coherent tax system within the Union. It is a common practice amongst MNEs arranging their corporate structures in such a way to benefit from tax incentives of more favored tax regimes. A more beneficial tax ruling of a MS may serve as a motivation for companies to shift profits from one MS to another (aggressive tax planning), leading ultimately to loss of revenue of the State where the economic

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both questions is *yes*! The fact that tax administrations obtained the information illegally, is not *per se* an impediment for authorities to act upon such data (investigate, impose penalties, initiate criminal proceedings etc). Moreover, denying information assistance infringes Union principles such as ***union loyalty*** and ***enhanced cooperation***. Nevertheless, some authors (*Baker/Pistone*) understand that MSs can refuse to provide information assistance: "*(…) Whether or not governments should utilise illegally obtained information in tax investigations is a separate issue; it should clearly be a public policy ground for a country to refuse to supply information where the request originates out of the acquisition of illegally obtained information by the requesting State*". (emphasis added). The *HSBC files* case is an example of illegal obtained information later used by tax authorities against taxpayers. In 2006-07, a HSBC Switzerland subsidiary, had its clients' financial information illegally extracted by an employee who fled to France after the fact. Swiss authorities required extradition of the employee back to Switzerland, which was ultimately denied by French authorities. In 2014/2015, France, Belgium and Argentina charged HSBC with money laundering and tax evasion. Although the entity that had its rights violated by such disclosure may file criminal/civil suites against the perpetrator, this should not prevent tax authorities from acting. An analogous situation, also related to the "*fruit of the poisonous tree*" defence, is whether illicit earned income should be liable to tax. The subject has already been ruled by the Brazilian Supreme Court in 1998 which applied the "*non-olet*" principle over illicit earned income: "*(…) uninformed profits related to drug trafficking, results ultimately in tax evasion,* ***being the duty of the Federal Police to investigate such a crime*** (drug trafficking)*: it is irrelevant that the income was earned through illicit activities (…). Tax exemption of economic results of an illegal act (…) compromises the* ***integrity of the tax system*** *(…)*"*emphasis added*. HC 77530, Relator(a): Min. SEPÚLVEDA PERTENCE, Primeira Turma, julgado em 25/08/1998, DJ 18-09-1998 PP-00007 EMENT VOL-01923-03 PP-00522). Pursuing our discussion on the (il)legality of the acquisition source (information, alternatively income) back in 2000, the UK tax revenue authority was questioned why it had not inform the police of a drug dealer who have been declaring illicit earnings for over a decade. According to a former Inland Revenue inspector, Chris Chadburn,*"(…) The Revenue isn't permitted to make spontaneous disclosure to the police because the appropriate statutory gateway does not exist (…)"*. According to Article 29 UK's Data Protection Act, the act may not be applied in any of the following circunstances: (a) the prevention or detection of a crime, (b) the apprehention or prosecution of offenders, or, (c) the assessment or collection of any tax, duty or any imposition of a similar nature. *Data Protection Act* (1998) Chapter 29. Unfortunetly Mr. Chadburn was illinformed.

[379] The Directive's commercial, industrial or professional secret limitation provision (Article 17(4)), may be used to refuse automatic mandatory exchange of information. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 226.

[380] Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation. 2015/0068 COM (2015) 135.

activity occurred. For that matter, the inclusion of both types of mandatory exchange of information will tackle such situation. The amendment defines ***advance cross-border rulings*** and ***advance pricing arrangement*** as "*any agreement, communication, or any other instrument or action with similar effects, including one issued, amended or renewed in the context of a tax audit (…)*". The amendment defines the objective, substantive, personal, temporal scope and statute of limitations as we shall see bellow.

Objective Scope. Article 1(1) provides for a wide scope of information exchange, that is, any information "foreseeably relevant to the administration and enforcement of the domestic laws of the Member States concerning taxes referred to in Article 2" must be exchanged. The information needs must be "foreseeably relevant" that is, MSs will have to justify the need of the relevant information in order to obtain it, otherwise MSs are entitle to deny the exchange, preventing MSs to engage in "fishing expeditions" or from requesting "information that is unlikely to be relevant to the tax affairs"of a taxpayer.[381] Due to the challenges posed by "cross-border tax avoidance, aggressive tax planning and harmful tax competition"[382] the Commission will extent the exchange to cross-border tax rulings and pricing arrangement between associated enterprises, [383] in the context of tax audits (Article 3 (14) (15)). [384]

Substantive Scope. Article 2(1) extents the Directive's application to "all taxes of any kind levied by, or on behalf of, a Member States of the Member State's territorial[385] or administrative subdivisions, including local authorities". Nonetheless, the Directive shall "not apply to value added tax and customs duties, (…) excise duties (…) compulsory social security contributions payable to the Member State or a subdivision of the Member States or to social security institutions established under public law" according to Article 2(2). Fees regarding issuing of public documents or dues of a contractual nature are also excluded (Article 3 (a) (b)). The Commission included within the Directive's scope advance pricing arrangements and advanced cross-border rulings. Nonetheless, three criteria must be met before the relevant authority proceed with the exchange, namely the ruling must be **legally binding,**[386] it must be ***made in advance***, that is, "before the transactions to which the ruling relates are carried out**"** and it must relate to a **"cross-border transaction**". [387]

Personal Scope. MS may exchange information of taxpayer's "who are neither nationals nor residents of any of the Member States", therefore, any

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[381] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 209.
[382] Council Directive amending Directive 2011/16/EU2015/0068 COM (2015) 135.
[383] "(…) *Enterprises are associated enterprises where one enterprise participates directly or indirectly in the management, control or capital of another enterprise or the same persons participate directly or indirectly in the management or control of the enterprises* (…)".COM (2015) 135 Article 3 (15) (c).
[384] Council Directive amending Directive 2011/16/EU COM (2015) 135 Article 3 (14) (15).
[385] Denmark's territories (Faroe Islands and Greenland); British territories (Isle of Man and Akrotiri and Dhekelia); Finland's territory (The Aland Island); French territories (Martinique, Mayotte, Guadaloupe, French Guiana, Reunion, Saint Martin and Monaco); Portuguese territories (Madeira and Azores); German territories (The Island of Heligoland and Büsingen); Greek territories (Mount Athos); Italian territories (Livigno, Campione d'Italia, Italian waters of Lake Lugano and San-Marino); Dutch territory (The Netherlands Antilles) Spanish community and Territories (Canary Islands, Ceuta and Melilla). Article 52 TEU and Article 355 TFEU.
[386] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 221.
[387] Ibid 221.

person (wide sense) or legal arrangement (hybrid entity for instance), fall within the Directive's personal scope.

Temporal Scope. The Directive established that "information regarding taxable periods" on the categories of income listed by Article 8(1) to be outside the Directive's scope before 1 January 2014. The legislator chose to ***modulate the effects*** on the automatic exchange of information of advance cross-border rulings and advance pricing arrangement *from the 31 of December 2016* on[388] (certain 'old rulings' issued, amended or renewed after 31 December 2011 are within the Directive's scope as an exception to the rule).[389] A lack of the Directive's modulation effect would result in considerable administrative costs to MSs that would have to apply a considerable amount of resources in order to be in full compliance with the new cooperation rules established in the Directive. Furthermore, the absence of such ***modulation effect*** could infringe legal principles such as ***legal certainty*** for it would allow MSs to initiate administrative procedures against taxpayers who supposedly violated organic law in the past. Moreover, the ***statute of limitation*** for tax authorities to assess and challenge possible inconsistencies of a taxpayer's tax liability, expires generally in five years from the date the return was due or the date which the return was filed. Article 8 (a) (2) of the amendment states that, under certain circumstances, particular persons or groups of persons with a wide ***net turnover of less than EUR 40.000.000,00***, may be excluded from the mandatory automatic exchange provision, insofar the information on advance cross-border rulings and advance pricing arrangements were issued, amended or renewed ***before 1 of April 2016***.

According to Article 21, all information provided by MSs (mandatory, on request, spontaneous or any other form provided for the Directive), shall be provided electronically, through a Common Communication Network (CNN),[390] within the time limits imposed by the Directive according to the relevant type of information exchange (information on income and capital,[391] financial account information,[392] tax rulings[393] or on request)[394] whereas all costs related in providing such information shall be waived by MSs. The possibility of forwarding

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[388] COM (2015) 135 Article 8a (4).

[389] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 221.

[390] Common Communication Network (CCN), is an information network used by National Administrations to support and exchange information regarding common policies in the customs area and excise duties. Article 3(e) Directive 2010/24/EU defines CCN network as a "*(…) common platform based on the common communications network (CCN) developed by the Union for all transmissions by electronic means between competent authorities in the area of customs and taxation."*

[391] Communication regarding *mandatory exchange information on income and capital*, must take place annually, within nine months following the end of the tax year of the Member State during which the information became available. COM (2015) 135 Article 8(6)(a).

[392] Mandatory exchange on *financial account information* must take place "for the information laid down in paragraph 3a: annually, within nine months following the end of the calendar year or other appropriate reporting period to which the information relates.' became available. COM (2015) 135 Article 8(6)(b).

[393] Information on *tax rulings* must takes place "*within one month following the end of the quarter during which the advance cross-border rulings or advance pricing arrangements have been issued or amended*". COM (2015) 135 Article 8a(4) (a).

[394] *On request* information must be provided "(…) *as quick as possible, and no later that six months from the date of receipt of the request*." Directive 2011/16/EU Article 7(1).

information to third-countries is also possible and properly regulated by the Directive. Nonetheless some conditions must be first met, for instance, the relevant third Country would need an agreement authorizing such exchange, provided that the received information is "*foreseeably relevant*".[395] Furthermore, article 19 of Directive 2011/16/EU provides a MFN clause, that is to say, if a MS cooperates with a third country, that MS must extent such cooperation to other MSs without restrictions.[396] In sum, the inclusion of *cross-border tax rulings* and *pricing arrangement* provision indirectly tackles tax competition and prevents the concession unfair fiscal subsidies.

5. Savings Directive[397]

The savings Directive (2003/48/EC), envisaged discouraging taxpayers from transferring portfolios (relocation of funds) within the Union in order to avoid taxation. The aim of the Directive was expressively established in its first Article, to "enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State to be made subjected to effective taxation in accordance with the laws of the latter Member State".[398] The effectiveness of the taxation on savings demands full cooperation of tax administrations and without full international cooperation, it is impossible to confront "challenges posed by cross-border tax fraud and evasion (...)"[399] for it is a consensus amongst the international community that "[U]nreported and untaxed income considerably reduces national tax revenues".[400] According to the Directive, all Members States were required to inform the relevant tax authority of cross-border payments (Member States such as Belgium, Luxembourg and Austria) were given a seven-year transitional period,[401] under the condition that 75% of the tax withheld were transferred "to the resident State of beneficial owner of the interest".[402] A penalty for not sharing financial information for such long period perhaps. Nevertheless, they could waive withholding taxes if the information was provided.[403] The Directive was repeld by Directive 2015/2060, mainly due to the advent of Directive 2011/16/EU on the mandatory exchange of information adopted by the Council. Numerous other Directives were adopted by the Council

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[395] Directive 2011/16/EU Article 24 (1).
[396] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 232.
[397] Ben Terra and Peter Wattel (n 60) 452.
[398] Council Directive 2003/48/EC of June 2003 on the taxation of savings income in the form of interest of payments. Article 1.
[399] Council Directive (EU) 2015/2060 of 10 November 2015 repealing Directive 2003/48/EC on taxation of savings income in the form of interest payments. (2).
[400] Council Directive (EU) 2015/2060. (2)
[401] Ben Terra and Peter Wattel (n 60) 454.
[402] Ibid 454.
[403] "Article 13 (1) (a) Member States levying withholding tax (…) shall provide for one or both of the following procedures in order to ensure that the beneficial owners may request that ***no tax be withheld***: (a) A procedure which allows the beneficial owner expressly ***to authorise the paying agent to report information*** (...), such authorisation covering all interest paid to the beneficial owner by that paying agent (...). (b) procedure which ensures that withholding tax shall not be levied where the beneficial owner presents to his paying agent ***a certificate drawn up in his name by the competent authority*** of his Member State of residence for tax purposes (...)." (emphasis added).

in order to avoid tax avasion/avoidance, namely the exchange of financial account information Directive (2014/107/EU), the *know-your customer* Directive (91/308/EE),[404] and future ones are still to come in 2019, such as the amendment to the *Directive for Administration Cooperation* (DAC), imposing upon tax advisors, accountants, banks, lawyers etc, the obligation to disclose tax schemes, special tax regimes or the use tax havens outside the EU.

6. Recovery Assistance Directive (Tax collection Directive)

Directive 2010/24/EU provides for rules regarding ***MSs'* recover of tax *claims*** (mutual assistance between Member States for the recovery of each others' claims),[405] that is, "the requested authority may supply the applicant authority with the information which the latter needs in order to recover claims arising in the applicant Member State and notify to the debtor all documents relating to such claims emanating from the applicant Member State. The requested authority may also recover, at the request of the applicant authority, the claims arising in the applicant Member State, or take precautionary measures to guarantee the recovery of these claims".[406] The Recovery Directive has a particularly important role on enhancing the quality of cooperation procedures between MSs, for it provide MSs instruments aimed at maintaining the *effectiveness of fiscal supervision* and as well the *integrity of relevant tax system*.

The effectiveness of the Directive, according to *Luca Cerioni*, can be assessed under ***three benchmarks***: *legal certainty*, *tackling cross-border tax evasion* and lastly, *simplifying the administrative recover process*.[407] The ***Legal certainty*** benchmark assesses the results of the home State assistance on the recovery of taxes from the source State.[408] The prevention of ***cross-border tax evasion*** and the ***simplification of administrative burden*** benchmarks, are ultimately assessed according to the MSs' "willingness to cooperate".[409] The Directive covers all duties and taxes with the exception of social security contributions, fees not expressively listed and other contractual duties and pecuniary penalties of a criminal nature.[410]

The "collective directive"[411] provides that MSs may assist other Member States by ***exchanging information*** (Art. 5), ***notifying the addressee*** (Art. 8),[412]

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[404] The first *know-your-customer* Directive 91/308/EE was repealed in 2005 by Directive 2005/60/EC and in 2015 by Directive 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

[405] Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures. (1).

[406] Council Directive 2010/24/EU (7).

[407] Luca Cerioni. *The European Union and Direct Taxation. A solution for a difficult relationship*. Ed. Routledge (2015) 90.

[408] Luca Cerioni (n 418) 90.

[409] Ibid 91.

[410] Directive 2010/24/EU Article 2(1).

[411] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 240.

[412] When the resquesting MS files a claim, the requested MS must, "notify the addressee (*the relevant entity to the taxable event, individual or undertaking*) all documents, including those of a judicial nature, which emanate from the applicant Member State and which relate to a claim" regarding "(a) (…) taxes and duties of any kind levied by or on behalf of the Member State or its territorial or administrative subdivisions, including the local authorities or on behalf of the Union; (b) refunds, interventions and other measures part of the system of total or partial

recovery upon request (Articles 10 to 15)[413] and lastly, by acting in a ***precautionary manner regarding a request*** (Art. 16 and 17).[414] According to the Directive, information may be exchange as it follows: (*i*) *exchange on request,*[415] *(ii) spontaneous exchange of information*[416] *and* (*iii*) between *administrative offices in participation in adminsitrative inquiries.*[417] However, MSs may deny assistance: (***1***) if the requested MS would not be able to obtain from the requesting MS siminar information (Article 5(2)(a)), (***2***) if the information leads to the disclosure of commercial, industrial or professional secrets (Article 5(2)(b)), (***3***) if such information would put in risk social order or contrary to public policy - Article 5(2)(c) (*Ordre public*), (***4***) if the claim creates "serious economic or social difficulties in the requested Member State, in so far as the laws, regulations and administrative practices in force in that Member State allow such exception for national claims" (Article 18 (1)), (***5***) if the "initial request for assistance made in respect of claims (…) are more than 5 years old" (Article 18 (2)) and, if (***6***) the "total amount of the claims covered (…), is less

financing of the European Agricultural Guarantee Fund (EAGF) and the European Agricultural Fund for Rural Development (EAFRD), including sums to be collected in connection with these actions" and "(c) levies and other duties provided under the common organization of the market for the sugar sector". Directive 2010/24/EU Article 2 (1) (a) (b) (c) and Article 8.

[413] When requested to enforce a certain recovery (*uniform instrument,* which resumes the original domestic enforcement claim, whether born out of an administrative or judicial procedure – Article 12 Directive 2010/24/EU), MSs must treat the request as if it were domestic, that is, "The requested authority shall make use of the powers and procedures provided under the laws, regulations or administrative provisions of the requested Member State applying to claims concerning the same or, in the absence of the same, a similar tax, duty, except otherwise provided for this Directive" (Article 13(1)). In other words, it imposes upon MSs a ***non-discrimination*** obligation in respect to other MSs' tax recovery claims. Nevertheless, MSs must first apply "appropriate recovery procedures available in the applicant Member State" unless "there are no assets for recovery in the applicant Member State" and "where the recourse to such procedures in the applicant Member State would give rise to disproportionate difficulty." Directive 2010/24/EU Art.11 (1)(2)(a)(b).

[414] Generally, acting in a *precautionary manner regarding a request* imposes upon tax adminsitrations the duty to "ensure recovery where a claim or the instrument permitting the enforcement in the applicant Member State is contested at the time when the resquest is made, (…) in so far as precautionary measures are also possible, in a similar situation, under national law and administrative practices of the applicant Member State". It also provides for the recognition of documents regarding recovery claims. Directive 2010/24/EU Art. 16 and 17.

[415] The information must be provided on a case-by-case basis and according to its relevance. If both requirements are met, the MS will comply by passing on the requested information. Restrictions may apply. Directive 2010/24/EU Article 5.

[416] The ***spontaneous information exchange*** is not at the discretion of MSs, but a duty imposed upon MSs that shall provide the other MS the required information. If any of the five cases provided in Article 9(1) of the *Information Exchange Directive* are present, MSs have the duty to inform. Contrary to the *Information Exchange Directive* (Article 2(1)), Article 6 of the Recovery Assistance Directive, allows the exchange of information *on refunds of taxes other than VAT*, paid by a certain MS. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 240.

[417] Article 7 Directive 2010/24/EU affords the possibility of government officials to personally conduct (under previous authorization) administrative inquiries in the other MS. The Article reads "By agreement between the applicant authority and the requested authority and in accordance with the arrangements laid down by the requested authority, officials authorized by the applicant authority may, with a view to promoting mutual assistance (…): (a) be present in the offices where the administrative authorities of the requested Member State carry out their duties; (b) be present during administrative enquiries carried out in the territory of the requested Member State; (c) assist the competent officials of the requested Member State during court proceedings in that Member State."

than EUR 1 500" (Article 18 (2)). Practical note, although MSs must obbey the time limits imposed by the legislation of the ***requesting MS*** (statute of limitation), the requested MS may not deny assistance on grounds that the time period for the relevant recovery had elapsed, if the laws of the requesting MS provides that the the claim is still demandable (Article 19(1)), a "suspension, interruption, or prolongation of the period of limitation" is determine by the laws of the ***requested MS*** (Article 19(1)).[418]

Objective Scope limits the provisions' application to mutual assistance for the recovery of tax claims between MSs (Article 1).

Substantive Scope of the Directive covers "all taxes and duties of any kind levied by or on behalf of a Member State or its territorial or administrative subdivisions, including the local authorities, or on behalf of the Union" (Article 2 (1)), as well as to "administrative penalties, fines, fee and surcharges" Article 2 (2)). Compusory social security contributions, dues of a contractual nature and criminal penalties imposed "on the basis of a public prosecution" (Article 2(3)) are covered by the Directive.

Personal Scope of the collective directive refers to a person (whether natural, legal, association of persons or any other "form, which has legal personality or not, owning assets which including income derived therefrom" Article 3(c). The broad scope of the article allow MSs to act, and provide assistance on tax recovery.[419]

Temporal Scope. Article 29 repeals the late Directive 2008/55/EC from 01 January 2012 on, therefore the new Directive's provisions shall be applicable from its publication date on, nevertheless "there are no general rules in the Directive on the taxable periods to which requested recovery assistance has to be related", leading to the conclusion that there is no limitation as to which taxable years a assistance request may relate to.[420]

Statute of Limitations. The ***requesting MS*** is limited by its own laws (Article 19(1)), whereas, in case of "suspension, interruption, or prolongation of the period of limitation", the requesting State if bound to the laws of the ***requested MS*** (Article 19(1)).[421]

7. Double Taxation Conventions (DTCs)

After the establishment of the North German Confederation in June 1867, the Federation's representatives drafted a law that would regulate the freedom of movement and establishment, so that German citizens could move freely along German territory.[422] A special group of representatives of the Confederation,

[418] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 244.
[419] Ibid 239.
[420] Ibid 239.
[421] Ibid 244.
[422] Article 3(1) of the 1867 Constitution of the North German Confederation determined that "There shall be a common citizenship for the entire federal territory, and the nationals of each State of the Confederation shall be treated as natives, and shall accordingly have the right of becoming permanet residents, of carying on business, of filling public offices, of acquiring real estate, of obtaining citizenship, and of enjoying all other civil rights under the same conditions as those enjoyed in their native State, and they shall also have the same treatment as regards judicial remedies and the protection of law the laws." John Tiley. *Studies in the History of Tax Law*. Hart Publishing Vol.6 (2013). 33.

worked on a draft that would regulate in more detail the practical consequences of the new Constitution's guarantees (citizenship, freedom of movement etc). During the deliberating meetings, the commission received a petition from Prussian citizens who owned land in Saxony, imposing upon that commission a solution to the problem of double taxation that would occur were the income taxed over the land in Prussia and Saxony transferred to the newly formed North German Confederation[423] (by the beginning of the 19th century, tax was mainly levied "on the constituent elements of property", such as tax on land, buildings and on business).[424] From a historical perspective, the shift from excises to wealth taxation, that eventually would form to the ***ability to pay***, walks basically alongside a shift in world history which began in the age of Enlightenment (when the idea of a divine power granted to an absolute monarchy or the Holy Church itself began to be questioned). This change in paradigm culminated ultimately in the French Revolution (1789-1799), and in various wars in colonies for independence, such as the United States (1775-1783) Brazilian independence (1821-1825) etc. Now, back to the North German Confederation, as previously mentioned, in 1867, the recently formed North German Confederation (unification of a number of small counties, duchies, free cities and kingdoms)[425] was vested by its new Constitution. However, the new Contitution did not "take away the fiscal sovereignity of the Member States. Instead, the various taxes imposed throughout the Federation had to be reconciled and harmonized with the positive constitutional affirmation of the individual, rights of equality, freedom of movement, and establishment".[426] The petition presented to the representatives of the freshly formed German Confederation by Prussian landowners failed to the extent that the suggested double taxation clause was not included. Nevertheless, the matter stirred great turmoil amongst political leaders, who eventually had to tackle the matter somehow. Here lies the foundation, the true birth of ***Double Tax Conventions***. In 1820, Prussia mainly levied two types of taxes, namely, land tax and class tax. The latter can be summarized as it follows. Society was divided in classes according to the criteria organized by the State and taxes were levied accordingly (social standing or nobility, occupation etc). Business were classified according to its operations and "some of which were taxed in terms of external criteria such as imputs that were

[423] Here we quote an extract of such petition "should a national of the North German Confederation move freely within the federal territory and choose his domicile at will, he should not be penalized for this change of location by a double imposed personal tax at the same time; according to § 8 of the Saxon law of 23 April 1850 strangers not even established were subjected to Saxon personal tax, albeit to a lesser extent than residents, who may as foreigners also be subject to income tax in Prussia, according to § 18 of the Law of I May; such rules and principles can, however, not be applied to nationals of the North German Federation in accordance with the spirit and purpose of the Constitution of the latter; for they could not possibly be regarded on the same footing as foreigners. The correctness of this view had already been recognized elsewhere…property taxes are only imposed at the place where the land is located. Business taxes are found only in the place where the business operation, municipal taxes are payable only in the municipality where one stays; apart from business and property ownership, the tax can only be paid by the person from their income, whether it be class, income, or personal tax, and cosenquently they only have to succumb to it once, be in the home State or in the place where they stay." John Tiley (n 422) 38.

[424] John Tiley (n 422).

[425] John Tiley (n 422) 33.

[426] John Tiley (n 422) 34.

common in an industry (eg number of workers, machinery etc)".[427] Prussia and Saxony levied taxes on land, businesses and a poll tax.[428] Nonetheless, the greatest concern of the time was not the taxation on land *per se*, for that was levied according to its *situs,* that is, where the property was located. This single connecting factor (*situs*) resulted in the creation of the principle that, ***business profits should be taxed where the business conducts its operations*** ("the place where a person stayed for purposes of municipal taxes and, in the case of taxes imposed on the person either in the state where the person was staying or in his or her home state").[429] As we shall study in other parts of this investigation, this model greatly resembles the current allocation rules provided by the Model Convention on double taxation. The origin of the OECD Model Convention on Double Taxation lies in the 1869 Tax Treaty Between Prussia and Saxony (*Late Model*).[430] Notably most of the rules contained in that treaty, are still applied in current DTCs, for instance, allocation rules on the basis of citizenship, income should be taxed where the activity – or the land – was located, income exemption if already taxed in that other State etc.[431] Exceptions to that rule are still applicable today by the OECD Model, for example military persons' and civil officials' income must be taxed "from whose coffers these receipts flow".[432] Article 19 of the Model still provides for the same rule.[433] An interesting approach taken by the *Late Model* was that citizens that were nationals of Prussia and Saxony were inevitably taxed twice (whether on income derived from land, business etc), for they benefited of social advantages of citizenship from both States, therefore, they were liable to taxation in both States. The *Late Model*, was applicable mainly to foreigners of other Contracting States, and "expressively allowed dual-nationals to be subjected to double taxation".[434] Such rules served just as temporary measures in order to avoid (at leat to some extent), the incompatibity of that tax system with the new Confederation's Constitution, which allowed the free movement of establishment, movement, citizenship etc. After the *Late Model,* the North German Confederation drafted in 1890 the Imperial Double Taxation Treaty (*Imperial Model*), which aimed basically to provide its citizens the possibility to relocate freely within the

[427] John Tiley (n 422) 35.
[428] Ibid 36.
[429] Ibid 39.
[430] "(…) legal mechanisms to avoid double taxation, whether in the form of bilateral tax treaties or federal legislation, were originally conceived as a political tool to achieve a fiscal centralism that would enhance the unification of the German territories" On the Origins of Model Tax Conventions: Nineteenth-Century German Tax Treaties and Laws Concened with the Avoidance of Double Tax. Ibid 33.
[431] According to Article 1 Prussia/Saxony DTC "Taxes on property as well on the operation of a fixed trade (on industrial or commercial facilities) and on income arising from thse sources will be paid only in the State in which property is situated, or in which the business is exercised". Article 2 provided for exemption "The income from these sources is exempt from the taxation of the whole of the income assigned to a State under Article 1 insofar as it was already accordingly taxed in the other State and provided that the tax demonstrably imposed in the other State is deducted from the whole balance of the taxable income amount removed from the State authorized under Article 1". John Tiley (n 422) 40.
[432] John Tiley (n 422) 40.
[433] "Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State." OECD Model Article 19.
[434] John Tiley (n 422) 40.

Confederation. The Act, signed by Bismarck himself on behalf of Kaiser Wilhelm I,[435] was shortly after transposed to the newly formed German Empire's legal framework after the German unification in 18 January 1871.[436]

The *Late Model* and the *Imperial Model* were considerably similar. In fact, much of the *Late Model* was basically transferred to the *Imperial Model* being the major difference the change from a citizenship to a residency allocation factor.[437] Nonetheless, although the *Imperial Model* was a great advance on the elimination of DT, it was ultimately left to German Courts to sculpt some of the principles used by the modern *Model*. For example, the *Residence Factor (Wohnsitz)* was highly explored by taxpayers who had more than one residence throughout the Empire, for it was not entirely clear if the concept of *Wohnsitz* should be deemed as "the place occupied as a dwelling in circumstances that indicate an intention of permanently maintaining an abode there".[438] The tax residence idea was originally based on civil law, which resulted in tax planning and tax competition among German States. Nevertheless, after 1870 the Imperial Double Taxation Law was ultimately amendment, therefore materializing an independent notion of tax residence.[439]Another concept that ultimately was modified by case law was the ***Permanent Establishment*** concept (*Betrib eines Gewerbe),* that is, where should the profits of a company operating in more than State be taxed? In the State where the PC resides which presumably, has full control over the PE's operations? Or in the State where the PE operates, that is, where the economic activity occurred? An interesting case that contributed greatly to the shaping of the PE concept, was the *Life Insurance Bank of Germany* case. The Bank's revenue

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[435] John Tiley (n 422) 45.

[436] "The first Prussian king whom Bismarck served as ambassador, Frederick William IV, was torn between Gerlach's legitimist conservatism and the opportunities inherent in Bismarck's *Realpolitik* (*policy based on calculations of power and national interest over ideology, that is, a more pragmatic approach to foreing policy*). Bismarck insisted that his King's personal regard for the traditionally pre-eminent German state must not inhibit Prussian policy. Since Austria would never accept Prussian hegemony in Germany, Bismarck's strategy was to weaken Austria at every turn. In 1854, during the Crimean war, Bismarck urged that Prussia exploit Austria's break with Russia and attack what was still Prussia's partner in the Holy Alliance without any better justification than the auspiciousness of the occasion (…). Although Austria had been Prussia's principal ally for over a generation, it now presented a rather incongruous partner in Bismarck's eyes. It had become the main obstacle to Prussia's growth (…) Prussia needed to break its confederate bond to Austria (…). Within five years of coming to power in 1862, he eliminated the Austrian obstacle to Germany unity (…) expelled Austria from Germany and destroyed lingering Richelieuan illusions in France. (…) As soon as Germany had achieved the borders he considered vital to its security, Bismarck conducted a prudent and stabilizing foreign policy. For two decades, he maneuvered Europe's commitments and interest in masterly fashion on the basis of *Realpolitik* and to the benefit of the peace of Europe. (…) the legacy Bismarck left Germany was unassimilable greatness" Henry A. Kissinger. *Diplomacy*. Touchstone. Rockefeller Center. New York, New York (1994). 130 et seq.

[437] According to Johann Hattingh, "[T]he reasons why resident-based taxation was definitely adopted is not quite clear. During the North German Federal Parliament's readings in 1870 of the draft of the 1870 Imperial Double Taxation Law, Finance Minister Camphausen is reported to have stated that the term *Wohnsitz* (…) coincides with 'the state where the taxpayer mainly enjoys public protection and where he participates in public non-profit institutions'. Taxation based on a person's place of residence was thus viewed as the appropriate proxy to establish the state in which a taxpayer enjoyed the most public goods and services (***the benefits theory of taxation).***" (*emphasis added*). John Tiley (n 422) 45.

[438] John Tiley (n 422) 48.

[439] Ibid 49.

consisted mainly of insurance premiums and interst from capital. Nonetheless, the Bank's place of management was located in Gotha, but the Bank conducted a great amount of its business through its agents (representatives) in Baden. The Bank did not owned any property in Baden, and challenged the fact that Baden authorities levied taxes on their operations conducted by its agents. According to the the Bank's argument its agents worked under an employment contract, therefore its activites could not fall under trade activities. On the other hand, Baden tax authorities contended that since there was no specific provision that exempted the banking industry on the *Imperial Model*, the provisions of that Statute could not exempted such income (Article 3 of the Imperial Model stated that "Ownership of land and the operation of a trade, and the income arising from these sources may be taxed only by those federal states in which the property is located ***or the business is operated***" (*emphasis added*).[440] The Administrative Court of the Grand Duchy of Baden ultimately rejected both arguments under the reasoning that the *Imperial Model* applied to all persons regardless the legal entity involved, and that "the factual information was sufficient to show that the bank obtained very substantial acquisitions from its permanent facilities for purposes of lending money at interest".[441] The Administrative Court of the Grand Duchy of Baden's decision was perhaps the first case, on the elimination of double taxation, where the exclusive taxation of business income at the source became connected to the activities of an entity's permanent agents, in this case, the Bank's representatives. The court's decision changed substantially the configurations of a number of tax treaties entered into by the Empire created the permanent establishment rule as a tax principle.[442]

Source allocation of Business Income is also a product of Imperial Geman case law, as well as the ***separate entity*** principle. According to *Johann Hattingh*, the first case that dealt with *source allocation of business profits*[443] related to an undertaking which operated its manufacturing process in a certain German State, and proceed to sell its products in other State.[444] These are perhaps one of the earliest formulations of the present system of allocation of profits "to a permanent establishment on the basis of the arm's length principle used currently by the OECD."[445] Nonetheless, the separate entity principle was not a product of one single case, but built by a number of different cases.[446]

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[440] (No. 475) *Act for the Elimination of Double Taxation of 13 May 1870*. Federal Law Gazette of the North German Confederation. No 14 Issued at Berlin on the 19th of May 1870 (Government Gazette Edition). Ibid 75.

[441] Ibid 52.

[442] Ibid 52.

[443] "The court dealt with the manufacturing business whe the factory was located in one federal state while the commercial selling and other activities were exclusively conducted in another. It is reported to have decided that the income from this business had to be divided equally between the two sources. The court felt that, in the circumstances of the case, each aspect of the business had an 'equally important influence on the achievement of profit'". Ibid 53.

[444] Das Reichsgesetz vom 13. Mai 1870 wegen Beseitigung der Doppelbesteuerung under vergleichender Berücksichtigung des schweizer Bundesrechts (1888) V Finanz-archiv: Zeitscrift für das Gesamte Finanzwesen 147, 148 (as cited in Tiley, John. 2013). John Tiley (n 422) 54.

[445] John Tiley (n 422) 56.

[446] *Johann Hattingh* in his study "On the Origins of Model Tax Convention: Nineteenth-Century German Tax Treaties and Laws Concerned with the Avoidance of Double Tax", he translates a ruling given by the Saxon Ministry of Finance of 12 January 1885 that contributed forming the current OECD Model principle, namely, separate entity and arm's length principle: "[T]he fact

Issues on income classification.[447] The *Imperial Model* is a product of various factors, such as the North German Confederation unification, the taxpayers' pressure on Confederation's representatives and most importantly case law. The following case helped shaping personal income classification. The director of a company resident of a certain federal State was responsible for managing a manufacturing plant. The company operated in more than one State. The director paid income tax in his State of residence according to section I 1870 Imperial Double Taxation Law and "at the same time was subjected to a different sort of tax in the other federal state on the basis that it was business income that fell wihin the ambit of section 3 of that law".[448] Ultimately, the *employee*'s income was taxed in both States.[449] The problem was solved by the Federal Council of the German Empire, deciding that the Imperial Double Taxation Law 1870 could not be applied to the director's income, for there was "no relevant difference between an ordinary worker and a director of the commercial operations, that the latter was not even he owner of the business enterprise and that his income was not income from the commercial operation but stemmed from a service relationship. As a consequence, his employment income was to be taxed exclusively by his state of residence."[450] Such reasoning was then applied to the income of physicians, lawyers, artists, that eventually worked in a State other then his/her resident State.[451]

After the *Imperial Model,* several treaties had also great influence over the current Mordel used by the OECD, for instance, Article 2 Prussia/Austria-Hungary Double Tax Treaty,[452] contained a source tax provision regarding business profits, permanent establishment[453] etc, ultimately paving the way for future tax treaties, such as the Austria/Liechtenstein Double Tax Treaty (1901), Prussia/Luxembourg (1090), Hesse/Luxembourg (1913) etc.[454] In 1927 the

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that both trading operations belong to the same person must be disregarded and the matter should be trated as if they belong to differente persons. The trade transactions must then be accounted for as if they would customarily be delivered to independent commercial business or the price at which it could be delivered without damage to the manufacturer, and the same applies to the production costs while equals the difference between the whosale selling price and the basic price. A lower calculation of the price of goods delivered to branch operations is harmless as far as the tradesperson is concerned but it reduces taxable income in the State in which manufacturing takes place and consequently violates the taxing right of that State and therefore such a calculation should be ignored" John Tiley (n 422) 55.

[447] Ibid 58.

[448] Ibid 59.

[449] Ibid 59.

[450] Ibid 59.

[451] Ibid 59.

[452] "The ownership of land and buildings, and the operation of a fixed trade, as well as the income arising from these sources are only to be assessed for direct State tax in the State in which the land and buildings are situated or where a permanent establishment for the exercise of trade is maintained. Branches, factories, depots, counting houses of buying and selling, and other business facilities maintained for the exercise of a fixed trade by a proprietor himself, business partners, attorneys or other permanent representavies are to be regarded as ***permanent establishment***" (*emphasis added*). Article 2. Prussian Law, Concerning the Avoidance of Double taxation of 18 April 1900. John Tiley (n 422) 78.

[453] "When permanent establishments of the same commercial enterprise are located in both areas, the assessment for direct State tax in each area must only be in accordance with the actual operations of the domestic permanent establishment." Article 2. Prussian Law, Concerning the Avoidance of Double taxation of 18 April 1900. John Tiley (n 422) 77.

[454] John Tiley (n 422) 70.

League Nations drafted its Model Tax Treaty (1927) concerning business taxation.[455] In 1929 the League of Nations drafted two Models on Double Taxation and, despite the ongoing WWII, arranged a subcommittee composed mainly by Latin American Countries, when the Mexico Treaty of 1943 was draft.[456] Further progress was made in 1946 with the drafting of the London Treaty. The OECD predecessor (OEEC) continued its research on international taxation, submitting numerous articles between the years of 1956 an 1961, resulting consequently in the so called *OECD Model Convention*.[457] Revisions on the *Model*'s text were carried out in 1977, 1992, 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010, 2012, 2014 being its last update in 12.2017.[458]

In order to avoid taxing the same income (passive or active), countries either take independent measures, or make use of double taxation treaties. Such treaties are mainly based on the OECD Model, which provides a template for DT avoidance rules (allocation rules) allowing countries to adapt such template to their own specifications. International Double Tax Conventions (DTC) in sum are contracts (voluntary arrangement amongst two or more persons) entered into two or more States where each party to such contract expressively agrees to behave in a certain manner.[459] Double taxation conventions are "international agreements entered into between governments for the allocation of fiscal jurisdiction."[460] In the field of International Law the ***Vienna Convention on the Law of the Treaties*** (VCLT) codifies how international treaties should be interpreted within the international community. When two or more States inter into a double taxation *contract*, the relevant States agree to act within the terms it had previously agreed upon, that is to say, the relevant States commit "themselves to relinquishing, completely or partially, the imposition of taxes in specific situations.[461] According to Article 60 of the Vienna Convention on the Law of Treaties "[a] material breach of bilateral treaty by one of the parties entitles the other to envoke the breach as a ground for terminating the treaty suspending its operation in whole or in part". Nevertheless, as we shall study in other parts of this investigation, if a Treaty's provision conflicts with domestic provision, the Treaty should prevail "under public international law" principles,[462] not leading to its termination.

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[455] *Tax Treaty Policy on Article 9 of the OECD Model Scrutinized*. https://www.wu.ac.at/fileadmin/wu/d/i/taxlaw/institute/staff/publications/steindl_bulletinibfd031303_128.pdf. Accessed in 23 Sep 2017. 129.

[456] Andrea Amatucci (n 2) 150.

[457] Andrea Amatucci (n 2) 151.

[458] *Tax treaties: update to OECD Model Tax Convention realesed.* (2017) http://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm. Accessed in 23 Sep 2017.

[459] Hans Kelsen (n 34) 140.

[460] Andrea Amatucci (n 2) 149.

[461] Michael Lang. *Introduction to the Law of Double Taxation Conventions*. 2nd Ed. Linde (2013) 32.

[462] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. OECD, Action 6 – 2015 Final Report. 81.

a. The OECD Model and other Model Conventions

As previously mentioned, DTCs are contracts entered into by States where each State imposes upon itself certain tax limitations. Therefore, all conventions are negotiated separately and Contracting States will bargain with its counter part the extent of its tax limitations. Nonetheless, the ***OECD Model Tax Convention*** is the starting point for almost every DTC active today. The OECD Model Convention is the product of historical, economical and political facts dated long before the creation of the European Union having its roots in the works of the *League of Nations.* A full study on the developing process of the OECD Model Convention will certainly fall outside the main purpose of this investigation. Added to the *Model*, the UN also published its own model in 1980, which is considerably similar to the OECD Model. The ***UN Model Tax Convention*** was initially drafted with the ultimate goal to preserve the taxing rights of developing countries.[463] For example, Article 7 (1)(b) and (c) UN Model provides for the ***limited force of attraction principle*** which grants the PE's parent company taxing rights over income derived in the other State (under the condition that such goods or services are of a different nature than those of the PE). Some countries, concerned about possible a departure by other contracting States of the OECD Model (USA and Belgian)[464] drafted their own DTC Models, which eventually became the basis for their future bilateral negociation. Nonetheless, such Models are not significantly different from the OECD Model convention. [465] Still developing Countries also drafted their own Model Conventions, for instance the *Andrea Model*, based on the needs of the Andrea Group in 1971 (Bolivia, Chile, Ecuador, Colombia, Peru and Venezuela).[466]

b. Effects and DTCs' interpretation

The ultimate purpose of DTCs is to allocate taxation rights between the Contracted States, nonetheless one must not loose sight of the fact that the DTC itself does not give the relevant jurisdiction a taxing right, that is to say, the jurisdiction's taxing rights were conferred by its sovereignity as a State and not by the DTC ("States have original jurisdiction to tax and this is in accordance with international law").[467] This concept is particularly important for the DTC itself ***may not*** impose upon the Contrating State the obligation to create a certain tax if the State itself ***does not*** tax such fact.[468] The effects of DTC may range from the avoidance of double taxation *per se* (exemption or credit methods) to ***double non-taxation***. For instance, only a few jurisdictions have adopted an exemption

[463] In order to reduce expenses MNEs may shift their operations to developing countries in order to benefit from the low costs as well as tax benefits of the relevant jurisdiction. For that matter, the UN body decided to produce a Model that would better serve those countries.
[464] Andrea Amatucci (n 2) 151.
[465] Michael Lang (n 461) 34.
[466] Andrea Amatucci (n 2) 151.
[467] Michael Lang (n 461) 35.
[468] Such statement was refuted by Michael Lang who argues that "In tax literature, it has been said that DTCs cannot generate tax liability; however, there is no legal basis for this statement. There is no international law rule preventing tax liabilities from being increased because of a DTC (…)" and he concludes by stating that there is nothing that prevents DTCs to "worsen the position of the taxable person." Michael Lang (n 461) 36.

approach in respect to non-business capital gains (capital gains deriving from immovable property), therefore if a national from Finland resident in Germany sells his immovable property in Finland after the ten year period, such individual would be liable to tax on such capital gains, nonetheless, Article 13 German-Finland DTC states capital gains on the sale of immovable property arising in a Contracting State may be taxed in that State.[469] Under Finish law, the individual would be exempt from tax for his property was sold after the required period of ten years (after the speculation period).[470] Note that under the DTC Germany should refrain from taxing such gains and Finland was also prevented from taxing such gains due to its domestic law, which resulted in a ***double non-taxation***.

The manner in which DTC relate to domestic law is particularly important in order to comprehend the institute. Although it is true that in most countries international treaties are transposed into the relevant country's legal framework consequently gaining equal status to that of domestic legislation (either by incorporating or by enactment of comparable law), one must first assess the existence of a cross-border element, that is, in the absence of a cross-border transaction, there is no reason for a jurisdiction to apply the rules of a DTC domestically. DTCs entered into between EU members are not different from those contracted between non-members, therefore Member States must also do what is necessary, and take all appropriate measures to *"*(…) *ensure fulfilment of the obligations arising out of the Treaty or resulting from the action taken by the institutions of the Community*".[471] As mentioned before, DTCs provide for the proper allocation of fiscal jurisdiction between the contracting parties and eventually becomes a part of the States' tax legislation, [472] whether by incorporation or enactment of the law.[473] Nonetheless, the vertically pyramidal applicability of ***primary and secondary Union law as well as ECJ decisions, have supremacy over bilateral DTCs***, creating thus an overriding effect over double tax convention agreements.[474] DTCs may be adopted by the Contracting parties according to two possible approaches, either by creating a **direct effect** upon the contracting party's legislation in such a way that the DTC is self applicable, that is, it automatically becomes part of that State's Law,[475] or create an **indirect effect** on the party's legal system, where the treaty's provision would have to be transformed in proper enforceable law by the legislative

[469] "Gewinne aus der Veräußerung unbeweglichen Vermögens im Sinne der Artikels 6 Absatz 2 können in dem Vertragsstaat besteuert warden, in dem dieses Vermögen liegt." Artikel 13 (1) Gesetz zu dem Abkommen vom 5. Juli 1979 zwischen der der Bundesrepublik Deutschland under der Republik Finland zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steurn vom Einkommen und vom Vermögen sowie einiger anderer Steuern.

[470] According to Finish law, from 1920 on, residents are liable to tax on capital gains from the alienation of immovable property held for a period less than ten years. Stefano Sintacchi. *Taxation of Capital Gains under the OECD Model Convention with special regard to immovable property*. Klumer Law International (2007) 51.

[471] Treaty establishing the European Community (Amsterdam consolidated version) Article 10.

[472] Although bilateral agreements are more common, there are currently multilateral agreements in force. The Nordic Convention on income and Capital entered into by Finland, Iceland, Norway, Denmark and Sweden and the Convention on Mutual Administrative Assistance in Tax Matters, are two examples of such multilateral agreements.

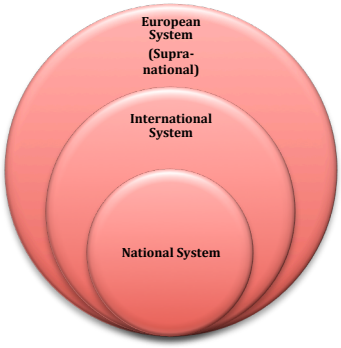
[473] Andrea Amatucci (n 2) 146.

[474] COM (2001) 582 final 288.

[475] The Netherlands, USA, France and Japan.

delegates.[476] Under the latter, the treaty is not enforceable *per se* before being properly converted into national law.[477] Again, when assessing which legislation one should apply within the Internal Market (domestic law, DTC or EU legislation), one should obey the following steps: (***i***) is there any applicable uniformed Supra-national legislation in force (EU Law)? If the answer to such question is ***yes***, then European Law have precedence over bilateral or multilateral agreements, for instance, in respect to direct taxation, EU Directives (Merger Directive, Parent-Subsidiary Directive and Interest and Royalties Directive)[478] have precedence over DTCs, however if he answer is ***no***, (***ii***) is there a bilateral or multilateral treaty regulatimg the relevant matter (DTC)? If ***yes***, such treaty should be applied as the legal basis for solving the matter. Finally, if matter is neither covered by EU legislation, nor by international treaties, States will approach the case under principles of international law and according to its domestic legislation.

Figure 1



Consider the following example, a Dutch enterprise resident in the Netherlands derives income from its activities within its borders, therefore such income will obviously be taxed according to Dutch legislation (***national system***). Now consider that the same enterprise has a subsidiary in Germany (a distributer, for example). According to the Parent-Subsidiary Directive, profits devired by that subsidiary and distributed to the parent company are exempt from tax.[479] However, considering that the relevant parent company has the necessary amount of the subsidiary's shares according to that Directive, that is to say, above the threshold limit imposed by the Statute (10%), but not reached the minimum holding period of two years.[480] In such a case, the Parent-Subsidiary Directive states that MSs main not apply the Directive's benefits. Therefore, if the

[476] Canada, India, UK.
[477] Andrea Amatucci (n 2) 155.
[478] "The application of the Directive should prevail over domestic and tax treaty law. Art. 7(2) (Parent-Subsidiary Directive), however, contains a derogation to the principle, where it is provided that the Directive may not affect the application of domestic or agreement-based provisions aimed at eliminating or lessening economic double taxation, such as the repayment of an indirect tax credit to foreign shareholders. (Usually, state adopting an imputation system only provide for an indirect tax credit in purely domestic dividend distributions. However, such states may exceptionally extend such tax credits to foreign shareholders, whether or not reciprocally, through a double tax convention)". Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer. (n 40) 154.
[479] Parent-Subsidiary Directive Article 5.
[480] Parent-Subsidiary Directive Article 3 (2)(b).

subsidiary distributes profit to its parent company, the distribution would not fall under the Directive's terms, but under the Dutch-German DTC (***international system***). Lastly, consider that the same enterprise has a PE in Germany, and all requirements contained in the Parent-Subsidiary Directive are properly meet (threshold holding period, rule of control, and that such income was deducted at the source). In this case, the EU legislation overrides the DTC's effects,[481] thus the situation would be governed by the Parent-Subsidiary Directive (***supra-national system***). Approaching on such a systematic manner (starting national to the supra-national level) has proven considerably successful when determining tax liability.[482] The orverrring effect of Union legislation was already subjected to the ECJ, which ruled that DTCs do not "serve to overcome the effects of the restriction on the freedom establishment" or to any other freedom for that matter (*Denkavit case*).

As we have already studied, when a subsidiary transfers income to its parent company, and if it had fulfilled all necessary requirements (*be listed in the Annex, resident of that MS*[483] and *subjected to corporate taxes*)[484] such transfer may be tax exempted, insofar the income was already subjected to taxation in the source State. If an undertaking of a MS mergers with a company of another MS, the capital gains of such transaction may be deferred, provided that all necessary requirements have also been fulfilled under the Merger Directive and finally, if the a company of a MS has a debt related income or receives royalties over the transfers of an intangible property, the recipient of such income may benefit from the Interest and Royalty Directive. Nevertheless, when none of the above situations apply to the relevant case, MSs must apply DTC to prevent double tax instances. For example, if a MS intents to levy taxes of business profits arising from purchases of a resident of another MS not related to a PE operating in that MS, that MS will not be able to levy tax of such profits (the operation would be liable to tax in that MS if profits were attributable to a PE, if not, the profits will be taxed in the other MS).[485]

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[481] COM (2001) 582 final 288.

[482] According to Michael Lang, approaching the matter systematically by "(…) first consulting the domestic law to determine whether any tax liability for tax exists and then consulting the DTC to determine whether it provides any relief from this tax liability" has proven to be functional, for "if there is no liability under domestic law, there is no need to consult the DTC since the DTC in practice does not create liability to tax (…). The mere allocation of taxing rights to a contracting state does not create an independent basis for taxation. On the other hand, it can occasionally be useful to consult the DTC first to determine whether the contracting state has the right to tax at all, and, as a second step, to determine the manner in which the contracting state exercises this right. If, under the treaty, there is no right to tax, there is no need to consult domestic law." Michael Lang (n 461) 39.

[483] In order for the Directive's benefits to be applied, the company must be a resident under treaty and domestic law. In this case, if the company is considered to be a resident of both contracting States, the tie-break rule is applied, that is to say, the State where the company effectively manage its business, will be break the tie. OECD Model Art 4(3).

[484] The Directive lists the corporate tax forms that should be include. The second part of paragraph (iii) includes a clause that has as ultimate purpose the inclusion of any other related substitutive tax.

[485] "Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State." OECD Model Article 7(1).

Purpose. The main goal of double tax convention is of course to prevent economic and juridical double taxation as well as fiscal evasion. Double Tax Conventions are an important instrument in order to prevent double taxation to the extent that the Contracting States "*waive tax claims, and bind themselves not to levy taxes, or to tax only to a limited extent, in cases when the treaty gives the taxing right to the other Contracting State either entirely or in part.*"[486] It is paramount that we understand that such treaties do not create tax claims that would not otherwise exist in the other State, that is, if an economic operation not liable to tax is performed in ***State A***, but liable in ***State B*** (State's A counterpart to the DTC), ***State A*** will not be able to levy tax on such operation if the product of such operation is transferred to ***State B***, in other words "*a tax treaty cannot create nor extend the taxing rights of a country*".[487] Although countries draft their DTCs according to the terms negotiated with its counterpart, the OECD Model Convention is generally used as a basis for such agreements. The *Model* has no binding force whatsoever. It is not our intention to study the historical process of the creation of such *Model*, nevertheless, the *Model Convention* is a product of more than 10 years of negotiation conducted by the United Nations Economic and Social Council (ECOSOC) members.[488] In sum, *DTCs are Tax Instruments,* contracted between States in order to effectively tackle double taxation.

c. DTC's Basic Structure

Generally, the *Model* is structured by distributing and classifying the income according to its nature and source, consequently establishing which State will have the right to tax according the applicable situation. DTCs may grant (***1***) full taxing rights, (***2***) limited taxing rights and (***3***) no taxing rights.

(***1***) *Full taxing rights*

The problem of double taxation may arise when a State where the taxpayer is a citizen of, applies a worldwide income system, that is, regardless of where the income arose, the State will have taxing rights over such income, thus, in this case, the taxpayer's income will be liable in full – ***full tax liability*** - (***universality principle***).[489] Full tax liability suggests that the taxpayer's connection to that State is strong enough to determine that the State is entitled to such rights. However, the complexity of the situation increases when the same taxpayer's income is fully liable in two jurisdictions, for instance, the taxpayer is a citizen of a State that applies worldwide tax on income, that is, where the taxpayer maintains his permanent home, however, this taxpayer is employed in another State where he/she generates income which also operates under a worldwide tax system. Note, in the absence of DTC or any other legal instrument for that matter (EU legislation), the States would not abdicated from its right of taxing such income. In reality, it is all about how deep a connection one has to the State, that is to say, "if the connection is weak or consists only of objective

[486] Andrea Amatucci (n 2) 153.
[487] Ibid 153.
[488] Ibid 151.
[489] Michael Lang (n 461) 27.

factors, only the income earned in that state is taxed (principle of territoriality). This is called limited tax liability",[490] as we shall see bellow.

(***2***) *Limited and shared taxing rights (Limited tax liability)*

As previously mentioned, the stronger the taxpayer's connection to a certain State (residence, nationality, center of vital interests etc), the likelier will that State be entitled to tax. Nonetheless, if the taxpayer's *lieu* is fragile, so will be the taxing rights of that State, resulting in a limited or shared taxing rights. Consider the following example, a taxpayer resident of Country A, maintains the center of his vital interests – marriage, job, main source of income etc – in that Country, however, he may as well be a shareholder of a Company located in another State, from which he receives dividends. The State center to the taxpayer's vital interests (resident State) have limited taxing rights over that income (dividend), for the source State also has taxing rights over such income. In other words, if the State where the shareholder resides applies a ***worldwide system*** and the source State, where the shareholder hold its shares applies a ***territorial system*** the dividend may be taxed twice. However, if the taxpayer's *lieu* is "weak or consists only of objective factors", both States then would be entitled to a ***limited tax liability*** which, although may result in double taxation, it is less common were the States to apply opposite systems.[491] Hong Kong, Singapore, France, Belgium and the Netherlands, apply a territorial system of taxation. In other words, taxpayers will only be liable to taxation over its income if such income derived within the State's territory. The limited tax liability principle may serve as grounds to deny deduction of foreign losses, in order to preserve the cohesion of the tax system.

(**3**) *No taxing rights*

Basically, the State where the income arises is entitled to tax, that is, where the economic activity actualy occurred (source State). Nonetheless, the resident State has also taxing rights over the income if it applies a worldwide system of taxation. Now, if the taxpayer of a certain State accrues income in another State independently, that is, without a PE or subsidiary, Article 7 OECD Model grants the source State no taxing rights whatsoever.[492]

d. Scope of DTCs' application

Personal Scope. Article 1 of the Model provides that its rules shall be applicable to "*residents on one or both of the Contracting States.*"[493] The resident may be an individual, a company or a group of persons (partnerships).[494]

[490] Michael Lang (n 461) 29.
[491] Michael Lang (n 461) 29.
[492] "Gewinne eines Unternehmens eines Vertragstaats können nur in diesem Staat besteuert warden, es sei den, daß das Unternehmen seine Tätigkeit im anderen Vertragstaat duch eine dor gelegene Betriebstätte ausübt (...)" Artikel 7 OECD Musterabkommen zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen. (OECD-MA 2014).
[493] OECD Model Article 1.
[494] OECD Model Article 3(1).

Pursuing our discussion on the *Model*'s personal scope, Article 4 properly defines the term "*resident of a Contracting State*"[495] which is fundamental to the *Model*'s distributive rules. It is also important to mention that the *Model* also determines in a general manner what the connecting tax factor may be, whether "*domicile, residence, place of management or any other criteria of a similar nature*". Again, although the *Model* provides a broad definition of connecting tax factors, countries may adjust the actual agreement in accordance to its own needs.[496] Article 4(3) also provides an important rule intented to solve conflicts if the person resides in both Contracting States. This conundrum is solved by the "***tie-breaker rule***", which to the interpreter misfortune must be dissected on a case-by-case basis. We present a short example. During a certain tax year, a natural person resided in the *UK* for 3 months (1 January till 31 March) and then it moves to *Australia*, where he fixed his residency for a period of time longer than 183 days (till the end of the same year, from 01 April to 31 December), that is, for more than a half of the working year. In this case, he is considered a tax resident according to *Austrialian* law. If the HMRC[497] apply to that person a special guidance (HMRC 6 1.5. UK Domicile),[498] therefore considering him a resident for tax purposes even though he did not meet the 183 days threshold, [499] the person is liable to income tax on the income accrued in the source State (UK), as well as in the other State (Australia). This is a typical "***tie-breaker"*** situation.[500]

Subjective Scope. Article 2 of the *Model* provides that "*all taxes on income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amount of wages or salaries paid by enterprises as well*

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[495] According to the OECD's commentaries, the concept of "resident of a contracting State" has number functions. For that matter, the study points out the three main important points, that the concept intents to regulate: (**a**) determine the personal scope of application of futures conventions; (**b**) solving problems of double residence in respect to double taxation and (**c**) solving double taxation cases where the tax arises in the State of residence, source or where the immovable is located "*situs*". OECD Commentaries on the Model Tax Convention C(4)-1.

[496] Article 4 DTA between Australia and Ireland reads "1. For the purposes of this Agreement, a person is a resident of one of the Contracting States – a. in the case of Australia, subject to the provisions of paragraph (2) of this Article, if the person is a resident of Australia for the purposes of Australian tax law; and b. in the case of Ireland, if the person is liable to tax herein by reason of his domicile, residence, place of management or any other criterion of a similar nature but not if he is liable to tax in Ireland in respect only of income from sources therein." Double Taxation Treaty between Ireland and Australia. Agreement between the Government of Ireland and the Government of Australia for the avoidance of Double Taxation and the prevention of fiscal Evasion with respect to Taxes on Income and Capital Gains. http://www.revenue.ie/en/tax-professionals/tax-agreements/double-taxation-treaties/a/australia.pdf. Accessed in 23 Sep 2017.

[497] Her Majesty's Revenue and Customs (HMRC). UK Revenue service.

[498] HM Revenue & Customs. Guidance Note: Residence, Domicile and the Remittance Basis. (2016)https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/528018/RDR1-residence-domicile-remittance.pdf. Accessed in 23 Sep 2017.

[499] The general rule determines that, if an individual remains more than 183 within the UK territory, his is considered a resident for tax purposes.

[500] The Model gives preference to the State where the person maintains his ***permanent home***. In most cases, this will solve the matter. Nevertheless, if the person has a home in all Contracting States, the Model gives preference to the place where majority of the person's ***economic relations*** takes place. If none of both solutions solves the matter, then preference is given to the Contracting Party of which he is a ***national***. OECD Commentaries on the Model Tax Convention C(4)-1 e seq.

taxes on capital appreciation"[501] shall be covered by the DTC. Nonetheless, such list is not exhaustive serving merely as a guidance to Contracting States.[502]

e. Juridical, Economical and Virtual DT

According to the OECD TP Guidelines "[D]ouble taxation means the inclusion of the same income in the tax base by more than one tax administration, when either the income in the hands of different taxpayers (***economic double taxation***, for associated enterprises) or the income is in the hands of the same juridical entity (***juridical double taxation***, for permanent establishments)."[503]

Econonical DT [504]occurs when the same income is taxed in two or more States with the same person (different persons + same income taxed in two or more States = ***economical DT***). Double economical taxation is more recurrent in transfer pricing[505] issues, that is, when two or more associated enterprises contract with each other.

Juridical DT[506] arises when same taxpayer is taxed on the same income by the source State and by the resident State (same person + same income taxed in two or more States = ***juridical DT***).

Virtual DT[507] result from the lack of exercise of one's taxing rights, while the other party (Contracting State) taxes the income, that is to say, had the first party exercised its taxing rights, the income would have been double taxed, but since it did not make use of such prerogative, it ended up creating a virtual DT, that in practice do not exist (same or different person + same income taxed in only one State = ***virtual DT***).

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[501] OECD Model Article 2 (2).

[502] Michael Lang (n 461) 29.

[503] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, http://dx.doi.org/10.1787/tpg-2017-en. Accessed in 01 May 2018. 171.

[504] Economical double taxation (*Wirtschaftliche Doppelbesteuerung*) "Bei ***wirtschaftlicher Doppelbesteuerung*** ist im Gegensatz zur juristischen Doppelbesteuerung keine Identität der Steuersubjekte gegeben. Es wird im gleichen Besteuerungszeitraum dasselbe Steuergut bei verschidenen Steuerpflichtigen zu einer vergleichbaren Besteuerung heangezogen." Gernot Brähler. *Internationales Steuerrecht. Grundlagen für Studium und Steuerberaterprüfung. 7. Auflage* (2012). Springer Gabler. E-Book. Accessed in 24 Sep 2017. 17.

[505] "*(…) Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises, and "transfer pricing" is to be construed accordingly*". COM (2015) 135 Article 3 (15).

[506] Juridical double taxation (*Juristische Doppelbesteuerung*) "Zu einer ***Doppel – oder Mehrfachbesteuerung im juristischem Sinne*** kommt es, wenn derselbe Steuerpflichtige von zwei (oder mehr) souveränen Steuer hoheiten für denselben Steuertatbestand, d.h. für dieselben Einkünfte bzw. Dieselben Vermögenswerte, im selben Zeitraum gleiche oder vergleichbare Steuern zahlen muss." Gernot Brähler (n 504) 17.

[507] Virtual double taxation (*Virtualle Doppelbesteuerung*) "Im gegensatz zur realen Doppelbesteuerung ist die ***virtuelle Doppelbesteuerung*** nur eine ***denkbare Doppelbesteuerung***. Es besteht lediglich die theoretische Möglichkeit der doppelten Besteuerung, eine tatsäschliche (effektive) Doppelbesteuerung entsteht nicht". Gernot Brähler (n 504) 17.

8. Arbitration Convention and OECD Model Convention on Tax Arbitration

In order to eliminate double taxation, effectively tackle abusive tax practices and ultimately prevent the occurrence of its effects (negative impact on competition, reduction of tax bases, welfare, treaty shopping etc), the full cooperation of tax jurisdictions within the international community is absolutely mandatory, otherwise, jurisdicions would be *dead in the water*. The *Arbitration Convention* (hereinafter reffered as *Convention*) and the OECD Model Convention (hereinafter reffered as *Model*) provide for the so called *Mutual Agreement Procedure* (MAP), an institute that allows undertakings and tax jurisdictions alike to discuss tax related disputes amicably, before resorting to arbitration. Such instrument is an important progress in solving tax disputes with greater speed and more importantly, in a cheaper way needless to say it is an important tax harmonization instrument that contributes to the attainment of a more fair system of international taxation. The *Convention* is not an EU legislation, "but a multilateral international law convention",[508] and although it is considered as a *secondary legislation statute* in the same group of Directives and Regulations, therefore **legally binding to all** MSs, the *Convention* operates under a more "limited level of integration"[509] when compared to its peers, for instance, as previously mentioned, a "***directly effective provision*** of EU law may be relied upon before national courts of law as well as before national administrative authorities, thus becoming thereafter a part of domestic law", for it is a ***direct applicable provision***. A provision from the Parent-Subsidiary, Interest and Royalty or from the Merger Directives, is directly, self-executing within its scope of application (cross-border element) and takes precedent over domestic law. However, the *Convention*'s provisions ***DO NOT*** take precendent over national law and it must be enforced within the boundaries of the constitutional order of the relevant MS. Moreover, the ECJ has no jurisdiction over matters concerning the *Convention*'s application. The maim aim of the *Convention* is to create a dispute resolution mechanism emanated from profit adjustment[510] imposed by tax administrations of a contracting State, that have not been adjusted by the tax administration in the other contracting State (Transfer Pricing disputes).

Both the EU and the international community have created its own alternative dispute resolution system in respect to taxation, whereas the former limited the scope of application to ***TP disputes***, and the latter covers a wide range of cases (the attribution of profits to a permenant establishment under the *Model,* taxation in the State of the payer of the excess parts in respect to interest and royalty payments, application of thin capitalization laws "when the State of the debtor company has treated interest as dividends", situations where "lack of information as to the taxpayer's actual situation has lead to a misapplication" of the *Model* etc).[511] Article 25 OECD *Model* (Mutual Agreement Procedure - MAP) provides that undertakings, as well as States may present its case to the relevant tax authority "within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the (*Model*) Convention").[512]

[508] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 260.
[509] Ibid 261.
[510] Ibid 258.
[511] Commentaries on the Articles of the Model Tax Convention. 355.
[512] OECD Model Convention Article 25 (1).

Article 6 of the *Convention* has a similar provision. The relevant authority must resolve the matter by ***mutual agreement*** wih the tax authority of the contracting State, that is, the "competent authority of any Contracting State concerned, with a view to the elimination of double taxation" must endeavor to conclude the matter by mutual agreement, and "[A]ny mutual agreement reached shall be implemented irrespective of any time limits prescribed by the domestic laws of the Contracting States concerned".[513] If a certain company understands unduly taxes were levied, that company would, in the absence of a MAP (and ultimately an agreement to arbitrate) litigate in a domestic Court of law "with all the disadvantages and uncertainties that such situation entails".[514] Nonetheless, ***if*** the matter is not [re]solved under MAP (whether from the EU or from an international perspective) the dispute may be susbjected to arbitration. The arbitral process provides a number of advantages over litigation, for it allow parties to a dispute setting their own procedural rules, such as rules on discovery, evidence, impose limits on how arbitrators should award damages etc. In sum, arbitration offers a higher degree of flexibility and adaptability when compared to the rules one is subjected to, had the dipute been submitted to national courts of law, that is to say, the arbitration procedure is ultimately tailored to the needs of the parties involved.[515] However, the matter is still controversial amongst scholars as to whether arbitration is the more appropriate system for resolving taxation disputes. The Institute for Austrian and International Tax Law has organized in July 2018, a conference where matters regarding the subject at hand will be debated, where students, academics, reporters and practitioners from all over the world will present their personal experiences and views over the subject. Debates such as these are important in order to ascertain the effectiveness of arbitration in respect to tax matters.

As previously mentioned taxation disputes may arise from, TP issues, the attribution of profits to permenant establishments, disputes in respect to interest and royalty payments, issues on thin capitalization laws as well as from the lack of information as to the taxpayer's actual situation in the Contracting State (International perspective – *Model*). Cases concerning the *Convention* will be submitted to the procedural rules of that legal Statute, and cases not related to the *Convention* (non-EU members), will be solved according to the relevant DTC. However, if the DTC do not contain an arbitration clause, the parties to the dispute may agree to *submit* the dispute to arbitration by means of the MAP (submission agreement). [516] Tax disputes may also arise from Bilateral Investment Agreements - BITs. Nevertheless, BITs may exclude taxation disputes by including a: (***1***) general exclusion clause, (***2***) limited exclusion based on WTO principles clause, (***3***) limited exclusions based on the distinction between certain taxes (direct and indirect taxes) clause, (***4***) limitation by veto to non-

[513] Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises - Final Act - Joint Declarations - Unilateral Declaracions 90/436/EEC. OJ C 160, 30.6.2005, p. 11–22. Article 6 (1).

[514] Commentaries on the Articles of the Model Tax Convention. 355.

[515] Luiz Henrique de Lacerda Sanglard. *A Study on International Arbitration and Economics*. (2016) 11.

[516] There are two types of arbitration agreement, namely, (a) those that submit future disputes to arbitration (arbitration clause), and (b) those that submit existent disputes to arbitration (submission clause). Luiz Henrique de Lacerda Sanglard (n 515) 12.

expropriation clause, (***5***) priority of taxation treaties over international investment agreements clause and under (***6***) complex combinations of exceptions to exclusion clause.

a.General exclusion

Under general exclusion, the BIT expressively prohibits future disputes be submitted to arbitration, for instance, Article 5(2) of the Argentine/New Zealand BIT states that "The provisions of this agreement shall ***not apply to matters of taxation*** in the territory of either Contracting Party. Such matters shall be governed by domestic laws of each Contracting Party and the terms of any agreement relating to taxation concluded between the Contracting Parties"[517] (*emphasis added*). In sum, both States operate under the understanding that matters related to taxation should be regulated by the relevant DTC.

b. Limited exclusion based on WTO principles

Some BITs limit the scope of application of certain WTO principles that would allow Parties to evoked them, and use it as a basis, grounds to initiate a tax dispute.[518]

aa. National Treatment (NT) and most-favoured-nation MFN. Article 3(3) of the recently terminate BIT India/Austria provides that "The provisions of paragraph (1)[519] shall not be construed to oblige one Contracting Party to extend to the investors of the other Contracting Party and their investment the present of future benefit of any treatment, preference or privilege resulting from (b) any matter, including international agreements, pertaining wholly or ***mainly to taxation***". Another example, Article 2103 (1) NAFTA reads "Except as set out in this Article, ***nothing in this Agreement shall apply to taxation measures***". Nonetheless, Article 2103 (4) (b) NAFTA states that "Articles 1102[520] and 1103[521] (Investment (Investment – National Treatment and Most-Favoured Nation Treatment) (…) ***shall apply to all taxation measures***" and

[517] Agreement Between the Governament of the Argentine Republic. The Government of New Zealand for Promotion and Reciprocal Protection of Investments. Signed in 27.08.1999. Not in force.

[518] Julien Chaisse. *The Treatment of (National) Taxes in Tax and Non-Tax (International) Agreements.* 6th Meeting of the Asia-Pacific Foreign Direct Investment (FDI) Network. (2016). Accessed in 24 Sep 2017.

[519] "Each Contracting Party shall accord to investments of investors of the other Contracting Party treatment no less favourable than that accorded to investments of its own investors (***National Treatment – NT***) or investments of investors of any thid State (***Most-Favoured-Nation - MFN***)." Agreement between the Government of the Republic of Austria and the Government of the Republic of India for the Promotion and Protection of Investments. BGBI. III – Ausgegeben am 31. Jänner 2001 – Nr. 27. Article 3 (1)

[520] "Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors (…)". (NT) NAFTA Article 1102.

[521] "Each Party shall accord to investors of another Party treatment no less favourable than that it accords, in like circumstances, to investors of any other Party or of a non-Party". (MFN) NAFTA Article 1103.

"Subjected to paragraph 2[522] and without prejudice to the rights and obligations of the parties under paragraph 3, Article 1106(3), (4) and (5) (Investment – Performance Requirement)[523] ***shall apply to taxation measures***" (*emphasis added*). [524]

ab. Fair and equitatable treatment (FET).[525] The fact that Article 1105 (1) NAFTA does not explicitly provides that Contracting States should apply *FET* to tax matters, ***but only to investments*** ("***Each Party shall accord to investments of investors of another Party*** treatment in accordance with international law, including fair and equitable treatment and full protection and security"), lead arbitration tribunals not interpreting the provision as to include taxation. Therefore, it cannot be relied upon to initiate a tax dispute.

ac. Limited Exclusion based on the distinction between certain taxes (direct and indirect taxes). Under the provisions of Article 2103 (4) (b) NAFTA, "Articles 1102 and 1103 (Investment (Investment – National Treatment and Most-Favoured Nation Treatment) (…) shall apply to all taxation measures, ***other than those on income***, ***capital gains*** or on the ***taxable capital of corporations***, ***taxes on estates***, ***inheritances***, ***gifts*** and ***generation-skipping transfers***[526] (…)" (*emphasis added*).

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[522] "Nothing in this Agreement shall effect the rights and obligations of any Party under any tax convention. ***In the event on any inconsistency between this Agreement and any such convention, that convention shall prevail to the extent of the inconsistency***". NAFTA Article 2103 (2).

[523] "Article 1106 (3) No Party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investors of a Party or of a non-Party, on compliance with any of the following requirements: (a) to achieve a given level or percentage of domestic content; (b) to purchase, use or accord a preference to goods produced in its territory, or to purchase goods from producers in its territory; (c) to relate in any way the volume on imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment; or (d) to restrict sales of goods or services in its territory that such investment produces by relating such sales in any way to the volume or value of its exports of foreign exchange earnings. (4) Nothing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non- Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory. (5) Paragraphs 1 and 3 do not apply to any requirement other than the requirements set out in those paragraphs." NAFTA Article 1106 (3) (4) (5).

[524] NAFTA Article 2103 (1) (4) (b), (5).

[525] "Article 1105 (1) Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including ***fair and equitable treatment and full protections and security***. (2) Without prejudice to paragraph 1 (…), each Party shall accord to investors of another Party, and to investments of investors of another Party, non-discriminatory treatment with respect to measures it adopts or maintains relating to losses suffered by investments in its territory owing to armed conflict or civil strike. (3) Paragrah 2 does not apply to existing measures relating to subsidies or grants that would be inconsistent with Article 1102 (…)". (emphasis added). North American Free Trade Agreement NAFTA.

[526] *Generation-Skipping Transfer Tax* (GSTT) are duties levied on estate planning instances where the planner avoid taxes by skipping generation lines (transferring assets to grandchildren instead of children – skiped person). Mark E. Powell. *The Generation-Skipping Transfer Tax: A Quick Guide* (2009) https://www.journalofaccountancy.com/issues/2009/oct/20091804.html. Accessed in 24 Sep 2017.

ad. *Limitiation by veto to non-expropriation.*Some Agreements provide for an ***arbitration veto*** (applied by the relevant tax authority) if an expropriation measure applied by a certain Contracting State was instrumentalized by taxation, ***and*** the relevant authority ***DO NOT*** subscribe to the fact that such measure was in fact of an expropriatory nature. In other words, if the relevant tax authority understands that the measure was in fact of an expropriatory nature, the party may initiate arbitration proceedings. For instance, Article 2103 (6) NAFTA provides that "Article 1110 (Expropriation and Compensation), shall apply to taxation measures ***except*** that no investor may evoke that Article as the basis for a claim under Article 1116 (Claim by an Investor of a Party on its Own Behalf) or 1117 (Claim by an Investor of a Party on Behalf of an Enterprise), where it has been determined pursuant to this paragraph that the measure is not an expropriation. (…). ***If the competent authorities*** (…) ***fail to agree that the measure is not an expropriation*** within a period of six months (…) ***the investor may submit its claim to arbitration*** under Article 1120 (Submission of a Claim to Arbitration)" (*emphasis added*).

ae. *Priority of taxation treaties over Internation Investment Agreements.* Parties to an investment agreement may choose not to exclude from the scope of the agreement matters related to taxation, therefore, eventually, in case a dispute arises and taxation is ultimately *sub judice*, the BIT may prioritize the application of the relevant DTC instead of the BIT's provisions. For example, Article 20 Japan-Iraq BIT states that "Nothing in this agreement shall effect the rights and obligations of either Contracting Party under any tax convention. In the event of any inconsistency between this Agreement and any such convention, that ***convention shal prevail to the extent of the inconsistency***"[527] (*emphasis added*).

af. *Complex combination of exceptions to exclusion.* Certain Statutes expressively prevent its provisions be applied to tax disputes, and alternatively, present a number of exception to that limitation. Article 2103 NAFTA provides for such complex combination, that is, on the one hand states that "nothing in this Agreement shall apply to taxation measures", but in the other allow the application of its provisions to tax measures in respect to Performance Requirements (Article 1106(3), (4) and (5) NAFTA). Another example of complex combinations can be found in the Canada-Equador BIT. Although Article XII (1) provides that "Except as set out in this Article, nothing in this Agreement shall apply to taxation matters" (*limited exclusion based on WTO principles*), it provides for a *veto to non-expropriation* ("Article VIII may be applied to a taxation measure unless the taxation authorities of the Contracting

[527] Agreement Between Japan and the Republic of Iraq for the Promotion and Protection of Investment (2012).

State (…) determine that the measure is not an expropriation.")[528] for a *priority rule,* namely, "Nothing in this Agreement shall effect the rights and obligations of the Contracting Parties under any tax convention".

The agreement to arbitrate is basically backed by an *Arbitral Clause* generally included in the relevant DTC, which states that if the MAP is unsuccessful, the dispute should be submitted to arbitration. In the *Convention*'s case, Article 7 especifically states that "[I]f the competent authority fail to reach an agreement that eliminates double taxation (…), they shall set up an advisory commission charged with delivering its opinion on the elimination of the double taxation in question". The *Convention* provides for the constitution of a *advisory commission* (Article 9 – *list system*), the procedure that should be followed before the advisory' commission (Article 10), the time limit for delivering an opinion (Article 11) etc. The *Model,* however does not provide how the arbitration procedure should be conducted, under which rules (UNCITRAL, ICC Rules of Arbitration, the European Convention on International Commercial Arbitration, ICSID Convention etc), whether should be up to the arbitrators to choose the procedural and evidenciary rules (*Ad Hoc arbitration – private practitioners*)[529] etc.[530] Generally, DTCs provide for an arbitration clause in case the matter is not solved through MAP. Nonetheless under the *Model*, MAP provisions can only be applied solely in cases "coming within paragraph 1, *i.e.* where tax has been charged, or is going to be charged, in disregard" of *Model* provisions.

9. Anti-Avoidance Directive (ATAD) 2016/1164

The Anti-avoidance Directive (ATAD) is a product of a political EU agenda to tackle base erosion and profit shifting at an EU and international levels (Anti Tax Avoidance Package).[531] The agenda consists mainly of four pillars, namely, the (***i***) ATAD, (***ii***) recommendation on the implementation of measures against tax treaty abuse,[532] (***iii***) revision of the administrative cooperation directive and lastly a (***iv***) communication strategy with third countries for effective taxation.[533] During the 2017, the Code of Conduct group (group created in 1998 formed by MSs' officials who meet periodically in order to discuss the current effects of national tax legislations throughout the EU with the ultimate purpose of preventing harmful tax practices, fairness of the tax system and deter tax competition), in co-ordination with the High-Level Working Party on Tax Questions ("the HLWP"),[534] worked heavily on strategies in order to tackle anti-

[528] Agreement Between the Government of Canada and The Government of the Republic of Ecuador for the Promotion and Reciprocal Protection on Investments. (1996).
[529] Luiz Henrique de Lacerda Sanglard (n 515) 11.
[530] OECD, Improving the Resolution of Tax Treaty Disputes (Report adopted by the Committee on Fiscal Affairs on 30 January 2007). 21.
[531] *Anti Tax Avoidance Package.* https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en. January (2016) Accessed in 24 Sep 2017.
[532] Commission Recommendation on the implementation of measures against tax treaty abuse. C (2012) 271 final.
[533] Communication from the Commission to the European Parliament and the Council on an External Strategy for Effective Taxation. COM (2016) 24 final.
[534] High-Level Working Party on Tax Questions (HLWP).

BEPS standards, improve tax transparency and enhance fair taxation within the EU. To that effect the group examined 92 States that supposedly are too lenient to certain tax practices promoted by MNEs. Working alongside the Council, the task force provided in the end 2017 a report on a number of tax jurisdictions that did not fit the standards of international taxation policies. The "*Council Conclusions on the EU list of non-cooperative jurisdictions for tax purposes*",[535] (hereinafter *Conclusions*) is the "first ever ***black list of tax havens***"[536] published by the Commission (5 December 2017) and it is expected the States expressively listed in the document to take actions in oder to adapt their system to international standards. Moreover, the task force (Code of Conduct group) has an important role in bringing to the EU's agenda matters that affect directly the functioning of the Common Market, and reports such as the *Conclusions* are the product of such concern (*Musterbeispiel*). Is is also important to point that after the publication of the "***black list***",[537] the *Conclusion's* draft provides that the list must be "updated at least once a year".[538] Moreover the Group will continuously

[535] Concil Conclusions on the EU list of non-cooperatinve jurisdictions for tax purposes. ECOFIN 1088. FISC 345. Council of the European Union (adopted 05/12/2017).

[536] Initially the 15 following States were included in the list: American Samoa, Bahrain, Barbados, Grenada, Guam, Korea (Republic of), Macao SAR, Marshall Islands, Mongolia, Namibia, Palau, Panama, Saint Lucia, Samoa, Tunisia, the United Arab Emirates and Trinidad Tobago. However by 23/01/2018, the following jurisdictions have been removed from the list and currently hold a ***monitoring status***, namely, Barbados, Grenada, The Republic of Korea, Macao SAR, Mongolia, Panama, Tunisia and the United Arab Emirates. Taxation: Eight jurisdictions removed from EU list (2018) http://www.consilium.europa.eu/en/press/press-releases/2018/01/23/taxation-eight-jurisdictions-removed-from-eu-list/. Accessed in 01 Feb 2018.

[537] The ***black list*** is primarily a "tool to deal with external threats to Member States'tax bases. It also means to promote more dialogue and cooperation with international partners on tax issues". The list's aim is to ***improve transparency***, hindering ***unfair tax competition*** and ***promoting fair taxation*** where the economic activity actually takes place. The listing process consists mainly of three steps, (***1***) ***selecting*** **–** the Commission sets a ***scoreboard*** (***selection indicators of the scoreboard*** will be based on the *strength of the relevant State economic tie with the EU*, the *financial activity performed* in that State – FDI, income flows etc, and *stability factors* – corruption, regulatory quality etc and ***risk indicators of the scoreboard*** will based on the *transparency and exchange of information*, the *existence of preferential tax regimes* and on the *applicable CIT* – non-corporate income tax or a zero corporate tax) in order to indicate to which degree the analysed jurisdiction may contribute to tax avoidance practices. The Commission will then present the scoreboard to the Code of Conduct Group that will analyse its findings and render an opinion. After such assessment, the results will be presented to MSs' delegates who will assess which third States should be screened, which takes us to the second step of the process, namely screening. (***2***) ***Screened*** States will be subjected to a thorough analysis. During the screening phase, an important dialogue with the screened Nations are conducted, "to allow then to react to any concerns raised or discuss deeper cooperation with the EU on tax matters". Such discussions are, in our opinion, mandatory, for including States in a black list without granting third States the right of being heard, certainly infringes a number of EU guarantees. After being heard, if the both parties do not reach an understanding, the screened Countries are untimately listed. (***3***) ***Listing*** consists on the last phase of the process, that is to say, "third Countries that refused to cooperate or engage with the EU regarding tax good governance principles, when all other attempts to engage with these countries have failed". The ***List*** "is (…) a last resort option". The Commission will perform the monitoring of the listed Countries and update the list once a year. *Scoreboard of Indicators*. First step towards a new EU list of third country jurisdictions: scoreboard. (2016) https://ec.europa.eu/taxation_customs/sites/taxation/files/2016-09-15_scoreboard-indicators.pdf. Accessed in 24 Sep 2017.

[538] Currently, the following Countries refused to engage with the EU's good governace tax policies: American Samoa, Bahamas, Guam, Naminia, Palau, Samoa, Saint Kitts and Nevis, Trinidad Tobago and US Virgin Islands. The EU List of non-cooperative jurisdiction for tax

observe the listed jurisdictions, as well as other *screened* jurisdictions,[539] and MNEs that insist on using those listed States in their schemes will inevitably suffer great negative impact on their credibility, which would force such groups (allegedly) to avoid using those States in order to avoid reputational damage, loss of future business, lack of trust, loss of future clients/customers, lost opportunities, low moral etc (intangible assets).

Now, the ATAD is the Commission's response to taxpayers: (***i***) that abuse the international tax system by arranging schemes intended to explore the "differences in the legal characterization of payments (financial instruments) or entities and those differences surface in the interaction between the legal systems of two jurisdictions",[540] therefore creating double deductions (DD) or deductions without being taxed in another State (D/NI) - (***Hybrid Mismatch Arrangements*** – Article 9 ATAD), (***ii***) that shift profits to subsidiaries resident of low-lax jurisdictions where little or no economic activity occurred (***CFC*** – Articles 7 and 8 ATAD), (***iii***) that enter into structured tax schemes in order to avoid taxation, that is to say, into arrangements that "are not genuine" and have the sole purpose of avoiding taxation (***GAARs*** – Article 6 ATAD), (***iv***) that "moves assets or its tax residence out of the jurisdiction of a State" where the "economic value of any capital gain" was created before the gain has not yet been realised and the time of the exit (***Exit tax*** – Article 5 ATAD) and lastly, (***v***) that generate excessive interest payments in order to increase deductibility (Interest limitation rule – Article 4 ATAD). All situations will be properly studied in other parts of this investigation when covering tax avasion and avoidance. To conclude, the ATAD Directive will certainly "improve the resilience of the internal market as whole against cross-border tax avoidance practices".[541]

10. CCCTB Directive (2011), CCTB Directive (2016) and *CCCTB Directive (2016)*

In 2010, Mario Monti on his report to the President of the European Commission "A New Strategy for the Single Market" wrote "[E]urope has a highly fragmented tax landscape, (…) the operation of 27 different set of rules implies significant compliance costs and administrative burden for citizens and business operating cross-border. When an EU tax framework exists, it lacks ***transparency***, leads to ***loopholes*** and opens the door to ***uncertainties*** as regard the applicable rules or to instances of ***double taxation*** or ***tax discrimination***. (…) The functioning of the single market – coupled with the wider globalisation process - places a growing challenge for the operation of domestic tax systems and may erode in the long term their revenue raising capacity, as well as their ability to pursue social and redistribution policies at the national level. Addressing this underlying tension between market integration and tax

purposes. FISC 345. ECONFIN 1088. 15429/17 (2017) http://data.consilium.europa.eu/doc/document/ST-15429-2017-INIT/en/pdf. Accessed in 24 Dec 2017.

[539] Concil Conclusions on the EU list of non-cooperatinve jurisdictions for tax purposes. ECOFIN 1088FISC 345. Council of the European Union. (adopted on 05/12/2017). Preamble.25.

[540] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal Market. L 193/1.

[541] Council Directive (EU) 2016/1164 (16).

sovereignty is one of the avenues for reconciling the market and the social dimension of the single market."[542] Professor Monti stressed one of the most serious hindrances to the attainment of a pure and fully functional internal market, which has been discussed for years. Note that Europe's fragmented tax system mentioned by professor Monti enhances the lack of transparency, create the possibility for companies to structure tax schemes making use of legal loopholes, therefore generating uncertainty, double taxation, tax discrimination etc. Nonetheless, such hindrances (problems) are not new to the European Community, for since the *Neumark report* was published in 1962, proposals such as a harmonized company taxation system within the internal market were brought to discussion. Then came the Ruding report in 1992, also stressing the fact that differences in tax systems caused market distortions and enhanced tax competition. In 1996 Dr. Monti, debated the effects of tax competiton within the Internal Market. Then the Primarolo's report in 1999 and the Commission's working paper in 2001, reaching also the same conclusion as the other reports have, that an uncooperative set of tax rules costs Europe: ***Europe***.

The 2011 CCCTB[543] Directive Proposal[544] was indeed a big step in reaching a uniformed tax system within the EU, nonetheless, MSs opted for a two-step approach, mainly due to the impossibility of an agreement between MSs on the "apportionment of the consolidated tax base", [545] therefore in 2016 the Commission relaunched the CCCTB Directive Proposal,[546] in the form of CCTB (Common Corporate Tax Base), that contrary to the ***optional regime*** of the 2011 CCCTB Directive Proposal (Articles 6 to 8 CCCTB Directive Proposal), it imposes upon companies a ***mandatory tax regime*** "for groups above a certain size, in order to enhance the resilience of the system against aggressive tax planning practices".[547] The *optional* Common Consolidated Corporate Tax Base aimed to provide MNEs a common set of rules across the EU for determining taxable base, which would be ultimately consolidated across the EU. The scheme consisted of three basic elements: (***i***) optionality, (***ii***) common rules to determine the taxable income and (***iii***) consolidation and allocation of taxable shares by formulary apportionment (FA). Discussions since 2011 have shown that the CCCTB proposal was in fact a very ambitious project making therefore the Commission taking a step back. Various elements (especially, tax consolidation) "have given rise to a difficult debate and could be holding back progress on other fundamental features of the system. The CCCTB 2011 Directive proposal ***will be withdrawn*** as the Commission submit new proposals, namely, the CCTB Directive (COM (2016) 685 final) proposal and the CCCTB Directive proposal (COM (2016) 683 final). In this regard, it is fundamental that tax consolidation remains as an essential element of the CCCTB initiative, since the major tax obstacles faced by companies in the Union" [548] can only be tackled through consolidation and unoformization".

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[542] Mario Monti. *A new Strategy for the Single Market. At the service of Europe's Economy and Society*. Report to the President of the European Commission Jose Manuel Barroso (2010) 79.
[543] Gemeinsame Konsolidierte Körperschaftsteuer-Bemessungsgrundlage (GKKB).
[544] COM (2011) 121/4 final.
[545] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 38.
[546] COM (2016) 685 final.
[547] COM (2016) 685 final. 3.
[548] COM (2016) 685 final. 3.

The ***Common Corporate Tax Base*** (CCTB) is a big step to the EU's integration process, for it will allow companies to use a single set of rules when assessing profis. The fact of the matter is that currently, a company operating within the internal market, has to cope with 28 different tax systems,[549] each one applying specific rules ultimately adapted "to increase mobility of taxable bases as a result of globalization".[550] Moreover, "not only does each Member State have its own sets of rules for determining taxable profits, but it also has its own arrangements for collection and administration of taxes (e.g. different rules and deadlines for completing and filing tax returns, different procedures to deal with tax authorities, etc.) and its own network of tax treaties. For businesses that operate in a cross-border environment, the level of complexity is exacerbated, as they are confronted with multiple tax regimes, potentially subject to frequent changes".[551] In 2001 the study "*Company Taxation in the Internal Market*"[552] suggested a number of actions to reduce complexity and improve efficiency, therefore enhancing macroeconomic performance (employment, economic growth, welfare). The Commission's ultimate goal was to (a) ***reduce tax related compliance costs***, (b) ***eliminate double taxatio***n and (c) ***eliminate over-taxation*** on cross-border activity due to the absence, or "limited availability" of cross-border relief,[553] for as the Commission indicated in 2001 "***compliance costs*** is one of the most important general cross-border tax problems, and given that the importance of the problem is greater for SMEs than for bigger companies, thought might be given to Community action in this area. In particular, a simplified and ***uniform tax return***[554] and ***simplified bookkeeping rules*** for small and medium-sized enterprises which they could file throughout the EU would constitute an enormous help for the businesses concerned. Moreover, consideration could be given to the standardisation of formal and procedural requirements (similar filing dates, similar penalty regimes and a similar basis for charging interest on late payment etc). Such an initiative should be acceptable to Member States as most Member States already apply specific tax arrangements for small and medium-sized enterprises which are designed to mitigate the administrative burden and reduce their ***compliance costs***."[555] The elimination of ***double taxation*** and ***over-taxation*** on cross-border activities are also part of the "main objectives of the proposed policy Directive".[556]

The 2016 CCTB proposal laid a ***two-step approach*** to the the final EU-wide corporate tax system, the ***first*** (CCTB) being limited to the elements of a *common corporate tax base*[557] (rules for calculating the corporate tax base, inclusion of

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[549] COM (2016) 685 final. 2.

[550] Commission Staff Working Document Impact Assessment Accompanying documents to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB). COM (2011) 121 final. 8.

[551] COM (2011) 121 final. 8.

[552] COM(2001) 582 final.

[553] COM (2011) 121 final. 16.

[554] The CCTB proposal simplify the filing system by implementing a single tax return procedure where the group "would file a single tax return with the tax authority of its principal Member States through what is called a ***one-stop-shop system***". Denis Weber (n 45) 254.

[555] COM (2001) 582 final. 366.

[556] COM (2011) 121 final. 47.

[557] A ***compulsory common corporate tax base*** creates a mandatory set of rules, from where the tax base would be calculated. This solution would reduce uncertainty as well as improving

provisions against tax avoidance and on the international dimension of the proposed tax system, rules against debt bias and a super-deduction is given for research and development - R&D). [558] The ***second step*** consists of "***[C]onsolidation*** (…) envisaged to be addressed in a separate proposal for a Directive (…), due for examination at a second stage, *i.e.* after the elements of the common base have politically been agreed. Until then, the proposal for a CCCTB will remain pending for examination in Council. To make up for temporarily depriving taxpayers from the benefits of tax consolidation, there is provision for a mechanism of cross-border loss relief with subsequent recapture. This would be due to remain in force until the introduction of the consolidated tax base (CCCTB), which makes cross-border loss relief an automatic outcome of applying the rules."[559]

The CCTB Directive proposal is also in tune principles of ***proportionality*** and ***subsidiarity***. ***Subsidiary.*** According to Article 5 Protocol (No.2) on the application of the principles of subsidiarity and proportionality, ***"***[D]raft legislative acts shall be justified with regard to the principles of subsidiarity and proportionality. Any draft legislative act should contain a detailed statement making it possible to appraise compliance with the principles of subsidiarity and proportionality",[560] thus aware of its duties, the Commission presented its justification based on the fact that the implementation of a CCTB and CCCTB proposals could only be "dealt through collective action". We have to agree to the Commission's reasoning, for the current tax system as it is did not solve, for example "mismatches in the legal qualification of entity payments leading to double taxation or double non-taxation".[561] ***Proportionality.*** The proportionality of the CCTB and CCCTB Directive proposals are also deemed as propostional by the Commission due to the fact that both Directives do not "restrict Member State's sovereignity to determine their desired amount of tax revenues in order to meet their budgetary policy targets" [562] for the Directive proposals does not "affect the Member States' right to set their own corporate tax rates".[563]

Scope. The Directive shall apply to EU companies listed in the annex (SE, SCE etc) that are subject to national corporate income taxes (or similar subsequently introduced taxes). It shall also apply to third country companies which have a similar form to EU companies and which maintain a taxable presence in the EU through a PE. The Commission revised the 2011 CCCTB Directive proposal only to ***exclude*** from the revised version ***PEs situated outside the Union***, therefore only permanent establishments situated within the Union and belonging to a taxpayer who is resident for tax purposes within the Union are covered by the Directive. The Commission's "aim would be to ensure that all concerned taxpayers share a common understanding and to exclude the possibility of a mismatch due to divergent definitions. (…) The third-country

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transparency in relation to the taxable base, solve transfer pricing problems, while maintaining the State's independence to set its own tax rate.

[558] The super-deduction for R&D and rules against debt bias were included on the 2016 proposal. COM (2016) 685 final. 3.

[559] COM (2016) 685 final. 3.

[560] Consolidated version of the Treaty on the Functioning of the European Union Protocol (No 2) on the application of the principles of subsidiarity and proportionality. C 326/1.

[561] COM (2016) 683 final. 5.

[562] COM (2016) 683 final. 5.

[563] COM (2016) 683 final. 5.

dimension is thus left to be dealt within bilateral tax treaties and national law."[564] Both 2016 Directives (CCTB and CCCTB) remained mostly unchanged when compared with the 2011 CCCTB Directive, for instance, the ***definition of a group***, ***business reorganizations*** and the ***taxation of losses and unrealized capital capital gains***, the ***treatment of withholding*** taxes and the ***sharing mechanism***, ***formulary apportionment*** and its factors (labour, assets and sales by destination) remained unchanged.

The major aspects of the proposal are (***a***) limitation to CIT, (***b***) Consolidated basis (only for the CCCTB Directive proposal), (***c***) exclusion of TP rules, (***d***) simplification of dispute settlement mechanism, (***e***) interest limitation deduction (absent from the 2011 CCCTB Directive proposal)[565] and (***f***) domestic tax incentives.

a. *Limitation to CIT.* ***Both proposals*** (CCCTB and CCTB) are limited to CIT. Moreover, it is fair to assume that a uniformed tax base[566] ultimately allow European companies to compete more fiercely with companies from other markets (USA, China, India, Japan, Brazil etc).[567]
b. *Consolidated basis (CCCTB).* Under a consolidation scheme, it is expected undertakings to reduce compliance costs due to the fact groups operating within the internal market would only use the CCCTB rules, that is, groups will "replace the national corporate tax systems, which has been built up over decades of legislation, parliamentary explanations, resolutions and case law" [568] for CCCTB's provisions.
c. *TP.* Transfer princing rules are excluded under the CCCTB, for revenue distribution will be carried out through FA. Tax authorities will also benefit from such simplificatication for the group will deal mainly with the tax administration of the MS where the PC resides.[569]
d. *Arbitration and dispute settlement.* ***Disputes between MSs*** will continue to be submitted to arbitration, nonetheless, ***disputes between MSs and taxpayers*** will be submitted to CCCTB

[564] COM (2016) 685 final. 9.
[565] COM (2016) 685 final. 10.
[566] There is no formal link between the base and International Accounting Standards/IFRS. The rules for the common tax base would therefore define the tax base itself but not the methodology for adjusting the accounts (sometimes called the 'bridge') to arrive at the tax base. That would not be possible as companies will potentially be starting from financial accounts prepared under 27 different national GAAP. However, it should be noted that the work for defining the common tax base has made constant reference to IAS/IFRS. Further, unless uniform treatment is explicitly provided for in the legislation, the tax base would be computed by reference to the general principles in the Directive. Resident taxpayers (i.e. EU-resident companies) shall be subject to corporate tax on their worldwide income. Non-resident taxpayers (i.e. third country companies) shall be subject to tax on business income attributable to their EU-located PE(s), as defined in the OECD Model (subject to existing treaty obligations with third countries)." COM (2011) 121 final. 92.
[567] Denis Weber (n 45) 187.
[568] Denis Weber (n 45) 42.
[569] COM (2016) 685 final. Pag. 8.

procedures[570] according to the 2016 CCCTB Directive proposal administrative procedural rules (Articles 66 to 68).

e. *Interest Deduction.* The interest limitation deduction rule is in tune with the OECD BEPS initiative on interest limitation, and the ATAD Directive, which also provide for such rule discouraring "practices of profit shifting towards low-tax countries".[571] The rule allow interest to be offset against taxable interests, and other financial revenues to a certain limit, that is to say, if there is a "surplus of interest costs" the excess will be subjected to deductibility restrictions which will be determine by the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).[572]

f. *Domestic tax incentives.* Upon completion of both steps (CCTB and CCCTB), tax optimization schemes will be neutralized, that is, "immediate start-up loss compensation, one language, simple rules, one return" for the entire group. Before the CCTB 2016 Directive proposal was presented, companies could opt whether or not entering the scheme, and now, should the CCTB Directive be approved, embracing the CCTB will be mandatory for all "***groups above a certain size***". [573]

We conclude with the remarks made by the EU Commissioner for Taxation Customs, Anti-fraud and Audit, *Algirdas Šemeta*: "The CCCTB will make it easier, cheaper and more convenient to do business in the EU. It will also open doors for SMEs looking to grow beyond their domestic market. Today's proposal is good for business and good for the EU's global competitiveness".[574]

IV. Taxation Policies in an Enlarged EU

A. Introduction

Companies, whether small, medium or multinationals, are the backbone of global economy. The globalization process has changed the world's economic configuration in an irreversible way and although notably countries generally began to close themselves mainly due to waves of ***nati***onalism created by politicians who advocate Armageddon by capitalizing on problems produced by a complete failure of Western countries in performing a proper and functional foreign policy in the Middle-east, it is our opinion (and hope) this ***nati***onalist

[570] COM (2011) 121 final. 99.
[571] COM (2016) 685 final 10.
[572] COM (2016) 685 final 10.
[573] Article 2 (2) reads "The rules of this Directive shall apply to a company that is established under the laws of a Member State, including its permanent establishments in other Member States, where the company meets all of the following conditions: (c) it belongs to a consolidated group for financial accounting purposes with a total consolidated ***group revenue that exceeded EUR 750 000 000*** during the financial year preceding the relevant financial year". COM (2016) 685 final.
[574] *European corporate tax base: making business easier and cheaper* (2017) http://europa.eu/rapid/press-release_IP-11-319_en.htm. Accessed in 27 July 2017.

wave, at some point, to collapse. People change, policies fail, and what seemed to be true and obvious in the past, may not serve the present and may be simply *undenkbare in die Zukunft*.

Businesses are intimately connected to the social environment where they operate and certainly are the main players in industrialized Countries, therefore, it is fair to say that the very existence of a company impose upon such entities the obligation to ***pay its fair share taxes*** after the proper assessment of the taxable base (net profit, sales, capital, asset-valuation and the transport of goods).[575] Before we study tax policies within the EU *per se*, it is important addressing to certain concepts, for they will constantly be referred to throughout this investigation.

B. Indirect Taxation

According to John Stuart Mill, indirect taxes are "*those demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another*".[576] Indirect taxation, contrary to direct taxation, is highly harmonized. Value-added taxes (VAT) and excise duties, for instance, are examples of such harmonization within the EU.[577] Article 113 TFEU (Ex 93 TEC), provides an order to harmonize indirect taxes across the EU. Such order is absent in relation to direct taxation.[578] There is little room left to MSs to legislate over indirect taxes. Measures taken by the European Commission, such as the Community Customs Code, the sixth VAT Directive and the horizontal excises Directive, prevent MSs to act in that field.[579] The scope of national tax policies in relation to indirect taxation is limited due to a high degree of harmonization.

C. Direct Taxation

When government authorities collect taxes, either from a natural person or undertakings, whether over income, capital or wealth, the entity's income was subjected to direct taxation. Although there is no general accepted definition, *John Stuart Mill* describes direct tax as is *"one which is demanded from the very persons who it is intended or desired should pay it*".[580] It is important to point out that differences between Member States' tax statues results in lack of transparency and consequently insecurity.[581] Compliance expenses are substantially high for undertakings operating within the internal market that have to provide for 27 different legislations.[582] Another undesired result of such

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[575] Wolfgang Reichenberger. *Die Verrechnung von Kuppelprodukten im Spannungsfeld komplexer Zielsysteme, dargestellt am Beispiel der Plannung in der Nahrungsmittelindustrie.*. Wien Wirtschaftsuniversität (1979). 175.

[576] IBFD International Tax Glossary. International Bureau of Fiscal Documentation. 128.

[577] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 7.

[578] Ben Terra and Peter Wattel (n 60) 149.

[579] Ben Terra and Peter Wattel (n 60) 22.

[580] IBFD International Tax Glossary. International Bureau of Fiscal Documentation. 127.

[581] Lack of transparency creates insecurity, consequently influencing investment decisions. An example of such results was the economic policy carried out by the Brazilian government during Dilma Rousseff terms, leading to a complte deterioration of the country's accounts by employing creative accounting practices in order to finance public spending.

[582] "*PricewaterhouseCoopers LLP* (PWC) carries out since 2005 an annual Total Tax Contribution

discrepancies is that it generates distortions in the internal market, for it influences the allocation of production factors which can restrain the ability of MSs to raise taxes at a national level.[583] The role of case law in relation to taxation within the European Union cannot be ignored, for it imposes upon MSs the duty to cease applying measures deemed as incompatible with Union Law. A Study conducted by the European Parliament,[584] on the impact of case law in the field of direct taxation, confimed the ECJ's fundamental role in bringing down tax barriers created by MSs. The Court of Justice may only become involved "following either an infringement procedure initiated by the Commission (…) or by the request of a national jurisdiction for a preliminary ruling concerning the interpretation of EU law". The ECJ's competences were already subjected to discussion in other parts of this investigation. In sum, the contrast of direct taxation legislation amongst Member States disfigures considerably the amount of capital allocated amidst MSs, ultimately resulting in dual taxation,[585] and the perversity of such phenomena contributes negatively to the Union's objective stated on Article 9 TFEU "[I]n defining and implementing its policies nad activites, the Union shall take into account requirements linked to the promotion of a high level of employment, the guarantee of adequate social protection, the fights against social exclusion, and a high level of education, training and protection of human health."

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survey of the Hundred Group of Finance Directors (ie an association of the 100 largest listed UK companies, which contribute nearly a quarter of the total corporation tax take in the UK) asking them to provide information on the time spent on compliance activities relating to their taxes borne and collected, as well as to provide data on their tax payments. The results of the 2007 survey showed an average cost of tax compliance for corporate income taxation of 2.2% of taxes paid. On top of that, around 15% of the time spent on compliance activities relate to the international aspects of corporate taxation (of which, transfer pricing represented 36%, Controlled Foreign Corporations 23%, double tax relief 19%, withholding tax 6%, treasury consents 4%, and other 12%). Furthermore, the results of the 2008 Survey show that 43% of the total compliance time and 54% of the total compliance costs relate to corporation tax. ***Research undertaken by the European Commission*** (…) confirms both the significance and the regressivity of compliance costs in the corporate sector. 700 companies across 14 MS of the EU responded to the survey (carried out in 2003), which shows that compliance costs for the large companies averaged € 1.5 million, which represented 2% of the taxes paid and 0.02% of sales. By contrast, SMEs incurred compliance costs, on average, of € 200,000, which represented 31% of the taxes paid and 2.6% of sales. The study also indicates that cross-border activity (for example, establishing a subsidiary in another Member State) is likely to lead to higher absolute and relative tax-related compliance costs, as are transfer pricing issues. Thus, these findings corroborate the view that cross-border operations make it more difficult for companies to comply with the administrative aspects of company taxation. (…) The ***Ernst & Young Transfer Pricing Surveys*** show that transfer pricing has increased compliance burdens over the last years, due to two main factors: (i) more demanding documentation requirements from tax authorities accompanied by tax authority reviews; (ii) adjustments and changes of the type and scope of business operations around the world. Particularly, the increased documentation demands owing to transfer pricing appear to be stretching tax department resources. In the 2007 Survey, 65% of respondents saw an increased need for transfer pricing resources over the former three years, with 72% meeting the need through increased reliance on external advisors and 34% by hiring in-house resources. Already in the 2005 Survey, many companies seemed to have expanded their internal resources dedicated to transfer pricing and task risk management, increasing their average headcount by 1 full-time equivalent to 2.5." COM (2011) 121 final. 10.

[583] Kristen Anderson, Lars Oxelheim, Eva Eberhartinger. *National Tax Policy in Europe. To Be or Not to Be?* Ed. Springer (2007). 7.

[584] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194).

[585] Ibid 7.

1. Tax Driver

Tax driver is a factor that can cause the change in the taxpayer's tax liability, that is to say, it fluctuates according to the relevant factor that triggered the burden. Tax drivers influence the taxpayer's effective tax burden, for example, the effective tax burden will change according to the tax base (broad or narrow), the effective tax rate (ETR) etc. Here a parallel can be made with cost driver, which determines the cost behaviour of a certain activity (activity based costing).

2. Nexus link

Resorting to a more basic and simple definition, *nexus link* is the connection between a fact and the reason for its existence. Here lies the basis for liability. *Nexus link* has already been mentioned in other parts of this study, specifically in the *Bachmann* case, where a direct *link*, between the deductibility of taxable income and the taxation of future benefits was deemed as a necessary in order to maintain "*coherence of the national tax system*".[586] Governments may grant taxpayers various tax benefits such as deductions, accelerated depreciation, deferral for unrealized capital gains etc, for they expect to recover some of that income in the future,[587] and here the *nexus link* has a crucial role. The ECJ has established that a casual *link* between the MS's obligation and the loss and damage suffered by the injured party is a primary condition when assessing a MS's accountability.[588] Take hybrid mismatch arrangements for instance, MNEs are able generate multiple deductions divorced from *nexus* with any income whatsoever. Another example, in the near future, resident companies operation within the EU will be able to use an apportionment formula for tax allocation purposes, that is, the income of the relevant undertaking will be apportioned to the relevant MS only if the undertaking has sufficient *nexus* in the MS (sales, labour – payroll and number of employees and assets).

Economic Link is also an important concept that connects preferential tax regimes to the place where the economic activity actually occurred, for there is a consensus among the international community that taxpayers that benefit from preferential tax regimes, must in fact foster economic activity and incur in expenditures in that State. Tax should be collected in those countries where the economic activity and operation took place, where the profits were actually accrued. Action 5 of BEPS specifically provides for such rule.[589]A deeper study of *nexus link*[590] will certainly fall outside the scope of this study, therefore we conclude the topic with the OECD's definition of the rule: *"a requirement in tax*

[586] Ben Terra and Peter Wattel (n 60) 66.
[587] Ben Terra and Peter Wattel (n 60) 67.
[588] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 12.
[589] Countering Harmful Tax Practices More Effectively. Taking into Account Transparency and Substance, Action 5 - 2015 Final Report. OECD. 23. http://www.oecdilibrary.org/taxation/countering-harmful-tax-practices-more-effectivelytaking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en. Accessed in 24 Oct 2017.
[590] In the US, the taxable income of a MNE may be apportioned to a specific state only if the enterprise has sufficient nexus to the state.

law for determination of taxability or deductibility. For example, expenses are deductible if they have a nexus with gross income (…)".[591]

3. Broad and Narrow Tax Base

Tax base is the value of assets, investment or income streams that tax authorities are entitled to tax. For example, if an entity's income is subjected to taxation, either because the entity generated profits, realized capital gains etc, the entity's tax liability is determined on the ***basis*** (*base*) of that income. *Tax base* is a measure upon which the assessment of indirect tax liability (consumption tax, VAT, excise duties etc) and direct tax liability (revenue from undertakings, the wage of a natural person etc) is *based*. Now, if a certain legal Statute establishes that a certain concept should be interpreted ***broadly***, it is simply saying that that provision's spirit is to cover as many situations as possible. For instance, Article 229 Canadian Criminal Code reads "*Murder: Culpable homicide is murder*: (a) where the person who causes the death of a human being (i) means to cause his death, or (ii) means to cause him boadly harm that he knows is likely to cause his death, and is reckless whether death ensues or not (…)".[592] Article 121 Brazilian Criminal Code Reads "*To kill someone*: six to twenty years imprisonment".[593] Note that neither the Canadian Code, nor the Brazilian Code established that "*Murder: Culpable homicide is murder:* (a) where the person who causes the death of a human being (i) means to cause his death ***by knife*** or ***hand gun***" or "*To kill someone by* ***drowning*** *or* ***torture***: six to twenty years imprisonment", because the legislator's intention was to cover as many cases as possible (killing by knife, handgun, drowning, torture etc). The OECD *Model* chose set the Statute's substantial scope as ***broad*** as possible by covering all "taxes on income and on capital imposed on behalf of a Contractig State". The *Model* could have opted to include the term "*direct taxes*" instead of "taxes on income and on capital", and the reason is that *direct taxes* is "far too imprecise",[594] for we know States may interpret differently the concept. Following such reasoning a broad tax base therefore minimizes tax preferences and increase simplicity to the system. By broadening the tax base, States are able to increase revenue, for instance, the State may lower a income exemption bracket from 10 to 5, now taxpayers earning 5 or more will be liable to taxation, or tax certain products or services not taxed before or even reduce a certain tax exemption or rule out state aid granted through tax exemption to certain industries. In 2001 Germany, for instance, has broadened its tax base by: (***i***) substituting a full imputation system in force since 1977 by a shareholder relief system, where "only half of the dividends received by a private shareholder are subject to personal income tax" and by cutting in half "all deductions connected with dividend income" from the income tax base (*Corporation tax system*),[595] (***ii***) replacing the split-rate that "distinguished between retained (40%) and

[591] OECD Tax Glossary.
[592] Criminal Code (R.S.C,1985, c. C-46). Article 229 (a) (i) (ii).
[593] Decreto-Lei n 2.848, de 7 de Dezembro de 1940. Codigo Penal Brasileiro. Artigo 121. http://www.planalto.gov.br/ccivil_03/decreto-lei/Del2848compilado.htm. Accessed 01 Jun 2018.
[594] Commentaries on the Articles of the Model Tax Convention 75.
[595] COM (2001) 582 final 102.

distributed profits (30%)" for a single uniform tax rate of 25% (*Corporation tax rates*),[596] (***iii***)reducing the top marginal personal income tax rate from 53% "in three successive steps leading to a rate of 42% (…) in 2005" (*Income tax rates*)[597] and (***iv***) "cutting back the depreciation rules for tangible fixed assets and for buildings" (*Corporation tax base*).[598] A ***narrow tax base*** leads to lower revenue (high exemption brackets, State aid etc). Take India exemple, according to a 2017 study commissioned by the Indian income-tax department, only 1,6% of Indians pay income tax. Despite its narrow base for direct taxation, "most Indians contribute to tax revenue because India relies heavily on indirect taxes".[599]In sum, "[N]ational tax policy is restricted by the need to safeguard sufficient tax and social security revenues to finance government spending"[600] and India's *tax base* need certainly be revised.

4. Tax Connecting Factors

Basically, ***tax connecting factors*** provide for the allocation of tax rules, that is to say, which State has taxing rights over the relevant income. A connecting tax factor may by established according to the place of employment or where the business activity takes place, the place where the immovable is located (*situs*), place of mind and administration of an undertaking, the person's residence, the time period of cross-border employment, the State where the employee's pay is deducted etc.[601]

5. Surcharges (Surtaxes)[602]

A *surcharge*, or *surtax* is a fee, a charge added to the product's final cost. Surcharges may be imposed both by the State and by private undertakings. When charged by States, a *surcharge* may come in the form of a fine, or a fiduciary duty imposed by a court of law. When charged by private undertakings, surcharges are generally costs passed on to consumers, for instance, if the State raise taxes, the cost is ultimately passed on to the consumer by *surcharging* the product.

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[596] COM (2001) 582 final 102.

[597] "The top marginal tax rate begins at a taxable income of Euro 52.152. For the year 2001 the top marginal rate has been set at 48.5%, and it will be 47% in 2003. For the purposes of the following calculations only the situation applying from the year 2005 is considered." COM (2001) 582 final 102.

[598] "The maximum declining balance rate for tangible fixed assets has been reduced from 30% to 20%. For buildings, the straight-line depreciation has been reduced from 4% to 3%." COM (2001) 582 final 102.

[599] *Rethinking India's tax system.* Dec 26 2017. https://www.livemint.com/Opinion/z2DURCdrbtLjCPnutKs3gJ/Rethinking-Indias-tax-system.html. Accessed in 31 Dec 2017.

[600] Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 2.

[601] Ben Terra and Peter Wattel (n 60) 61.

[602] COM (2001) 582 final 5.

6. Statutory (nominal) tax rate (STR), Effective tax rate (ETR)

Statutory tax rate (STR), or *nominal tax rate*, is that imposed by a legal statute. It contrasts with *Effective tax rate* (ETR), which is the effective rate paid on the relevant taxable. According to a recent study on public finance conducted by the Congressional Research Service, [603] less the 1% of tax payers in the USA pay top *STR*. In Europe, a study a 2009 have showed that the average corporate ETR is at 22,3% "but this overall average hides considerably dispersion (…) across the individual Member States" being the lowest in Bulgaria (8,8%) and the highest in Germany (35,5%).[604] Statutory tax rates could be ultimately used as a loose form of tax coordination in the EU, that although legally binding, it does lead to an equalization of tax codes. A common STR in EU would have a "significant impact by decreasing the dispersion – both between parent companies and between subsidiaries – of marginal and average effective tax rates across EU contries. (…) such a scenario would be likely to go some way in reducing locational inefficiencies within the EU".

7. Tax Brackets

Tax rates may change according to the relevant system, namely, progressive system, regressive system, and proportional system. ***Progressive tax system*** (mainly used for active income) follows a schedule of acceleration, that is to say, the higher the income the higher the rate, either to personal or business income. ***Regressive tax system*** (applied to excises, sales tax), are the opposite from progressive systems, that is, the higher the transation's price, the lower the tax rate. Finally, ***Proportional tax system*** applies a flat tax rate to all taxpayers regardless the income (effective marginal tax rate *equals* the effective average tax rate / EMTR = EATR). A tax bracket is the division rule applied in respect to the applicable ***progressive*** or ***regressive tax system***. In Brazil, for instance, the natural person's income tax bracket varies according the annual intake.[605] Tax brackets may also be apply in regressive tax systems, for example, the tax rate on private retirement plans in Brazil range from 35% (till 2 years) to 10% for 10 years or more.

8. Measuring Effective Tax Rates (ETR)

Effective tax rate (*Effektivsteursatz*) is the ***actual*** amount of tax paid by a natural person or undertaking. Effective tax rates can be assessed accoding to two systems, namely *backward-looking system* and *forward-looking system*.

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[603] Molly F. Sherlock. *Statutory, Average and Effective Marginal Tax Rates in the Federal Individual Income Tax: Background and Analysis. Congressional Research Service*. "Summary" (2017). https://fas.org/sgp/crs/misc/R44787.pdf. Accessed in 31 Dec 2017.

[604] Christina Elschner and Werner Vanborren. *Taxation papers. Corpoarate effective tax rates in an enlarged European Union*. European Commmission's Directorate-General for Taxation and Customs Union (TAXUD). Office for Official Publications of the European Comminities, (2009). Accessed in 31 Dec 2017. https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_14_en.pdf. 11.

[605] Annual intakes of R$ 22.499,13 are exempt. For an annual intake higher than 55.373,55, the tax reaches a maximum of 27,5%.

Backward-looking system assess the actual endogenous data when calculating ETR. ***Forward-looking system*** focus on hypothetical (future) investments. This approach considers a hypothetical firm, tax law based –domestic and bilateral rates. Such method is largely used to analyse the effects of taxes in relation to investment behaviour,[606] for it accounts for a "*possible*" future investment. When applying forward effective tax rates (FETRs), the average tax burden imposed upon undertakings within the EU is 8,3%,[607] (10,5% / 39,1%) although that may depend on the form of finance involved (debt or equity).[608] Generally, tax systems maintain lower tax burden in intangibles, machinery and debt.[609]

	Advantages	***Drawbacks***
Backward-looking system	Easily calculated from actual data. Include tax planning activities of MNEs and may be used as basis with the normal taxation incidences.[610]	National and international activities cannot be separated added to the difficulty in to ascertaining data.[611]
Forward-looking system	Distinguish between domestic and international investments and correspond to investment decisions of MNEs also looking-forward.	High degree of complexity in calculating rates – "the net present value of a hypothetical investment has to be calculated with or without taxation and (…) tax planning activities of MNEs cannot be addressed."[612]

Forward-looking systems calculated either effective average tax rates (EATRs) – measuring the tax burden of an infra-marginal (profitable) investment, or as an effective marginal tax rate (EMTRs), measuring the tax burden of an investment which just earns the cost of the capital. A "measure of the effective tax rate should in principle be forward looking if it is meant to capture all the provisions of the tax code which allows the firm to reduce their tax burden in a forward looking measure. Backwarrd looking measures have therefore the main advantage, that the impact of the special rules of the tax code will tend to be captured in the data used to construct these measures. If the tax law remains relatively stable over time, a backward looking measure may be a good proxy for the ideal forward looking measure".[613]

9. *Pretax and Postax Rate of Return*

A *pretax* rate of return must be assessed alongside an investment, that is to say, what is the investment's return before taxes were levied? For example if a person purchases a 1000 EUR bond which pays 10% at maturity, the *pretax* return on that bond is 1100. Now, if the State where the bond was purchased levies a 25% capital gains tax rate, the *postax* return on that bond is 1075 EUR.

606 COM (2001) 582 final 3.
607 COM (2001) 582 final 4.
608 Idem
609 COM (2001) 582 final 4.
610 Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 16.
611 Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 16.
612 Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 16.
613 Tanja Kirn. *Measuring corporate marginal tax rates: looking forward or looking backward?* (2011). Accessed in 31 Dec 2017. 2. http://www.scb.se/Grupp/Produkter_Tjanster/Kurser/_Dokument/IMA/Kirn_2011.pdf.

The *postax* return on the bond could also be equal to the *pretax* retun if the State grants an exemption.

10. Effective Average Tax Rate (EATR)

Effective Average Tax Rate[614] is the ***ratio*** of the total amount of collected taxes to the total tax base, that is to say, EATRs are the product of nominal tax rate ***x*** the tax base,[615] therefore, it is fair to conclude that average tax rates measures tax burden. EATR provides for the before and after tax net value of the relevant investment,[616] and it measures the effects on real investment projects for "it also takes account on the definition of the tax base, and in particular the generosity of capital allowances. There is strong empirical evidence that differences in the EATR across countries affect the location of investment projects. The EATR is relevant in a context where a firm needs to decide among a set of mutually exclusive projects. This is the typical decision faced by a multinational choosing to locate investment in one of a number of countries. In other words, the EATR affects inbound FDI into a country".[617]

11. Effective Marginal Tax Rate (EMTR) and Negative Effective Marginal Tax Rate (NEMTR).

Effective Marginal Tax Rate is the ***percentage*** of an extra unit of income (extra dollar, euro etc) that the recipient looses due to income taxes, payroll taxes and any decline in tax credits and welfare entitlements, that is to say, the effective capital cost of an investment,[618] that is, EMTR measures the impact of taxes on incentives to produce, save, invest or spend. The tax base plays an important part in assessing the EMTR.[619] EMTR may also be negative, leading ultimately to a ***zero*** incentive to produce, save, invest or spend.

12. Asset Depreciation[620] (Capital Allowances)

When conducting its activities, undertakings use its assets to create profits. Over time, variations on the value of certain assets are inevitable due to excessive usage, for instance, a truck used by the company in order to transport its goods ***depreciates*** over time. On the one hand, an immovable property owned by a company (land) may ***appreciate*** due to market fluctuation prices, on the other hand the building located in that particular land may ***depreciate***. When an undertaking purchases a certain good which will be used on an item's

[614] "The EATR is relevant for real investment in real assets. It is less relevant for comparing location of headquarters, which depends more on the tax treatment of foreign subsidiaries and on CFC rules." John Vella. *Tax Rates Applied by Multinational Enterprises*. *In-Depth Analysis for the TAXE Special Committee*. European Parliament (2015). 12.
[615] COM (2001) 582 final 30.
[616] John Vella (n 614) 12.
[617] Such effect contributes and confirms the occurrence of tax competition among countries, that eventually may be tempted in lowering their rates to attract FDIs.
[618] John Vella (n 614) 13.
[619] The EMTR demonstrates the taxation over a break-even investment, whilst the EATR reflects the taxation of a more profitable investment. John Vella (n 614) 13.
[620] COM (2001) 582 final 34.

production, the cost of purchasing that good will be imputed on the company's loss account, that is, the tax liability of the relevant enterprise wil be reduced by the costs that the company incurred when producing that item. However, certain assets may not be simply included on a "loss account", for its usable life will certainly surpass that particular fiscal year, therefore, tax jurisdicitions apply depreciation rates according to the useful economic life of the asset. The IDBF glossary defines depreciation as "[T]he process of writing off for tax purposes the cost of certain business assets. The term is generally, but not always, applied in relation to both tangible and intangible assets (the term amortization sometimes being reserved for the latter). Although the tax concept is similar to that used for accounting purposes, the amounts often differ due to differences in methods or rates. While depreciation is generally allowed over the expected useful life of an asset, many countries prescribe guidelines for determining the expected useful life and depreciation rates, often by reference to specific categories of assets. Such guidelines generally specify the particular depreciation method or methods to apply. (…) In some cases, the depreciable base may be limited to the additional cost (or incremental expenditure) incurred in a particular year over that in former years. This is often the case where accelerated depreciation is allowed for R&D expenditure."[621]

Accelerated Depreciation. [622] Depreciation method under which "deductions in the earlier years of the life of an asset are greater than those under the straight-line depreciation method. Generally granted by way of an incentive to encourage capital investment in a specified category of assets. Examples of this method include the declining-balance method, the initial allowance, the sum-of-the-years'-digits method of depreciation and, in appropriate circumstances, the unit of production depreciation method."[623]

Declining balance depreciation mehod. Declining balance method involves the application of a depreciation rate against the non-depreciated balance. In other words, as an alternative for distributing the cost of an asset equably over its life, the asset's expenses are applied at a constant rate, resulting in declining depreciation prices each successive period. For example, if an asset costs $2,000 is depreciated at 25% each year, the deduction is $500. in the first year, $375 (1500 x 25%) in the second year etc.

Sum of the years' depreciation method, also called *SYD* method is used to accelerate the depreciation's rate in such a way that the depreciation associated with an asset is recognized in the first few years of its useful life. "The method is more appropriate than the more commonly-used straight-line depreciation if an asset depreciates more quickly or has greater production capacity in its earlier years than it does as it ages. The total amount of depreciation is identical no matter which depreciation method is used the

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621 *Absetzung für Substanzverringerung.* Glossary of Tax Terms. IBDF. https://online.ibfd.org/kbase/#topic=doc&url=/collections/itg/html/itg_depreciation.html&WT.z_nav=crosslinks&hash=itg_depreciation. Accessed in 31 Dec 2017.

622 "In Finland, accelerated depreciation is granted only to certain investments in some developing regions. Similar rules exist in Germany". Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 51.

623 *Beschleunigte Abschreibung; Sonderabschreibung.* Glossary of Tax Terms. IBDF. https://online.ibfd.org/kbase/#topic=doc&url=/collections/itg/html/itg_accelerated_depreciation.html&WT.z_nav=Navigation. Accessed in 31 Dec 2017.

choice of depreciation method only alters the timing of depreciation recognition."[624]

Investment Allowances are tax incentives given to undertakings in order to foster investment in which a certain percentage of such capital costs are deductible, including depreciation, from the companies tax liability.

13. Book Value (Buchwert)

Book value provide a definition for a number of instances, for example, *book value* may be the value or a certain asset stated on a balance sheet and calculated by taking the cost of an asset reduced by the accumulated depreciation rate. *Book value* can also be the market capitalization of an undertaking, assessed by calculating the total of the company's assets excluding intangible assets (patents, goodwill, IP, trade secrets, R&D, human capital) and liabilities. *Book value* may also reffered to the initial sum of an investment minus expenses such as trading costs, sales taxes, service charges etc.[625]

14. Source-Based Tax (territorial system) vs. Resident-Based Tax (worldwide system)

States finance themselves through various ways, but it is by levying taxes on income, CIT, payroll, excises, consumption etc that the State derives the bulk of its revenue. States may tax income only when accrued within its territory (source based or territorial system) or tax income worldwide (resident based or worldwide system).

Territorial tax systems will not tax a entity's income earned across its borders, which may incentive the relevant entity not transfering income back to that State. Nevertheless, such problem is not particular to territorial systems. Parent companies resident of worldwide systems may use CFCs in order to avoid taxation and shift profits to low tax jurisdictions where none economic activity whatsoever occured. Controlled foreign company rules were "first introduced by the United States (known as 'Sub-Part F') in the 1960s and have since been adopted by many other states. Under these rules the income of its subsidiaries located in low tax states is taxed in the hands of domestic parents. CFC rules vary in their breadth, narrower CFCs merely targeting 'diverted' passive income" [626] In worlwide systems, States may levy taxes on income generated across its borders as long as the person is a resident of that State, or tax a non-resident on income generated within its borders.[627].

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[624] *Sum of the years' digit depreciation*. (2017) https://www.accountingtools.com/articles/2017/5/17/sum-of-the-years-digits-depreciation. Accessed in 31 Dec 2017.

[625] "Der Buchwert ist der Wert, der in einer Steuerbilanz zum steuerlichen Übertragungsstichtag anzusetzen wäre (§ 1Abs. 5 Nr. 4 UmwStG)." Tim Jegarzewski and Jen M. Schmittamann. *Steuerrecht. Grundlagen und Anwendungsfälle aus der Wirtschaft*. 2. Auflage. Springer Gabler. 141.

[626] John Vella (n 614) 7.

[627] John Douglas Wilson, David E Wildasin (n 13) 1069.

15. Passive (indirect) Income and Active (direct) income

According to the OECD Glossary of Tax Terms passive income, or *indirect income* is that in which the recipient does not participate in the business activity that gave rive to that relevant income. Examples of such income are dividends, interest, rental income, royalties, capital gains etc. Alternatively, *active income* presumes an active participation of the entity on the realization of the relevant income.[628]

16. Withholding Tax

A proper definition of withholding tax cannot be found within the Council's Directives[629] (Interest and Royalty, Parent-Subsidiary nor Merger Directive). In sum, withholding tax is the amount of tax withheld by the party making the payment to a third party, ultimately paid to the State. The main purpose of withholding taxes, from a procedural perspective, is to facilitate or accelerate the tax collection process by collecting the *due* tax from the payer merely due to *tax convenience*. [630] Nevertheless, despite the relevant domestic legislation's classification of withholding tax, under an EU perspective any tax, duty or charge, must be determined according to its substance.[631] Article 5 of the Parent-Subsidiary Directive provides that profits distributed by a subsidiary to a parent company are exempted from withholding tax. In order to benefit from the article's exemption, the ECJ held that three main conditions must cumulative be met: (i) *the chargeable event of the payment is substiatially dividend distribution or any other income from shares*, (ii) *the taxable amount is the income derived from those assets* and (iii) *the taxable entity owns the shares*.[632] In the Epson case, the ECJ ruled that the term withholding tax is "not limited to certain specific types of national taxation".

Case C- 375/98 Epson Europe v. Ministério Público, Fazenda Pública

5- Epson Europe, a company whose registered office is in the Netherlands, onwed more than 25% of a subsidiary in Portugal. Upon distributing dividends to its parent company resident in the Netherlands, the company was subjected to a deduction on the amount of 15% - "a deduction of PTE 6 119 360 – and of a sum of PTE 2 039 786 in respect of ISD at the rate of

[628] John Vella (n 614) 7.
[629] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 146.
[630] According to Hugo de Brito Machado "Por conveniência da Administracao tributária, a responsabilidade pelo pagamento do tributo pode ser atribuida a outra pessoa que, sem estar essa pessoa diretamente relacionada ao fato gerador da obrigacao tributária, assume, por imposical legal, a responsabilidade pelo pagamento do tributo. Tem-se, então, a figura do responsável, prevista no art. 121, II do CTN." Article 121 II " Sujeito passive da obrigacao principal é a pessoa obrigada ao pagamento do tribute ou penalidade pecuniária. II – responsevel, quando, sem revestir a condicao de contribuinte, sua obrigacao decorra de disposicao expressa da lei." Hugo de Brito Machado. Comentários ao código tributário nacional. 2. Ed Sao Paulo, Saraiva (2004) 423.
[631] CJEU, 25 September 2003, Case C-58/01, *Oce Van Der Grinten*, ECLI:EU:C:2003:495, para.46.
[632] CJEU, 4, October 2001, Case C-294/99, *Athinaike Zithopiia*, ECLI:EU:C:2001:505, paragraphs 28-29; CJEU, 8 June 2000, Case C-375/98, *Epson*, ECLI:EU:C:2000:302, paragraph 23; CJEU, 25 September 2003, Case C-58/01, *Oce Van Der Grinten*, ECLI:EU:C:2003:495, paragraph 47.

5%".[633] Epson proceeded to recover such tax which was ultimately denied by the tax administration of that MS. After the appeal, the *Supremo Tribunal Administrativo* remitted the case for a preliminary ruling.

6- Should the derogation provided for in Article 5(4) Parent Subsidiary Directive be interpreted in such a way as to restrict its application only to IRC (Imposto dobre o rendimento das pessoas colectivas)?

7- No.

8- According to the Court, the derogation of Article 5(4) relates not only to corporation tax, but also to any taxation whatever its nature or classification. The Court ruled that "[I]t must be observed at the outset that, (…) the Directive seeks, by the introduction of a common tax system, to ensure that cooperation between companies of different Member States is not penalized as compared with cooperation between companies in the same Member State and thereby to facilitate the grouping together of companies at Community level. Thus, whith a view to avoiding double taxation, Article 5(1) of the Directive provides for exemption in the State of the Subsidiary from withholding tax upon distribution of profits (Jint cases C-283/94, C291/94 and C-292/94 Denkavit International and Others v Bundesamt für Finanzen [2996] ECR I-5063, paragraph 22)".[634] The court also stressed the fact that "[I]n order to determine whether the levying of ISD on distributed profits falls within the scope of Article 5(1) of the Directive, reference must be made, in particular, to the wording of the provisions. The term 'withholding tax' contained in it is not limited to certain specific types of national taxation. In particular, Article 2(c) of the Directive enumerates, for the purpose of identifying those companies in the Member States which are regarded as falling within the scope of the Directive, the national taxes to which those companies are normally subject, and the Portuguese tax referred to is the 'imposto sobre rendimento das pessoas coletivas', that is to say IRC. However, it connot be inferred from this that other taxes having the same effect are authorized, particularly sinne the final part of Article 2 refers expressively to '*any tax which may be substituted for any of the above taxes*'"[635] (emphasis added). Therefore the Court concluded that it was clear that ISD was a withhonding tax "for which the chargeable event is the payment of dividends or of any other income from shares (…)".[636]

The Epson case ruled Article's 5 Parent-Subsidiary Directive compatibility with the Portuguese donation tax, "which was applicable in respect of transfers, without consideration, of shares of companies".[637]

[633] Opinion of advocate general Cosmasw delivered on 17 February 2000. II – Facts.
[634] Case C-375/98 Epson Europe. Para 20.
[635] Case C-375/98 Epson Europe. Para 20.
[636] Case C-375/98 Epson Europe. Para 20.
[637] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 146.

17. Statute of Limitation[638]

In general, Statute of Limitations are laws which regulate the time limit for the State or any other entity to initiate legal proceedings. As a practical note, States and entities may act administratively even though the relevant Statute of limitation ruled out the possibility of initiating legal action. For example, we have seen cases in Brazil of the tax administration mailing invoices to taxpayers who although having an expired outstanding tax debt, paid the charges regarless for not knowing its rights, clearly in violation of the Statute that allow a five year time period to initiate procedings.

18. Tax Policy in an Open Economy

From the "WWI and decades that followed it, most countries adopted some kind of capital and exchange controls. In the 1970s and 1980s, a general wave of deregulation[639] followed propelled by a variety of forces, of which improvements in information technology played a dominant role." [640] Nonetheless, contrary to common knowledge, the deregulation process did not begin during the 1970s or 1980s, but gradually after long period of economic recession due to the 1929 crash. In 1932 the Federal Home Loan Bank Board (FHLBB) was created in the USA to regulate the banking industry and implement policies to improve the *housing market*. During the 1930s the US government also created the Federal Savings and Loan Insurance Corporation (FSLIC), a fund intended to boost that same market.[641] The FSLIC would operated under FHLBB's supervision, which limited the concession of loans to houses within a 50 mile radius from the borrowing institution, loans could only be contracted by natural persons, in urban areas etc, and most importantly, FSLIC would back such loans in the event of a default. During the 1960s the FHLBB authorized banks granting loans to purchase houses outside urban areas. It was not long before borrowers began to land flip, daisy chain, white knight etc. By 1972, 16 US billion were of due loans were ultimately paid by the American taxpayers (FSLIC). The deregulation crises within the banking industry reached its peak during the time Reagan was at office (approximately 300 US billion were used to bail those institutions out).[642] However, deregulating markets became sort of a *motto* during 1980s for it was common sense back then that too much regulation had become inefficient "[T]o some extent, this was also an expression of a change in the philosophy underlying national economic policy in the 1980s,

[638] In Austria 5 years and 10 years in tax evasion cases. The counting starts from the following year that in which the burden is crystalized. (2017) https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax austriaguide-2017.pdf Accessed in 31 Dec 2017.

[639] Luiz Henrique de Lacerda Sanglard. *White Collar-Crime. Uma perspectiva criminologica*. Universidade de Coimbra (2015).

[640] Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 3.

[641] Geis, Gilbert, Meier, Roberto F. Salinger, Lawrence M. *White Collar Crime. Classic and Contemporary* Views. Ed. New York. The Free Press. (1995). 203.

[642] Schlegel, Kip, Weisburd, David. *White Collar Crime Reconsidered*. Ed. Boston. Northwestern University Press (1990). 195.

reflecting the growing recognition that excessive controls are not compatible with efficient recourse allocation and solid and balanced growth"[643]

Now back to the topic of discussion, due to an increasing flow of FDI during the 1980s, countries adopted capital and exchange control rules such as exit taxes in order to protect its market from currency fluctuations.[644] Another way of slowing the process down was the instauration of CFC regimes therefore limiting the relocation of resources across borders.[645] The fact of the matter is that, when governments raise taxes companies tend to relocated capital in order to optimize performance/results ultimately eroding tax bases.[646] In sum, levying taxes in open economies reduces domestic investment,[647] public expenditure programs, stimulates tax competition ultimately leading to inefficient allocation of resources thereby, reducing welfare than would otherwise be obtained in different circumstances.[648]

19. Tax Policy in a Closed Economy

Implementing taxation policies in *closed economies* are perhaps less complex then in open economy, nevertheless, as in open economies high taxation will certainly influence the incentive to work, save capital, or make investments decisions, nevertheless there is no capital migration risks.[649] Closed economies are in principle self-sufficient and the economy functions exclusively by providing for the domestic market, that is to say, there is little or none exports or imports whatsoever. In such case, the only way individuals can circumvent taxation is by moving to another country.[650]

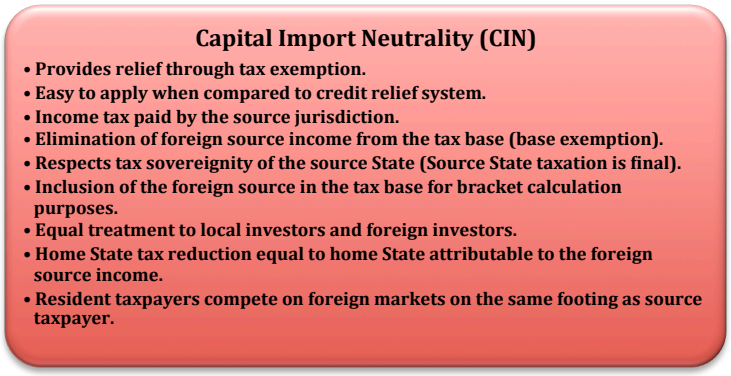
20. Capital Import Neutrality (CIN)

States that adhere to *CIN* provide relief through ***exemption***. Exemption States eliminates foreign income from its base, or add income for tax bracket calculation purposes.[651] Differences on companies' tax burden conducting operations within the single market infringes *CIN*,[652] particularly because it creates tax competition. Member States that apply *CIN*, operate under the assumption that the MS where the associated company functions should have the right to exercise its tax sovereignty, not due to brotherly relations, but because their MNEs should be able to compete against other MNEs on an international environment under different tax conditions.[653] Nonetheless, a "drawback of the exemption method is that it makes countries applying it vulnerable yo tax competition by low-tax jurisdictions".[654] Generally, exemption States limit the

[643] Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 3.
[644] Ibid 3.
[645] Ibid 3.
[646] Ibid 4.
[647] Ibid 3.
[648] Ibid 3.
[649] Ibid 2.
[650] Ibid 2.
[651] Ben Terra and Peter Wattel (n 60) 155.
[652] Ibid 146
[653] Ibid 347.
[654] Ben Terra and Peter Wattel (n 60) 347.

application of the exemption method in relation to active sources of income (business profits, dividends from subsidiaries etc). As for passive sources of income (interest and royalties etc) they are likely to provide a credit.[655]

Figure 2



The IBFD Tax Glossary defines CIN as a "*Public concept describing the situation where investors are subject to the same level of taxes on capital income regardless of whether they are made by a domestic of foreign investor* (…)." Open or too small economies traditionally prefer the exemption method due to limited expansion possibilities.[656]

- ***Applied by*** Luxembourg, Belgium, Austria, Ireland, Malta, the Netherlands, Norway, Portugal, Italy, Sweden etc.

21. Capital Export Neutrality (CEN)

According to *CEN*, the home-State should tax income generated at the source State, that is to say, neither encouraging or discouraging cross-border investment. Therefore, differential treatment between national and international investments infringes *CEN* rules.[657] The State where the tax payer (whether a natural person or a company) conducts his personal life, or where the company maintains its main management seat,[658] that is to say, where it/he derives its income/social benefits, has the right to tax such income, for it is the place where the person "*exists"*. This State is reffered to as "*Resident State*". The State where the person do not reside (non-resident), but nevertheless derives income, will be referred as "*Source State*", which also has taxation rights.[659] When transferring income from the *Source State* to the *Resident State*, the difference of both rates are credited to the amount that would have been paid, had the income been derived in the *Resident State*. For that matter, we present a short example. If the tax rate of *Source State A* is 20% and 30% in *Resident State B, State B* would tax only the difference of 10%. On the contrary, had the *Source State* a higher tax

[655] Ibid 157.
[656] Ibid 157.
[657] Ibid 153.
[658] "As far as companies or firms are concerned, their ***corporate seat***, (…) serves to determine, like nationality for natural persons, their connection to a Member State's legal order (…)." *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt.* C-307/97. Para. 36.
[659] Ben Terra and Peter Wattel (n 60) 153.

(say 30%) than the *Resident State* (20%), the *source State* would not grant a credit for the difference (-10%). There is no such thing as a ***full equalizing credit,*** which intends to equalize (neutralize) differences of tax rates within the Common Market. Needless to say, home tax neutrality becomes somewhat limited in its application scope.[660] Credit systems may also grant ***tax holidays***[661] as well as ***sparing credits***. [662] Such incentives are commonly used by governments in order to boost investment. Nonetheless, it is important to mention that the incentive will not benefit the foreign investor *himself* but the home-State Treasury whre he resides.[663] Member States that have opted for *CEN* operate under the assumption that MNEs should be on an *equal footing* compared to domestic companies. [664] Whether FDI or national investments, there is home neutrality.[665] Nevertheless the *CEN* may also be used to protect domestic markets for it discriminates *foreign dividends* due to the fact that it creates no credit to domestic shareholders, resulting ultimately in double taxation. According to *Wattel/Terra*, this explains why France moved from an exemption to a credit system, which was later abolished after the ECJ's rulings on the *Manninen case*.[666] Nevertheless, choosing one system over the other does not necessarily mean that jurisdictions will only use only that particular system, that is to say, credit States may apply exemption. For instance, exemption jurisdictions may limit exemption to active sources of income (dividends from subsidiaries, business profits, employment etc), and grant credits to passive sources of income (dividends, royalties etc).

Within the Common Market, credit jurisdictions such as Germany, Greece and Finland grant relief by exemption to transactions not covered by Directives or DTAs.[667] Hybrid relief systems are not uncommon, for States will generally apply the more appropriate relief method according to the relevant case. Again, there is no such thing as an obligation to apply one method over the other, in fact the Parent-Subsidiary Directive provides that "*The Directive shall not affect the application of domestic or agreement-based provisions designed to* ***eliminate or lessen economic double taxation*** (…)" (emphasis added).[668] In sum, if the tax burden in the Source State is comparable to the tax burden at the home-State, there is no reason granting a credit, thus tax authorities will simply exempt such

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[660] Ben Terra and Peter Wattel (n 60) 153.

[661] In order to boost investment, developing States offer tax holidays to MNEs. Nevertheless such measures turn out to be utterly inefficient. In Countries such as Nairobi, the government levies a 25% CIT but awards tax exemption for ten years. Before the benefit's expiration, companies change their control, thus restarting the counting of the 10 year period or, move its operations to another country, making the developing State only a tour destination for capital.

[662] Granted by Home States, it corresponds to the tax credit that would have been paid had the tax incentive not existed in the Source State. Countries that make use of such method do not extend the benefit to natural persons or companies if the Source State is a tax haven, have no tax treaty contracted or in case there is a possibility that Source State applies its tax rates in such a way to create tax competition. Ben Terra and Peter Wattel (n 60) 155.

[663] Ibid 154.

[664] ibid 348.

[665] By being **home neutral**, a jurisdiction neither encourages nor discourages its residents from investing abroad. Ben Terra and Peter Wattel (n 60) 154.

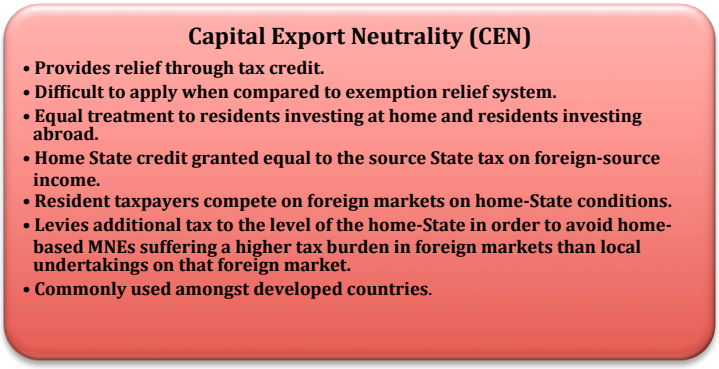
[666] Ibid 171.

[667] Ibid 157.

[668] Parent-Subsidiary Directive Article 7(2).

income from tax[669] moreover the complexity of credit systems prevents the application of a pure *CEN*.

Figure 3



Although the credit method is largely applied by most developed countries, when it comes to taxing ***dividends***, most Jurisdiction *switch* to the ***exemption mode***, (given) along with a ***affiliation privilege*** in order to avoid double taxation.[670] To conclude, we transcribe here the *CEN* definition provided by the IBFD Tax Glossary: "*Public finance concept to describe the situation where investors are subject to the same level of taxes on capital or income regardless of the country in which income is earned. The credit method of relieving international double taxation is often considered to illustrate this principle".*[671] Closed and large economies tend to apply a credit system. [672]

- ***Applied by*** the US, the UK, Japan, France, Italy, Germany, Spain, Brazil etc.

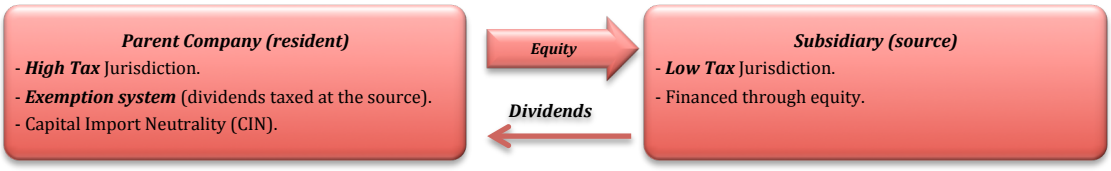
22. Thin Capitalization

It is through *debt,*[673] *equity*[674] or *retained profits* that companies finance their operations. In most cases, companies capitalize making use of both instruments. Nevertheless, when a undertaking seek finance only through debt, the relevant undertaking is referred to as being "*thinly capitalized* or *highly leveraged* or *highly geared*".[675] Consider the following example, a PC grants a loan to a subsidiary resident in another State, the interest payment made to the PC is a deductible expense, consequently (allegedly), the jurisdiction where the PC resides will be entitled to tax such income (***interest***). However, if the PC opts for financing its subsidiary through ***equity***, the return on capital is taxed in the

[669] Ben Terra and Peter Wattel (n 60) 157.
[670] Ibid 157.
[671] IBDF International Tax Glossary. International Bureau of Fiscal Documentation.
[672] Ibid 157.
[673] Third-party resources/capital (leases, financial derivatives "*synthetic loans*", factoring arrangements, overdrafts, redeemable preference shares). *Thin Capitalization Legislation A Background for Country Tax Administrators*. Initial draft (2012). 14. Accessed in 31 Dec 2017http://www.oecd.org/ctp/tax-global/5.%20thin_capitalization_background.pdf.
[674] Own resources/capital (share capital, capital contributions, interest-free loans, revaluation reserves, retained profits). Thin Capitalization Legislation (n 673) 14.
[675] Ibid 3.

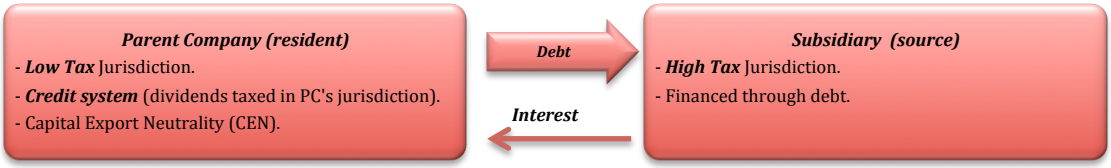
country where the subsidiary resides.[676] Now, if the State where the PC resides applies an ***exemption system***, the tax paid at the source is final. Note that the jurisdiction where the PC resides respects the tax sovereignty of the source State by not taxing the dividends born in that State. Therefore, it is fair to conclude that if the source State has a lower tax rate than the resident State, the PC is likely to opt for ***equity instead of debt***, considering that the resident State operates under an exemption relief system.

Figure 4



Now "***debt financing is preferred*** if the parent company is resident in a country with a comparably lower tax burden. If the parent company resides in a country that applies the credit method, repatriated dividends are subject to the tax system in the residence country of the parent company, while the foreign tax paid is credited. Thus, parent companies in tax credit countries will be indifferent to debt finance and equity finance (resident taxpayers are able to compete in foreign markets on home-State conditions). However, limitations of foreign tax credits may also pose an advantage to debt financing of investments in high-tax countries."[677]

Figure 5



Such frictions generate negative results to countries' tax bases, and tackled by measures such as interest limitation rules. Possible side effects are: solvency issues and excessive interest deduction claims. This topic will be properly studied in other parts of this investigation.

23. Arm's Length Principle

The ALP is enshrined in article 9 of the OECD Model Tax Convention.[678] The ALP is largely applied by customs administrations on a regular basis in order to

[676] Carsten Wendt. *A common Tax Base for Multinnational Enterprises in the European Union.* Gabler Edition Wissenschaft (2009). 97.
[677] Carsten Wendt (n 676) 97.
[678] "Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." OECD Model Tax Convention Article 9(1).

compare the value of imported goods of independent and associated enterprises.[679] When valuating controlled and uncontrolled transactions tax authorities may impose upon the relevant undertaking the duty to adjust the transaction's price. For instance, if a transaction between associated enterprises is classified as *non-recognizable*, the transaction will be subjected to price re-adjustment imposing upon the company residing both in the importing and exporting States the duty to readjust the transaction's price. On the one hand, should the relevant company pay more for the imported product, the company's deductible costs will decrease taxable revenue in that State. On the other hand, the exporting company would increase taxable revenue. Nevertheless, price adjustments are big white elephants, for tax authorities and as well as undertakings are likely to see their costs increased due to price adjustment (compliance costs, penalties, double taxation etc). Here the cooperation between customs and tax income administrations is fundamental in reducing the number of cases "*where the customs valuations are found unacceptable for tax purposes and vice versa*."[680]

III. Challenges of Corporate Direct Taxation within the EU

A. Introduction

In 1996, the Financial and Economic Affairs Council (ECOFIN) met in Verona to discuss the challenges MSs undertake to reinforce EU tax policy. The Commission's Communication "*A package to tackle harmful tax competition in the European Union*"[681] is the result of that meeting. The subjects discussed then were the draft of (***i***) a code of conduct for business taxation, (***ii***) measures to eliminate distortions created by capital income taxation, and (***iii***) measures to eliminate withholding taxes on cross-border interest royalty payment between associated companies. The soft law instrument (***i***) ***Code of Conduct*** for business taxation proposed to deter the harmfull effects of tax competition. A constant *follow-up* on the Code's effectiveness should be conducted by the Comission. In respect to (***ii***) ***capital income taxation*** (savings taxation), the Commission invited MSs to confirm their agreement to eliminate such distortions "in the form of a directive"[682] due to the absence of an effective taxation policy regarding "withholding taxes on interest payments made to residents of another Member States".[683] The product of of such commitment was materialized in the Savings Directive. And lastly, in order to avoid (***iii***) ***interest and royalties taxation*** within the EU the Commission invited Member States to make a political commitment to work towards the early adoption of a directive for which the Commission would make a proposal in 1998. This last commitment gave birth to the Interest-Royalty Directive of 2003 (2003/49/EC).

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[679] Transfer Pricing Guidelines (n 503) 83.
[680] Transfer Pricing Guidelines (n 503) 84.
[681] COM (97) 564 final. A packge to tackle harmful tax competition in the European Union. Communication from the Commission to the Council and the European Parliament.
[682] COM (97) 564 final. ANNEX 2. I.
[683] COM (97) 564 final. ANNEX 2. I.

B. Tax Coordination in the EU

As previously discussed tax integration may be materialized either by positive integration/harmonization or by negative integration/harmonization, positive being that made under common agreement and negative that made on a case-by-case basis.[684] Bellow we will discuss the main documents commissioned by the Union on the matter.

1. Neumark[685] Report (1962)

The 1962 Commission of the European Economic Community (EEC) published the "*General Report of Sub-Groups A, B and C*" (hereinafter *Report*) which dealt with various alternatives for tax harmonization within the Union. However, the report was only published in Dutch, French, German and Italian, which lead the EEC- Commission to prepare a transalation of the *Report* into English in 1963.[686] The *Report*'s main objective was to study the "disparities arising from the tax systems of the Member Countries, namely: disparities on the overall level of taxes, the composition of the tax burden with regard to the relative weight of different component parts of the system, the form (type) particular taxes take in the different countries on the one hand; disparities bearing on the level of significant particular taxes, including discrimination arising therefrom, on the other hand".[687] In sum, the *Report* suggested a "1. [R]eformed (harmonized company taxation (…), 2. (…) harmonization of personal income tax. 3. A multilateral convention for the avoidance of double taxation (…)"[688] amongst other measures.

2. Ruding Report[689] (1992)

The Commission assigned to the Committee of Independent Experts on Company Taxation (Ruding Committee) the production of a precise analysis on company taxation within the internal market. [690] The report provided answers to the following questions: (1) Do differences in taxation cause distortions in the functioning of the internal market?, (2) If such distortions arise, can they be eliminated through the interplay of markets forces and tax competition or is Community action required? and lastly (3) In the event that Community action is deemed to be necessary, what specific measures should be taken?[691] In sum, the Ruding-Committee suggested two main recommendations: (1) elimination of double taxation and (2) the implementation of a more uniformed and harmonized corporate tax system/base/rate.

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[684] Ben Terra and Peter Wattel (n 60) 152.
[685] Fritz Neumark (Jewish-German economist).
[686] Report if the Fiscal and Financial Committee. (1963). http://www.steuerrecht.jku.at/gwk/Dokumentation/Steuerpolitik/Gemeinschaftsdokumente/EN/Neumark.pdf. Accessed in 31 Dec 2017.
[687] Report if the Fiscal and Financial Committee. 100.
[688] Report if the Fiscal and Financial Committee. 100.
[689] Onno Ruding. Dutch minister of finance from 1982 to 1989.
[690] COM (2001) 582 final 203.
[691] COM (2001) 582 final 18.

The *Ruding Report*[692] as well as the Baker and the McKenzie[693] "*Survey on Effective Tax Burden in the EU*" did not contain a complete assessment of the effects of different tax systems within the Common Market, for instance, it did not present a consolidate data demonstrating profits and losses compensation, and it did not accounted for compliance costs bared by undertakings.[694] Nevertheless, it was a big step in understanding the effects of different tax systems within the internal market.

3. Monti Paper[695] (1996)

The Commission, acknowledging the future challenges regarding taxation policy within the common market, namely, *stabilization of MS's tax revenues*, *smooth functioning of the internal market* and *promoting employment*,[696] produced a study called "*the Monti paper*".[697] Where for the first time the perverse effects of tax competition were put into perspective. After the report was delivered the High-Level Group[698] was created, which advocated a complete elimination of ***unfair tax competition***.

4. Code of Conduct (1998)[699]

The code of conduct for business taxation is basically a gentlemen's agreement (soft law instrument, thus not enforceable) where MSs agree to act according to the best international tax practices.[700] The Code of conduct for business taxation, "complements administrative cooperation instruments with peer review of tax measures. It defines harmful tax measures as 'measures (including administrative practices) which affect or may affect in a significant way the location of business activity in the Community, and which provide for a significantly lower level of taxation than those that generally apply in the Member State concerned'. Business taxation measures have been assessed under the Code".[701] The *Code* listed a number of conducts that could ultimately result in

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[692] Report on the Committee of Independent Experts on Company Taxation. Commission of the European Communities. Official Publlications of the European Communities. Brussels, Luxembourg. (1992).
[693] COM (2001) 582 final 203.
[694] COM (2001) 582 final 4.
[695] Named after Mario Monti. Former Italian prime minister and EU Commissioner.
[696] Discussion Paper for the Informal Meeting of ECOFIN Ministers: SEC 487 Final, Brussels, 20 March 1996. EC Tax Review. 1992-2. 94.
[697] Ben Terra and Peter Wattel (n 60) 191.
[698] In 2014, the High-Level Group of own resources (HLGOR), jointly established by the EU Parliament, Council and Commission, chaired by Mario Monty, was formed. Its main objectives comprised the issuing of studies and recommendations regarding EU's budgetary matters. http://ec.europa.eu/budget/mff/hlgor/index_en.cfm. Accessed in 31 Dec 2017.
[699] Code of Conduct. Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy (98/C 2/01). *http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31998Y0106(01)&rid=1*.
[700] Ben Terra and Peter Wattel (n 60) 193.
[701] The following examples depict tax avoidance pactices "[T]he use of 'patent boxes' is a preferential tax treatment (generally a reduced rate of tax on revenue) aimed at attracting businesses which develop, manufacture and exploit patents. When linked with the development of real activity they can support growth and innovation. They exist in several EU countries, as well as in third countries. Such regimes are under assessment at EU level (in the framework of

tax avoidance/evasion:

(1) Advantages granted only to non-residents or transactions entered into by non-residents (off-shore instances);
(2) Ring-fenced advantages to domestic players, in order to protect the tax base of the relevant MS;
(3) Granting of benefits divorced from real economic substance;
(4) Non-application of international TP standards (TP exploitation);
(5) Lack of transparency in relation to advanced tax rulings and other administrative proceedures.

The *Code* provided also for the "*Standtill*" and "*Rollback*" clauses, in which MSs commit themselves: "not to introduce new tax measures which are hamful within the meaning" of the Code, therefore respecting "the principles underlying the code when determining future policy" (Standstill), and to proceed with the re-examination of "their existing laws and established practices, having regard to the principles underlying the code (…) and practices" deemed as "necessary with a view to eliminating any harmful measures as soon as possible taking into account the Coucil's discussions".[702] Other measures, such as review process for the sake of tax transparency (*Paras. E, F, G, H and I*), State Aid rules (*Para. J*) where Member States commit themselves to "the strict application of (…) aid rules (…) taking into account, inter alia, the negative effects of aid that are brought to light" (state aid), tackling tax avasion and avoidance (*Paras. K and L*), definition of the geographical extention concerning the code's application (*Para. M*), and lastly monitoting and resivion provision (*Para. N*).

5. Primarolo Report (1999)

The *Primarolo Report* was an initiative taken by MSs in assessing national tax measures that could fall foul in respect to EU's *Code of Conduct in Business Taxation*. The *report* was named after the group's head (Mrs. Dawn Primarolo),[703] and contained mainly a list of six occasions where harmful tax measures are likely to be found: (i) *financial services*, (ii) *insurance, reinsurance and captive insurance companies*, (iii) *transfer pricing*, (iv) *holding company regimes*, (v) *exempt and offshore companies* and (vi) *a variety of other measures such as tax-free zones*. Member States in general did not agreed to the *Report*. According to the Council, the report proved to be too controversial. [704]

Following Primarolo's report, recently (20 February 2018), the Code of Conduct Group, through the Council, published guidance assisting "Member

the code of conduct) and international level (BEPS – base erosion and profit shifting – an OECD project in the 'Forum on harmful tax practices'), but no interpretation has been agreed on the criteria for assessing whether those regimes constitute harmful practices. At EU level, 'patent box' schemes in force are under review. Another example of tax avoidance consists of shifting profit between subsidiary companies, for instance, systems allowing companies who do not have tax residence in a country to set up an operation in that country for the sole purpose of transferring their profits to tax havens, a scheme known as the 'Double Irish'; national authorities have recently decided to end this possibility". Cécile Remeur (n 127) 18.

[702] Code of Conduct. (98/C 2/01). Paras. C and D.

[703] Dawn Primarolo or Baroness Primarolo. British politician.

[704] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 40.

States in achieving in the 3 areas of finance branches, holdings and headquarter companies a balanced approach in comparable situations to standstill and to rollback of measures which the code of conduct group has found to be harmful as contained in the report of the code of conduct group of 23 November 1999 (SN 4901/99 - *Primarolo's Report*) as submitted to the ECOFIN Council on 29 November 1999",[705] namely:

- ***Headquarter's***[706] (Head Office) profits assessed contrary to OECD's transfer pricing guidelines, or "determined on a cost-plus (TP) or resale-minus basis (TP) (i) an adequate comparable uncontrolled price available (TP), or (ii) no real investigation into the facts has taken place or no genuine approximation of arm's length determination in envisaged (TP/ALP), or (iii) only non-residents or transactions with non-into account are aligible (advantages restricted in accordance with paragraphs B1 or B2 of the Code),[707] or (iv) not all charges and expeditures are taken into account for profit calculation on a cost-plus basis – there is a reduction in the expense base when assessing taxable income[708] - (TP);
- ***Branche's*** profits allocated "between a Head Office and a branch at less than an arm's length rate (…)" and "[E]xemption of branch profits by the country of the Head Office in cases where: (a) the level of taxation in the country of the branch is significantly lower in the country of the Head Office; and (b) the profits have not been subjected to effective anti-abuse or countermeasures which in paragraph L of the code[709] the Council notes play a fundamental role in counteracting tax avoidance and evasion".[710]
- ***Holding Companies'*** foreign source "dividend exemption in circumstances in which the profits giving rise to the dividends: (a) have been taxed at a significantly lower level in the source country than they would have been if they had arisen in the Member State; and (b) have not been subjected to effective anti-abuse or countermeasures which in paragraph L of the code the Council notes play a fundamental role in counteracting tax avoidance and evasion".[711] In other words, "if

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[705] *Agreed guidance by the Code of Conduct Group (Business taxation)* 1998-2018. FISC 44.ECOFIN 75. 5814/18. Concil of the European Union. https://www.parlament.gv.at/PAKT/EU/XXVI/EU/01/18/EU_11888/imfname_10787705.pdf. Accessed in 31 Dec 2017.

[706] Agreed guidance by the Code of Conduct Group (n 705) *Para 1.*

[707] "[W]hithin the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in Member State in question are to be regarded as potentially harmful and therefore covered by this code. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any relevant factor. When assessing whether such measures are harmful, account should be taken of, *inter alia*: 1. Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or 2. Whether advantages are ring-fenced from the domestic market, so they do not affectthe national tax base (…)" Letter B (1) (2) Code of Conduct. (98/C 2/01).

[708] Agreed guidance by the Code of Conduct Group (n 705) Para. 18 (vi) (a) (b) (c) (d).

[709] Paragraph L Code of Conduct reads "The Council notes that anti-abuse provisions or countermeasures contained in tax laws and in double taxations conventions play a fundamental role in counteracting tax avoidance and evasion". Code of Conduct. (98/C 2/01).

[710] Agreed guidance by the Code of Conduct Group (n 705) Para. 18 (ii) (a) (b).

[711] Agreed guidance by the Code of Conduct Group (n 705) Para. 18 (iii) (a) (b).

exemption of dividends received from foreign subsidiaries is granted although (i) the profits out of which they were paid were subject in the subsidiary State to substantially lower taxation than the holding company State tax level *and* (ii) no effective anti-abuse rule legislation is in force in the holding company State",[712] MSs must act in order to prevent such abuse.

6. Commission's Working Paper (2001)

The European Commission was invited in 1999 to conduct a study on corporate taxation within the EU, where actions against inefficiencies that could hinder economic development would be analysed.[713] The *Paper,* issued as a Communication (*Towards an Internal Market Without Tax Obstacles*), recognized the great and many challenges the EU would have to undertake in order to enhance efficiency and effectiveness of a tax system that should affect as little as possible investment decisions whilst improving transparency. The proper and longer version of the *paper* published under the title, *Company Taxation in the internal Market,*[714] analysed in depth the issues and problems MNEs operating within the EU had to manage in order to be in compliance with regulations throughout the European Market. For that matter solutions in order to reach a more interrelated tax system were proposed by the Commission,[715] such as the *Harmonization of Tax Bases,*[716] a *Common Consolidated Tax Base*,[717] *Home State Taxation*[718] and an *European Union Company Income Tax*.[719] When analysing the above mentioned four suggestions, the *Paper* also stressed the importance of

[712] Ben Terra and Peter Wattel (n 60) 196.
[713] Sec (2011) 315 final 4.
[714] COM (2001) 582 final.
[715] COM (2001) 582 final 371.
[716] ***Harmonization of tax bases*** requires a total harmonized base obliging undertakings, regardless its size, to comply with one European Tax Code, where States would consequently deny their own in order to apply this new compulsory Tax Code. This approach would preclude the need of a centralised administration, for each State would manage its own income, abolishing thus any form of uncertainty regarding rules, regulations, and legislations, solve discrepancies regarding the allocation of profits as well as cross-border losses. COM (2001) 582 final 377.
[717] A ***Common Consolidated Tax Base*** creates an optional set of rules, from where the tax base would be calculated. This solution would reduce uncertainty as well as improving transparency in relation to the taxable base, solve transfer pricing problems, while maintaining the State's independence to set its own tax rate. COM (2001) 582 final 376.
[718]In ***Home State Taxation***, companies would benefit from the simplicity of applying only one tax code in relation to the group as a whole, meaning that all subsidiaries would be treated as domestic subsidiaries. For instance, Company A located in State 1, has a subsidiary (Company B) located in State 2. Company A files the ***group's*** tax return in State 1. State 1 collects the tax according to its applicable rate whereas State 2 applies its own rate. The problem is that States have different rules in relation to the taxable base, group relief losses etc, meaning that a high degree of cooperation and coordination between MSs are mandatory in order for the system to function. COM (2001) 582 final 374.
[719] A ***European Union Company Income Tax*** would be a major step towards the creation of a total integrated internal European market, where States would relinquish their tax sovereignty over a European one. This solution would also require the edition of a new tax on corporate income to be applied throughout the Union, where the collected taxes would be used to finance EU institutions and its activities. COM (2001) 582 final 377.

mutual recognition of tax codes[720] and *harmonization*.[721] In sum, the *Paper* conducted a deep investigation on the problems posed by the great number of different tax legislations and and how MSs should tackle them in order to create a more straightforward tax system whilst solving difficulties regarding *group taxation*, *transfer pricing*, *tax-related labour costs* and *double taxation*, therefore enhancing economic growth within the internal market. The complexity faced by undertakings conducting cross-border transactions cannot be ignored for they represent a substantial investment impediment, discouraging small and medium-sized enterprises doing business across the EU.[722] It is important to note that a coordinated effort between MSs is at the center of a viable and successful system.[723]

The *Paper* also provided that there were a great number of tax obstacles that States would have to overcome in order to promote cross-border investment. The *Paper* analysed matters such as taxation on mergers and acquisitions, [724] capital gains tax, [725] transfer pricing, [726] cross-border losses/income off-setting[727] and double taxation legislation.[728] According to the *Paper*, the difference of effective tax burden may vary greatly within the single market, surpassing even 30 points depending on the State.[729] Moreover, it also stressed the fact that generally, within the Internal Market ***transactional***

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[720] Under the ***Mutual Recognition*** premise (Home State Taxation), States accept each other's tax codes, thus adjusting its national rules. This approach requires tax statues be compatible. The study points out that *Mutual Recognition*, could be an important step towards *Harmonization* although it may "freeze", that is to say, impede future developments to a uniformed taxable base. COM (2001) 582 final 383.

[721] ***Harmonization*** (Harmonized Tax Base, Common Consolidated Tax Base and European Union Company Income Tax) presumes the enactment of a uniformed and effective tax code, *"(...) on the extent to which rates are also harmonized, or at least restricted by a lower limit*" potentially influencing tax competition as well. COM (2001) 582 final 382.

[722] COM (2001) 582 final 223.

[723] *La réalisation de l'union économique et monétaire risque, par ailleurs, de réduire encore davantage l'autonomie des politiques budgétaires et fiscales nationales et de faire naître des situations où l'action concertée des gouvernements sera nécessaire à la stabilisation conjoncturelle de l'économie européenne. Une telle coordination, qui n'implique pas toujours des choix uniformes, serait grandement facilitée par l'existence de structures fiscales moins disparates. Puisque les progrès de l'intégration économique européenne ne manqueront pas de resserrer les interdépendances et de restreindre un peu plus les souverainetés nationales en matière fiscale, les remises en cause qu'ils imposent devraient être l'occasion pour les Etats membres de renforcer conjointement les instruments fiscaux permettant la poursuite concertée d'objectifs de croissance et de justice sociale à l'échelle de l'Europe*. "The goal of reaching an economic and monetary union, reduces the autonomy of national and fiscal policies while creating situations where joint actions conducted by governments will be necessary in order to stabilize the European economy. Coordination between European States, which may not be homogeneous, would be optimized if the differences amid tax structures were reduced. European economic integration will without a doubt enlarge interdependencies and curb national sovereignty in tax related matters and promote the possibility to Member States sharing forces in order to better its fiscal policies thus allowing them to enhance growth and social justice at the European level." (*free translation*) Henri Sterdyniak. *Vers une fiscalite europeenne*? Observations et diagnostics économiques n 31 (1991). 187.

[724] COM (2001) 582 final 224

[725] Ibid 224.

[726] Ibid 224.

[727] Ibid 224.

[728] Ibid 4.

[729] Ibid 5.

investments are taxed more heavily when compared to ***domestic investment***.[730] As we know, transactional investments are influenced by more favourable tax environments, influencing therefore investment decisions. Needless to say, the *Paper* contributed greatly in understanding the deficiencies that MSs were dealing with.

7. Communication (2006) 823[731]

In 2006 the Commission issued Communication (2006) 823 where it announced a series to iniciatives on order to promote the "better co-ordination of the national direct tax system in the Union".[732] The Commission's aim back then was to promote what, in its opinion, would be the only way to tackle certain inefficiencies created by lack of harmonization (double taxation, non-taxation, evasion and high compliance costs). The Commission believed that "the only systematic means of addressing the underlying tax obstacles which exists for companies operating in more than one Member State is to allow multinational groups to be taxed for all of their activities in the EU on a common consolidated tax base". [733] This Communication is in fact another step taken by the Commission to a CCCTB in Europe.

C. Tax Competition.[734]

1. General Definition

Tax competition is a key obstacle against the proper functioning of a Single European Market. In 1990 the European Commission requested an analysis on

[730] Ibid 6.
[731] Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee - Co-ordinating Member States' direct tax systems in the Internal Market [COM(2006) 823 final - Not published in the Official Journal].
[732] Ibid.
[733] Ibid.
[734] The definition of competition is well resumed by *Whish/Bailey* "Competition means a struggle or contention for superiority, and in the commercial world this means a striving for the custom and business of people in the market place: competition has been described as a 'process of rivalry between firms…seeking to win customers' business over time. The ideological struggle between capitalism and communism was a dominant feature of the twentieth century. Many countries had the greatest suspicion of competitive markets and saw, instead, benefits in the state planning and management of the economy. However enourmous changes took place as the millennium approached, leading to a widespread demonopolisation, liberalization and privatization. These phenomena, coupled with the rapid technological changes and the opening up of international trade, unleashed unprecedentedly powerful economic forces. These changes impact upon individuals and societies in different ways, and sometimes the effects can be unconfortable. Underlying them, however, is a growing consensus that, on the whole, markets deliver better outcomes than state planning; and central to the idea of a market is the process of competition. The important issue therefore is to determine the effect which competiton can have on economic performance. To understand this one must first turn to economic theory and consider what would happen in conditions of perfect competition and compare the outcome with what happens under monopoly, recognising as one does so that a theoretical analysis of perfect competition does not adequaly explain business behavior in the 'real' world". Richard Whish & David Bailey. *Competition Law*. Oxford University Press. Oxford. UK. (2015) Pag. 4.

the effects of Corporate Taxation in Europe, in order to ascertain whether taxation imposed a significant effect on investment decisions, ultimately creating distortions within the Common Market.[735] Taxation may hinder or serve as an incentive for undertakings investing in a Member State. A relevant Member State may conduct its tax policy in such a way to create incentives in order to attract investment. In the words of Mario Monti

> "Tax competition is a widely used practice in an integrated market, as national systems may use the fiscal tool to increase their attractiveness for businesses and capital. Tax competition, to some extent, serves a ***healthy purpose of putting pressure on governments to keep spending under control***. However, it presents a disturbing asymmetry. The liberalisation of financial markets and the expansion of the single market allow companies to pursue strategies of tax minimization and regulatory shopping in search of the most convenient taxation area. In response to this phenomenon, the burden of taxation within EU Member States has progressively shifted from more mobile tax basis (capital income and corporate income) towards a more extensive taxation of less mobile tax bases, notably labour. Over the past two decades, almost all Member States decreased their statutory corporate tax rates, competing for internationally mobile capital. The EU-15 average went from close to 50% in 1985 to slightly less than 30%. The average for the twelve countries that joined the Union in 2004 and 2007 is about 10 percentage points lower. At the same time, Member States broadened the tax bases, to eliminate opportunities for tax avoidance and safeguard their tax revenues. In 2007, taxes on labour accounted for 46% of total tax revenues on the arithmetic EU-average, whereas taxes on corporate income accounted for 9.8%. The average implicit tax rate on corporate income in the EU-25 amounted to 25.5% in 2007, while the average implicit tax rate on labour income amounted to 34.8%."[736]

A perfect tax system within the Common Market would create no impact on economic decisions, resulting thus in complete "*tax neutrality*". [737] Nevertheless, taxation is not the only factor one consider when deciding upon an investment, for the "existence and quality of economic infrastructures, the availability of qualified work, (…) the short and medium-term outlook in different markets and countries, (…) the geographical accessibility of markets,

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[735]COM (2001) 582 final Pag 2.

[736] A new Strategy for the Single Market (n 542) 80.

[737] "Taxation is, of course, only one of the determinants of investment and financing decisions. The existence and quality of economic infrastructures, the availability of qualified work, as well as the short and medium-term outlook in different markets and countries are among the other important determinants of investment behaviour. The geographical accessibility of markets, transport costs, environmental standards, wage levels, social security systems and the overall attitude of government all play an important role too. Which of these factors are relatively the more important very much depends on the individual type of investment decision. Nevertheless, as economic integration in the EU proceeds in the context of the Economic and Monetary Union and the Internal Market, in an environment where capital is fully mobile, the pattern of international investment is likely to be increasingly sensitive to cross-border differences in corporate tax rules". Taxation ***should not*** be one of determinants of investment decisions. ***Tax neutrality*** is the complete absence of taxation as a variable in investing in a certain State. COM (2001) 582 final 3.

transport costs, environmental standards, wage levels, social security systems and the overall attitude of government (…) "[738] are also inevitably considered.

A broad definition of tax competition would be a "*form of non-cooperative tax setting by independent governments*".[739] *John D. Wilson and David E. Wildasin* separate from this definition more narrower concepts, such as the influence that a government's tax policy have when allocating tax revenue,[740] or that governments are linked with one another through each other's tax policies, for they may influence the taxpayer's decision and evaluation of its politicians.[741] A central point to tax competition is that taxpayers tend to make rational decisions[742] in order to optimize costs.[743]

Tax competition *per se* cannot be considered an ilegitimate or abusive behavior. Moreover, the ECJ has already inferred tax jurisdiction shopping as a "legitimate activity in an internal market, even if the choice of jurisdiction or profits allocation is based solely on the wish to circumvent unwelcome domestic tax rules".[744] According to *Wattel/Terra*, the ECJ derived such understanding "from the (non-tax) *Centros case*,[745] concerning the use, by Danish individuals, and solely for Danish business activities, of a UK legal form (a limited company), expressively to circumvent Danish minimum capital contribution requirements" and they go further affirming that "it would seem that for a finding of abuse which could justify restrictive measures, the Court requires at least *artifice* to be present. In *Eurowings*, the German airline company and the Irish aircraft lease company were not associated, so *artifice* was not present. If, however, the Irish lease company had really (substantially) been German and a controlled subsidiary of the Airline company with ***no real economic presence*** in Ireland, then restrictions on the freedom of establishment might have been justified" (*emphasis added*).[746]

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[738] COM (2001) 582 final 3.
[739] John Douglas Wilson, David E Wildasin. (n 13) 1066.
[740] John Douglas Wilson, David E Wildasin. (n 13) 1067.
[741] John Douglas Wilson, David E Wildasin. (n 13) 1067.
[742] *Rational Choice Theory* have, for the last 60 years tried to explain how people make economic decisions, nevertheless, that theory has been tackle by scholars for the last 30 years through the study of *Behavioral Economics,* where parties are assumed to make irrational decisions. For a better understanding we would like to present a short example of such irrationality. Two players, (p_1; p_2), neither knows the identity of each other, thus they play anonymously. Their goal is to divide a sum of money, U$100. So, p_1 makes a proposal to p_2 about how should the U$ 100 be divided, where p_2 can either accept the that proposal, in which case the "judge" actually gives both parties the amount proposed by p_1, or reject the proposal, in which case neither player gets any money. A *Rational Choice* theory states that p_1 will take advantage of its position as the proposer to give itself a disproportionate share of the U$ 100, for example U$ 70. Well, p_1 should think that p_2 might be selfish, but after all, U$ 30 is better than nothing. The aforementioned game was experimented in over 140 countries among various groups (age, education level, religion etc) where the common answer was a 50-50 split of takes. Strangers may take advantage from one another in a *bargaining game*, where the rule of the game seems to be: treaty the other part fairly, exactly as one treats oneself. Robert Cooter and Thomas Unlen (n 15) 51.
[743] Cécile Remeur (n 127) 19.
[744] Ben Terra and Peter Wattel (n 60) 81.
[745] *Centros Case*. Case C-212/97. Paras 26 and 27.
[746] Ben Terra and Peter Wattel (n 60) 82.

2. Detecting Tax Competition

If the following four requirements are met, tax competition is a likely scenario, namely: (***i***) FDI is possible and MNEs use it in order to reduce tax liability, (***ii***) governments use taxation as a policy instrument, (***iii***) the instrument has as its ultimate goal attracting more investment to the relevant country and (***vi***) taxes are an important factor in attracting FDI. [747]

a. Horizontal Corporate Tax Competition.

Tax competition can be defined as a form of non-cooperative tax setting by independent governments, "under which each government's policy choices influence the allocation of a mobile tax base among regions represented by governments." [748] According to *Timothy Besley and Anne Case* vote seeking and tax competition are intimately connected through the nexus of yardstick (standard) competition, [749] for "voters use the tax policy of neighbouring jurisdictions as information to evaluate the performance of their incumbent politicians". [750] Consequently, a taxpayer in State "A" will be attentive on how State "B" conducts its tax policy. An interesting parallel to draw would be to compare Hirschman's ***voice*** to ***exit solutions***. When consumers chose products of one company over another, the *exit solution* takes place. On the other hand, when consumers opt to remain with the company's product instead of changing, a *voice solution* takes place. *Exit Tax Competition*[751] operate in such a way, when the tax base of one jurisdiction is shifted *horizontally*, that is to say, to another State.[752]

b. *Vertical Tax Competition*

Vertical tax competition can occur when different levels within a given government maintain the same tax base, thus competing with each other. An interesting and current case of pure vertical tax competition occurs in Brazil.[753] 27 regions compete amongst themselves, mainly through ISS[754] and ICMS.[755] Overall, tax competition is highly susceptible to movements of capital, therefore we have to conclude that without capital mobility, there is no such thing as tax competition. Nevertheless an interesting question would be whether capital mobility has a positive effect on welfare, or to what extent does it influence

[747] Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 12.
[748] John Douglas Wilson, David E Wildasin. (n 13) 1067.
[749] Albert O. Hirschman. *Exit, voice, and loyalty: responses to decline in firms, organizations, and states*., 1915-2012. 8300 defect for UNSW. Cambridge, Mass. [u.a.] : Harvard Univ. Press (1970).
[750] Timothy Besley, Anne Case. *Incumbent behavior: Vote Seeking, Tax Setting and Yardstick Competition*. National Bureau of Economic Research. 1050 Massachusetts Avenue. Cambridge. MA 02138 (1992).
[751] Albert O. Hirschman (n 749).
[752] Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 13.
[753] Hansjörg Blöchliger and José Pinero-Campos. *Tax Competition between sub-central governments*. OECD Network on Fiscal Relations acrss Levels of Government (2011). 5.
[754] Intra-municipal tax charged over services.
[755] Tax on circulation of goods and services.

corporate investment decisions, immigration etc. A deeper analysis of such questions would fall outside the main scope of our investigation.

c. Tax Competition Pros

As it regards to firm location, tax competition may be considered a good phenomena according to *Tiebout*. The author states that when local government authorities compete amongst themselves for households, they shape their public services according to the household's preferences.[756] Another positive effect of tax competition is the avoidance of *taxer's cartels*, [757] which under intergovernmental cooperation could set horizontal price agreements creating therefore distortions within the relevant market. Moreover, tax competition may also keep national governments more efficient, consequently bringing down unnecessary high tax rates.

d. Tax competition Cons

According to tax literature, tax competition may lower government spending and taxes below efficient levels,[758] with the potential of reducing welfare on the relevant country.[759] Government budgets may also be influenced, possibly resulting in fiscal degradation (erosion of national tax bases and tax revenues), illegal subsidies, over-taxation[760] etc, consequently frustrating a "healthy and equitable budgetary policy" [761]

According to *Brennan* and *Buchanan,*[762] tax competition reduces welfare (*Leviathan models*). Such idea lies in the fact that "the size of government would be excessive in the absence of this competition[763] (tax competition). *Rauscher*[764]

[756] According to *Tiebout*, when deciding upon where the relevant household should establish his residence, the *household or consumer-voter,* chooses the community that better satisfies his needs in relation to how the given "*municipality*" allocates its resources, that is to say, how the relevant region disposes of its public goods, for a "*(…) consumer-voter may be viewed as picking that community which best satisfies his preference pattern for public goods*". For that, the author poses 4 basic assumptions, namely: ***I***. Households are fully mobile and will reside where their needs are best satisfied, ***II***. They have absolute knowledge of their revenue and expenditure, ***III***. There are a great number of places where they could choose to live in, ***IV***. Employment restrictions are discarded, ***V***. The public services rendered present no cost advantage or disadvantage between "*municipalities*" ***VI***. In order to better explain his model, Tiebout gives an interesting example on the mobility of consumer-voters that may very well be applied to mobility factors or capital. John Douglas Wilson, David E Wildasin. (n 13) 1069.

[757] Ben Terra and Peter Wattel (n 60) 147.

[758] John Douglas Wilson, David E Wildasin. (n 13) 1069.

[759] Ibid 1071.

[760] In order to attract investment, governments may shift the tax burden in various ways, for instance, shift the tax burden from CIT to less mobile labour factors (according to economic theory, labour is a less mobile good when compared to others, such as capital or other tangibles) or raise VAT. Levying tax on environment-damaging activities is also a possible approach so that revenue is compensated, therefore over-taxing other bases.

[761] Ben Terra and Peter Wattel (n 60) 147.

[762] According to Brennan and Buchanan, the model of government as a Leviathan should be "tamed", that is to say, controlled. John Douglas Wilson, David E Wildasin. (n 13) 1066.

[763] G. Brennan, J. Buchanan. *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Cambridge. University Press, New York (1980).

[764] M. Rauscher. *Leviathan and competition among jurisdictions: the case of benefit taxation*. Journal of Urban Economics(1998). 44, 59– 67.

(1996, 1998) and *Edwards* and *Keen*[765] (1996) examine this view formally in various ''*Leviathan models*'', where governments are concerned in part with maximizing the size of the public sector. Their conclusions about the welfare implications of tax competition are mixed, but all three papers assume that governments retain some degree of ''benevolence'', perhaps caused by re-election concerns that are not formally modeled. Despite these different welfare conclusions, *Leviathan models* and the *Zodrow– Mieszkowski*[766] model both agree that ***tax competition lowers the size of government***."[767]

D. Fiscal Aid

Subsidy, in general, can be defined as an economic incentive granted by a government in order to raise the competitiveness of corporations in a given market. Article 107 to 109 TFEU provides the Commission to "deal with state aids that could distort competition in the internal".[768] Article 107 (1) TFEU reads "Save as otherwise provided in the Treaties, ***any aid***[769] granted by a ***Member State or through States resources***[770] in any form whatsoever ***which distorts or***

[765] J. Edwards, M. Keen. *Tax competition and Leviathan*. European Economic Review 40. (1996) 113– 134.

[766] G. R. Zodrow, P. Mieszkowski, Tiebout. *Property taxation, and the underprovision of local public goods*. Journal of Urban Economics (1986) 19, 356– 370.

[767] John Douglas Wilson, David E Wildasin. (n 13) 1071.

[768] Richard Whish & David Bailey (n 734) 258.

[769] "***Any aid***" means any positive aid (direct payments, state guarantees or benefits), or negative aid (exemption or charge mitigation), which has the same budgetary impact as "direct grants". In order to ascertain whether a derogation tax scheme fall under state aid, it is important to establish whether "the resulting tax burden is lower than rhat which would have resulted from rhe application of the relevant Member State;s normal taxation method". A tax expense may be reduce in a number of different manners, for instance, (1) reduction on the tax abse (special deductions, accelerated depreciation etc); (2) total or partial deduction in the total amount of tax due (exemption or credit), and finally, (3) deferment, cancellation or rescheduling of tax liability. Nonetheless, the following shall not be consider as State aid: (i) tax refund unduly collected, (ii) adequate compensation for the benefits received ("the fulfilment of general macroeconomic expectations of the Member States, such as reducing the employment rate of the fortering of underdeveloped areas, canot be seen as such a 'market equivalent' compensation for benefits granted. In order to discern adequate compensation from prohibited State aid, and to ensure that there is no 'overcompensation', the EJEU requires the fulfilment of certain conditions. The recipient undertaking must have clearly defined public service obligation to discharge, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, the compensation may not exceed what is necessary to cover all part of the costs incurred in the discharge of public service obligations and the enterprise that is to render the public services must be chosen pursuant to an objective public procurement procedure"), and lastly (ii) tax alleviation resulted from a tax reform on the general system, for example, a relevant State ceases to collect tax on labour (wages) in order to raise salaries, cannot be considered State aid "due to its remoteness". It is important to stress the point that Stae aid presumes ***selectivity***, being that *sine qual non* to its characterization. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 105.

[770] In order to be classified as illegal aid, the benefit must be a "burden to the public budget", which may also be characterized as a loss of tax revenue, for example. It is also important to assess the aid at the recipient's level, that is to say, the "fact that a tax aid scheme has a positive overall effect on budget revenue is not sufficient to rule out the presence of state resources". Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 107.

threatens to distorts competition[771] by ***favouring certain undertakings or the production of certain goods***[772] shall, ***in so far it affects trade between Member States***,[773] shall be incompatible with the internal market".

In general, States are prohibited from granting undertakings financial aid. The following four conditions, if fulfilled, characterize illegal State aid, namely: (1) the measure confers the enterprise and advantage, which ultimately relieves the undertaking from charges, (2) such advantage is granted by a State through the use of State resources, (3) the measure affects directly competition and trade and lastly, (4) the conferred aid is "specific or selective in that it favours certain undertakings or the production of certain gods".[774] Nonetheless, aid may also be granted by a State in order to provide for certain market failures, that is to say, State aid may "be required in order to give people goods and services that the market would not deliver on fair and equal terms or would not deliver at all".[775] For that matter, Article 107(2)(3) TFEU provides for exemptions conditioned to the Commission's prior authorization, "to make sure that Member States conceive and designed only aid measures to help firms produce goods and services that would other wise bot be provided in the internal market, and not measures that distor competition by strenghning the particular interests of a region or sector to the detriment of the economy as a whole". [776]

When governments subsidize certain economic groups, such as agricultural, heavy industry etc, it creates the possibility of distortions in the competitive process. According to Brander and Spencer,[777] when companies export goods to third countries, that government may intervene to increase national welfare with State aid,[778] moreover, both authors provide for models that points out to the conclusion that "domestic subsidy, not surprisingly, lowers price, increases domestic profit and lowers foreign profit. What is perhaps more suprising is that the subsidy actually increases domestic welfare net of the subsidy". [779] The fact of the matter is that "subsidies change the initial conditions of the game that firms play" mainly because State aid "improve the relative

[771] It is not necessary the aid to cause noticeable distortions on competition, that is, the mere possibility of creating "potential distortions to competition" fall under Article 107 (1) TFEU. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 107.

[772] "(…) categories could be, for example, certain sectors of the economy (sectorial aid), certain functions within a branch (horizontal aid), certain geographic areas (regional aid), public undertakings carrying out an economic activity, large companies, multinational companies, exports, sectors that are subject to international competition, offshorecompanies, or non-resident companies providing certain services (for example financial services) whithin a group" Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 111.

[773] "Competition is considered distorted and intra-Community trade is considered affected if the aid in question strengthens the competitiveness of the recipient, for instance by reducing its operation costs, in comparison with its competitors in the intra-Community trade". Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 108.

[774] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 97.

[775] Ibid 98.

[776] Ibid 98.

[777] James A. Brander, Barbara J. Spencer. *Export Subsidies and International Market Share Rivalry.* NBER Working Paper Serier No. 1464. National Bureau of Economic Research. Cambrige (1984). 1.

[778] James A. Brander, Barbara J. Spencer (n 777) 1.

[779] James A. Brander, Barbara J. Spencer (n 777) 7.

position of a domestic firm in a noncooperative rivalries with foreign firms, enabling it to expand its market share and earn greater profits". [780]

E. Double Taxation

As mentioned in previous topics, a number of reports and studies were delivered in order to tackle and and liquidate tax disparites, enhance cooperation, promote approximation of laws and tax treaties to avoid conflicts with laws and treaty provisions". In 1962 the Neumark Report was issued, then the Ruding Report (1992), then came the ECOFIN meeting in Verona and the Monti Paper, both in 1996. In 1998 the Code of Conduct was agreed upon by MSs and in the following year (1999) the Primarolo's Report. In 2001 the Commission's paper "Taxation in the Internal Market"was published, and in 2006 the Commission issued Communication (2006) 823 promoting the "better co-ordination of the National direct tax system in the Union".[781] In 2018 the Code of Conduct Group, following Primarolo's Report, published guidance on how MSs should confront harmful measures "which affect, or may affect, in a significant way the location of business activity in the Community".[782] Note that every single study or report (Neumark, Ruding, Monti, Primarolo and Company Taxation in the Internal Market) concluded that without or harmonization and/or co-ordination of tax bases/policies, the internal market would inevitably remain hostage to aggressive tax planning, that is, *Geisel von der finanziellen Macht.*

Uncertainties as to the proper allocation of taxation rights due to matter concerning PE's proper definition, TP price adjustments and other abuse measures such as splitting-up contacts, hiring-out labour cases, conducting transactions intended to avoid dividend characterization, dividend transfer transactions, conducting transactions that circumvent the application of Article 13(4), manipulating tie-breaker rules for determining the DTC's residence of dual-resident persons other than individuals or abusing preferential tax regimes where in the PE's jurisdiction, may lead to DT, or non-DT. Solution to such problems: ***harmonization*** and ***co-ordination***.

A number of possible solutions were put forward to "resolve the problmes of double taxation in the Internal Market and incompatibilities with the EC law that are are not currently being adequately addressed by bilateral tax treaties", such as (***i***) the "conclusions of a multilateral tax treaty between all EU Member States", (***ii***) the "development of an EU Model Treaty, based on the OECD Model but taking account of the equirements of the EC Treaty, which could be used by Member States in their future tax treaty negociations with which other and with third countries and (***iii***) the development of "specific EU concepts (such as the definition of 'residence' and 'non-discrimination') culminating in a recommendation to Member States or and agreement by Member States to reflect these concepts in their relations with each other and with their contries". [783] The road to harmonization is a long one we have to agree, nevertheless public policies only generate effects by implementation and execution. It is common understading amongst scholars that "high compliance

[780] James A. Brander, Barbara J. Spencer (n 777).
[781] Ibid.
[782] Code of Conduct (98/C 2/01). Para A.
[783] COM (2001) 582 final 357.

costs and (…) tax obstacles to cross-border investments translate into sub-optimal levels of investment and growth. In addition, the risk of double taxation, the uncertainty of implementation of existing rules and the risk of changing the tax rules one the investment is undertaking, all adds up to the need for tax reform and increased transparency in the field of taxation."[784]

F. International Accounting Standards (GAAP, IAS, IFRS)

The consulting activities and business models of today's major firms (Delloite, PricewaterhouseCoopers, Ernest & Young and KPMG[785] – after the Enron schandal a fith firm, namely, Arthur Anderson, formed the *big five group,* which was split in 2000 and re-named to Accenture) started "while American and British audit firms began to follow their growing corporate clients into other countries in order to maintain their service".[786] In 1970 partners of Delloitte and PricewaterhouseCoopers realized that transactions were getting more international, therefore they suggested that transactions should be recorded in a more uniformed manner, ultimately bringing together the AICPA[787] and a number of professional accounts of eight States to create "a voluntary body to write that, at the time, they called International Accounting Standards (IAS)".[788] In 1983 the IOSCO was created[789] (organization comprised by securities regulators from major Countries). In 1987, IOSCO created the so called *listing passport*, that is, now companies that were listed in other countries (or wished to do so) would have to present two types of reports, a national report, dictated by domestic rules, and a second report, dictated according to IOSCO's rules.[790] It is also important to add to our timeline the works of the IASC (1973), which was substituted by the IASB in 2001.[791] The IASB is a (standard-setter) to international accounting standards which was re-named to IFRS.[792] In 2007 more than "100 countries around the world, including all of Europe, currently require or permit IFRS reporting. Approximately 85 of those Countries require IFRS reporting for all domestic listed companies".[793] Nevertheless, IFRS contrary to US GAAPs was created in order to work independently from any national jurisdiction, that is, US GAAP follows very rigid and detailed set of rules, whereas IFRS are more based on principles and less detailed, moreover, it is fair to say that IRFS is more investor oriented than GAAP.[794] The reason for this lies mainly on the litigious environment that is peculiar to the US, allowing "companies and their auditors, when faced with a claim, to point to a rule book and say to a judge,

[784] Kristen Anderson, Lars Oxelheim, Eva Eberhartinger (n 583) 93.
[785] Klynveld Peat Marwick Goerdeler (KPMG).
[786] Peter Walton. *An executive's Guide for Moving From US GAAP to IFRS*. Financial Accounting Collection. Business Expert Press (2009). 4.
[787] American Institute of Certified Public Accontants (AICPA).
[788] Peter Walton (n 786) 1.
[789] International Organization of Securities Commission (IOSCO).
[790] Peter Walton (n 786) 2.
[791] International Accounting Standard Board (IASB).
[792] Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards. (L 243/1). Official Journal of the European Union. (7).
[793] Peter Walton (n 786) 2.
[794] Ibid 12.

'We followed the rules – so we have no case to answer'".[795] This more investment oriented form of accounting has its roots in Anglo-Saxon tradition, dating from the 19th (a product of the industrial revolution). In sum, the system "has evolved as part of the mechanism whereby investors share risks by participating in the financing of large companies. Anglo-Saxon accounting is about communicating to investors".[796]

Things were going quite well till Enron came along, which lead investors to doubt GAAP's reliability. The fact is that a too rigid set of rules welcomes avoidance, for "rules-based standards or a principles-only basis are likely to lead to lower quality financial reports (…) on the one hand, principles-only standards may present enforcement difficulties because they provide insufficient guidance or structure for exercising professional judgment by preparers and auditors. On the other hand, (…) rules-based standards[797] often provide a vehicle for circumventing the intention of the standard".[798] Notably this is true not only to accounting, for as we previously mentioned, over-protective statutes leads to possible distortions.

1. GAAP x IFRS (Main Differences)

In this section we will present some of the technical differences between GAAP US and IFRS. It is fair to assume that differences between one system over the other will influence transparency, comparability and efficiency when analyzing companies' numbers. As previously metioned, reports based on GAAP US are more detailed than IFRS.[799] The differences provided here are by no means exhaustive, therefore, for those who wish to get a more detailed presentation of the details concerning both methods, we suggest the material provided by the big four firms (KPMG, [800] E&Y, [801] Delloite and

[795] Peter Walton (n 786) 2.
[796] Ibid 3.
[797] According to IASB's chairman David Tweedie "[T]he US approach is a product of the environment in which standards are set. Simply put, accounting standards are detailed and specific because the FASB's contituents have asked for detailed and specific guidance because those details eliminate uncertainties about how transactions should be structured. Auditors want specificity because those specific requirements limit the number of difficult disputes with clients and may provide a defence in litigation. Securities regulators want detailed guidance because those details are though to be easier to enforce. (…) The IASB has conclude that a body of detailed guidance (*sometimes reffered to as* ***bright lines***) encourages a rule-book mentality of 'where does it say I can't do this'… Our approach requires both the company and its auditor to take a step back and consider whether the accounting suggested is consistent with underlying principle". *World Accounting report March* (2002). https://www.worldaccountingreport.com/resources/pdfarchive/?pdfYear=2002. Accessed Accessed in 01 Jan 2018.
[798] SEC Annual report (2003). 82. https://www.sec.gov/pdf/annrep03/ar03full.pdf.
[799] Peter Walton (n 786) 59.
[800] *IFRS Compared to US GAAP. An overview*. KPMG. (2015). https://home.kpmg.com/content/dam/kpmg/pdf/2015/12/US-GAAP-comparison-2015-overview.pdf. Accessed in 01 Jan 2018.
[801] *US GAAP versus IFRS. The basics*. November (2013). E&Y. http://www.ey.com/Publication/vwLUAssets/EY-US-GAAP-vs-IFRS-the-basics-2013/$FILE/EY-US-GAAP-vs-IFRS-the-basics-2013.pdf. Accessed in 01 Jan 2018.

PricewaterhouseCoopers).[802] A generic, but nevertheless important difference between IFRS and GAAP, is that IFRS "always ignore national requirements", that is to say, the method itself was not designed to individuals, but to provide a general guidance on "how to apply IFRS in the context of local legal issues".[803] An interesting example is that "FASB conceptual work framework is written with the object of informing decisions by standart-setters and does not appear in the FASB Codification of GAAP", therefore it is only considered when he "preparer has exhausted the authoritative guidance in the Codification; under IFRS it is to be applied directly by the preparer before going outside the IASB literature".[804] IASB has very little to no guidance on industry specific-sectors. IASB has some "minimal requirements for insurance companies nad mineral extraction companies", for as we might remember, IFRS has a more general approach than GAAP. [805] The IASB followed the US approach in preparing a SCI,[806] and allowed companies to place regular income "on one page, and carry forward the subtotal to the next page where OCI"[807] would be added to reach the TCI.[808]

Financial Statement Presentation. Both US GAAP and IFRS determine a split between "***current and non-curent items***, depending on whether an item is part of the business cycle. However, IAS 1 does not prohibit a presentation based on liquidity" if it is considered to offer a better information.[809] As for ***expenses***, companies may recognize them according to its ***nature*** (employment costs, depreciation and amortization, extermal supplies etc),[810] or to its ***function*** (cost of sales, marketing, and administration etc).[811] On a ***European level***, companies tend to present expendidure according to its ***nature***, nonetheless, most companies using IFRS choose to present expenditure according to its nature.[812] As for *cash flow statement* (IAS 7), both US GAAP and IFRS have the same headins, however, IFRS provides "less detail about what goes into each heading", as one might already expect.

Consolidation.[813] In respect to consolidation, the IFRS, as expected, has a more broad approach when compared to US GAAP. According to ***US GAAP***, a

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[802] IFRS and US GAAP: similarities and differences. PricewaterhouseCoopers. https://www.pwc.com/us/en/cfodirect/publications/accounting-guides/ifrs-and-us-gaap-similarities-and-differences.html. Accessed in 01 Jan 2018.
[803] Peter Walton (n 786) 60.
[804] Ibid 60.
[805] Ibid 60.
[806] Statement of Comprehensive Income (SCI).
[807] Other Comprehensive Income (OCI).
[808] Total Comprehensive Income (TCI).
[809] Peter Walton (n 786) 61.
[810] Ibid 62.
[811] Ibid 62.
[812] Ibid 62.
[813] According to ARB 51, the main purpose for consolidating statements is "(...) to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies. 2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of ***over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation***

parent company must consolidate the statements of associated companies where the parent company has "a controlling financial interest", therefore the US practice looks for "ownership of the majority of voting shares in another company for that company to be included in the consolidated accounts".[814] Under ***IFRS***, the parent company must consolidate the accounts of its associated companies if the parent company "(a) owns 50% or more of the voting shares, (b) has the power to govern the financial and operating policies of the investee, (c) can appoint or remove the majority of the board of directors, or (d) can cast the majority of votes at the board meetings of the investee." It is also important to mention that the fact the parant company owns less than 50% of its associated company, does not necessarily mean that the parent company would be waived from consolidating, for example, "if Company A owns 40% of the shares in Company B, and there are no other large blocks of shares in Company B, Company ***A would be deemed to have control*** and should consolidate Company B under IAS 27". *Control based on consolidation* will analyse parent company's control of a related party. A related party is a person "or a close member of that person's family (…) related to a reporting entity if that person has control, joint control, or significant influence over the entity or is a member of its key management personnel."An entity may also related to a reporting entity if "it is a parent, subsidiary, fellow subsidiary, associate, or joint venture of the reporting entity, or it is controlled, jointly controlled, or significantly influenced or managed by a person who is a related party."[815] US GAAP follows the same approach, nonetheless, differences on partial disclosure exemption in relation to government related entities are existent, for example, under US GAAP there is "no partial disclosure exemption for government entities that prepare financial statements in accordance with US GAAP".[816]

Revenue recognition. According to IAS 18, revenue "is the gross inflow of economic benefits during the period arising from the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants".[817] Under the same standard, revenue arising from (a) the sale of goods; (b) the rendering of services and (c) the use of others of entity assets yielding interest, royalties and dividends, must be properly recognized in the financial statement. Now, under Staff Accounting Bulleting (SAB)[818] 104, revenue is realized or realizable when the following criteria are met: (a) persuasive evidence of an arrangement exists, (b) delivery has occurred or services have been rendered, (c) the seller's price to

(…)" (*emphasis added*). ARB 51 paras. 1 and 2. *Consolidated Financial Statements*. ARB 51 Status. Issued: August 1959.

[814] Peter Walton (n 786) 62.

[815] *IAS 24 Related Party Disclosures.* https://www.ifrs.org/issued-standards/list-of-standards/ias-24-related-party-disclosures/. Accessed in 01 Jan 2018.

[816] *IFRS Compared to US GAAP* (n 800) 86.

[817] *IAS 18 Revenue.* http://www.ifrs.org/issued-standards/list-of-standards/ias-18-revenue/. Accessed in 01 Jan 2018.

[818] The selective Staff Accounting Bulletins (SAB) "(...) reflect the Commission staff's views regarding accounting-related disclosure practices. They represent interpretations and policies followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws." *Selected Staff Accounting Bulletins*. https://www.sec.gov/interps/account.shtml. Accessed in 01 Jan 2018.

the buyer is fixed or determinable and (d) collectibility is reasonably assured.[819] As previously mentioned, IFRS have a more broad approach in respect to financial reporting, whereas US GAAP has a more detailed and extensive literature in respect to indivicual industries, nonetheless, ***in the absence of IFRS literature, the relevant company may use US GAAP literature***.[820]

Nonfinancial assets. IAS 38 sets out the criteria for recognizing intangible assets. The referred standard reads "[A]n intangible asset is an identifiable non-monetary asset without physical substance. Such an asset is identifiable when is separable, or when it arises from contractual or other legal rights. Separable assets can be sold, transferred, licensed, etc. Examples of intangible assets include computer software, licences, trademarks, patents, films, copyrights and import quotas. Goodwill acquired in a business combination is accounted for in accordance with IFRS 3 and is outside the scope of IAS 38".[821] Under IFRS goodwill must be allocated to individual cash-generating units (CGUs), or groups of CGUs. Under US GAAP, goodwill "is allocated to that segment or one level below". Research and development costs are treated considerably different between IFRS and US GAAP. The SFAS[822] 2 (Accounting for Research and Development Costs), requires "that research and development costs are expensed as incurred, with an annual disclose as to the amount. IAS 38 requires that research costs are expensed but development costs must be capitalized provided that the entity considers that they are recoverable and the development will lead to a commercially feasible outcome that the entity is able to exploit". Drawing an exact line between the research phase and the product's development may be difficult, therefore it falls under the entity's discretion along with its auditors to judge the matter properly. The IAS do not recognise internally generated intangible assets. This is because it is often "difficult to distinguish from the cost of maintaining or enhancing the entity's operation or goodwill. For this reason, internally generated brands, mastheads, publishing titles, customer lists and similar items are not recognised as intangible assets. The costs of generating other internally generated intangible assets are classified into whether they arise in a research phase or a development phase".[823] In respect of property, plant and equipment (IAS 16),[824] both IFRS and US GAAP are

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[819] Peter Walton (n 786) 65.

[820] Peter Walton (n 786) 65.

[821] *IAS 38 Intagible Assets.* https://www.ifrs.org/issued-standards/list-of-standards/ias-38-intangible-assets/. Accessed in 01 Jan 2018.

[822] Statement of Financial Accounting Standards (SFAS).

[823] "Research expenditure is recognized as an expense. Development expenditure that meets specified criteria is recognized as the cost of an intangible asset. Development expenditure that meets specified criteria is recognized as the cost of an intangible asset. Intangible assets are measure initially at cost. After initial recognition, an entity usually measures an intangible asset at cost less accumulated amortization. It may choose to measure the asset at fair value in rare cases when fair value can be determine by reference to an active market. An intangible asset with a finite useful life is amortised and is subject to impairment testing. An intangible asset with an indefinite useful life is not amortised, but is tested annually for impairment. When an intangible asset is disposed of, the gain or loss on disposal is included in profits or loss." IAS 38 Intangible Assets (n 821).

[824] "(…) Property, plant and equipment are tangible items that: are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used during more than one period. Property, plant and equipment includes bearer plants related to agricultural activity. The cost of an item of property, plant and equipment is

substantially similar, that is to say, all "costs of bringing an asset into service should be capitalizes. Under IFRS this includes interest costs (but this calculated in the same way as under U.S. GAAP) and possible hedging gains and losses (excluded in the United States)".[825] However, the manner in which IFRS treats investment property is considerably different, for example, US GAAP makes no distinction for this kind of property, whereas IAS 40 identifies such property as "property (land or a building-or part of a building- or both) held (by the owner or by the lessee under a finance lease) to earn rentals of for capital appreciation of both, rather than for: (a) use in the production or supply of goods or for services of for administrative purposes; or (b) sale in the ordinary course of business".[826]

Impairment, is the core principle in IAS 36, that is, "an asset must not be carried in the financial statements at more than the highest amount to be recovered through its use or sale. If the carrying amount exceeds the recoverable amount, the asset is described as impared. The entity must reduce the carrying amount of the asset to its recoverable amount, and recognise an impairment loss. IAS 36[827] also applies to groups of assets that do not generate cash flows individually (known as cash-generating units)" (CGUs).[828] Under US GAAP standard, the "CGU is at reporting-unit level, which is one level below segment. Goodwill and intangibles with indefinite lives have to be tested annually for impairment under both sets of standards", that is to say, under US GAAP and IFRS.[829] Under IFRS, if the carrying amount is higher than its recoverable amount, the CGU must be impared.[830]

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recognised as an asset if, and only if: it is probable that future economic benefits associated with the item will flow to the entity; and the cost of the item can be measured reliably. An item of property, plant and equipment is initially measured at its cost. Cost includes: its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and the estimate costs of dismantling and removing the item and restoring the site on which it is located, unless those costs relate to inventories produced during that period." *IAS 16 Property, Plant and Equipment.* https://www.ifrs.org/issued-standards/list-of-standards/ias-16-property-plant-and-equipment/. Accessed in 01 Jan 2018.

[825] Peter Walton (n 786) 67.

[826] Ibid 68.

[827] IAS 36 applies to all assets except those for which other Standards address impairment. The exceptions include inventories, deferred tax assets, assets arising from employee benefits, financial assets within the scope of IFRS 9, investment property measured at fair value, biological assets within the scope of IAS 41, some assets arising from insurance contracts, and non-current assets held for sale. The recoverable a mount of the following assets in the scope of IAS 36 must be assessed each year: intangible assets with indefinite useful lifes; intangible assets not yet available for use; and goodwill acquired in a business combination. The recoverable amount of other assets is only when there is an indication that the asset may be impared. Recoverable is the higher of (a) fair value less costs to sell and (b) value in use. Fair value less costs to sell is the arm's length sale price between knowledgeable willing parties less costs of disposal." *IAS 36 Imparment of Assets*. https://www.ifrs.org/issued-standards/list-of-standards/ias-36-impairment-of-assets/. Accessed in 01 Jan 2018.

[828] IAS 36 Imparment of Assets (n 841).

[829] Peter Walton (n 786) 68.

[830] "The recoverable amount in this case is the higher of the fair value less costs to sell, or the "value in use." Value in use is the net present value of the CGU's expected future cash fl ows. Value in use is based on entity-specifi c cash fl ows discounted at a rate that reflects the risk of the asset being measured. When a CGU is deemed to be impaired, the impairment is charged against the

Financial Instruments. Reporting financial instruments under both standards (US GAAP and IFRS) is extremely complex. In 2008 the IASB published a discussion paper entitled "*Reducing Complexity in Reporting Financial Instruments*"[831] where possible ***intermediate***[832] and ***long-term solutions***[833] to the matter were discussed. The fact of the matter is that under both standards "debts, liabilities, and receivables are held at amortized costs and all derivaties are held at fair value. However, under IFRS all financial instruments have to be classified at inception as: available for sale, held for trading, and held to maturity."[834] Impairment rules are somewhat different, for instance, under US GAAP, the impairment has to be other than temporary to be recognized, but it is then not reversible. The approach to derecognition is also slightly different insofar as IAS 39[835] is based on a risk and rewards approach, which US GAAP is

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goodwill in the first case, and then to other assets. The write-off of goodwill cannot be reversed, but that of other assets may be. U.S. GAAP prefers to measure individual assets (other than goodwill) for impairment, rather than groups of assets. The U.S. approach works in two steps. First, the asset is tested to see if it is impaired—that is, whether the carrying value exceeds the undiscounted expected future cash fl ows (also known as the recoverable amount). If the asset fails the test, U.S. GAAP then has a separate measurement of the actual impairment. The asset is restated to its fair value. Impairment write-offs cannot be reversed. On the face of it, the IFRS impairment approach would be likely tolead to identifi cation of more impairments than would be the case under U.S. GAAP. In the fi rst place, the CGU is generally smaller, thus limiting the possibility of more profi table units obscuring less profi table units. In the second place, the U.S. hurdle to a recoverable amount is higher than IFRS because it is undiscounted. Peter Walton (n 786) 69.

831 *Reducing Complexity in Reporting Financial Instruments.* March (2008*).* https://www.asc.gov.sg/Portals/0/attachments/Consultations/dp-%20reducing%20complexity%20in%20reporting%20financial%20instruments.pdf. Accessed in 01 Jan 2018.

832 The possible intermediate approaches to reduce complexity are: "(a) to amend measurement requirements (eg by reducing the number of categories of financial instruments); (b) to replace the existing requirements with a fair value measurement principle and some optional exceptions to fair value measurement; and/or (c) to simplify hedge accounting". *Reducing Complexity in Reporting Financial Instruments.* (n 831) *5.*

833 Long-term solution would be to "measure in the same way all types of financial instruments within the scope of a standard for financial instrument. Many of the rules associated with measuring financial instrument in different ways could be eliminated (…) There are some concerns and issues associated with the fair value measurement of financial instruments, (…). The main concerns are (a) volatility of earnings arising from changes in fair value and (b) presentation of unrealised gains and losses in earnings. In addition, greater use of fair value might result in more complexity (eg the difficulty in disaggregating changes in fair value into components)". *Reducing Complexity in Reporting Financial Instruments* (n 831). *5.*

834 Peter Walton (n 786) 70.

835 IAS 39 was be superseded by IFRS for annual periods beginning on or after 1 January 2018 with early application permitted. IFRS 9 provides that when "an entity first recognises a financial assets, it classifies it based on the entity's business model for managing the asset and the asset's contractual cash flow characteristics, as follows: (A) Amortised cost-a financial asset is measured at amortised cost if both of the following conditions are met: 1. The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and 2. The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. (B) Fair value through other comprehensive income- financial assets are classified and measured at fair value through other comprehensive income if they are held in a business model whose objective is achieved by both collecting contractual cash and selling financial assets. (C) fair value through profit or loss-any financial assets that are not held in one of the two business models mentioned are measured at fair through profit or loss." *IFRS 9 Financial instruments.*

based on control".[836]

Liabilities and Equity. Under IAS 32[837] an "instrument that involves the entity in an obligation to settle for cash or any other financial instrument is treated as a liability".[838] The same approach applies to US GAAP. As previously mentioned US GAAP has a more detailed approach when compared to IFRS. US GAAP, for example, has a "mezzanine category between equity and liabilities into which instruments redeemable at the option of the holder, or those that would otherwise be categorized as equity, are displayed. Under IFRS, compound financial instruments have to be bifurcated. Minority interests are shown under IFRS as a peparate category within group equity, whereas in the United States they are in the mezzanine." [839]

Provisions and Contigencies. According to IAS 37 a "provisions is a liability of uncertain timing or amount. The liability may be a legal obligation or a constructive obligation. A constructive obligation arises from the entity's actions, through which it has indicated to others that it will accept certain responsabilities, and as a result has created an expectation that is will impose discharge those responsabilities", for example, warranty obligations, legal or constructive obligations to clean up a contaminated area. Contingent liabilities, however, are "possible obligations whose existence will be confirmed by uncertain future events",[840] for example, the outcome of a litigation. Here the IASB sets an "artificial threshold", that is, if the claim has a 49% chance to succeed, than the claim shall not be recognised, however, if the claim has more than 51% of being successful, then it must be recognised. Under US GAAP, the probability threshold is 80%, that is, bellow that it should not be recognised as a liability.[841]

Pensions. Postemployment costs are in fact a major element of an entity's financial position, and has a strong impact on both the market as well as the invertor's perception of the company. Both standards (US GAAP and IFRS), are substantially similar, nonetheless the details can present some differences. IAS 19 prescribes the "accounting for all types of employee benefits except share-based payment, to which IFRS 2 applies. Employee benefits are all forms of

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https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/. Accessed in 01 Jan 2018.

[836] Peter Walton (n 786) 70.

[837] "(…) financial instruments are classified into financial assets, financial liabilities and equity instruments. Differentiation between a financial liability and quity depends on whether an entity has an obligation to deliver cash (or some other financial asset). (…) A compound financial instrument such as a convertible bond, is split into equity and liability components. When the instrument is issued, the equity component is measured as the difference between the fair value of the compound instrument and the fair value of the liability component. Financial assets and financial liabilities are offset only when the entity has a legally enforceable right to set off the recognized amounts; and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously." *IAS 32 Financial Instruments: Presentation*. https://www.ifrs.org/issued-standards/list-of-standards/ias-32-financial-instruments-presentation/. Accessed in 01 Jan 2018.

[838] Peter Walton (n 786) 70.

[839] Ibid 70.

[840] *IAS 37 Provisions, Contingent Liabilities and Contingent Assets.* https://www.ifrs.org/issued-standards/list-of-standards/ias-37-provisions-contingent-liabilities-and-contingent-assets//. Accessed in 02 Jan 2018.

[841] Peter Walton (n 786) 73.

consideration given by an entity in exchange for service rendered by employees or for the termination of employment".[842]

Leasing. Both US GAAP and IFRS provide for capital lease and operating lease. IAS 17 prescribes that lease payments "under an ***operating lease*** are recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit". As for financial lease, IAS 17 provides that at the "commencement of the lease term, lessees recognise finance leases as assets and liabilities in their statements of financial position at amounts equal to their value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease".[843] Nevertheless, the main difference between US GAAP and IAS 17 is that the latter "defines finance lease as one where the risks and rewards of using an asset have passed substantially to the lessee. This is a classic example of the difference between IFRS and US standards."[844]

Other issues. Operating segments (IFRS 8) requires companies whose "debt or securities are publicly traded to disclose information to enable users of its financial statements to evaluate the nature and financial effects of the different business activities in which it engages and the different economic environments in which it operates".[845] Such standard is "virtually the same as SFAS 131" (US GAAP). Share-based payments (IFRS 2) addresses to transactions where the relevant company issues equity as opposed to an asset in order to settle an obligation, that is to say, it requires an entity to "recognise share based payment transactions in its financial statements, including transactions with employees of other parties to be settle in cash, other assets or equity instruments of the entity".[846] Comparing US GAAP and IFRS, some suggest that both standards differ on the grant date application, that is, the IFRS refers to "grant date being the point at which there is a 'share understanding' of the terms and conditions, whereas US practice is to consider grant date to be the date the option is approved by shareholders, which could be some time later".[847] IAS 12 provides for the accounting treatment in relation to income taxes, which shall include domestic and foreign taxes based on taxable profits.[848] Both standards base deferred tax provisions on the "difference between the book carrying value

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[842] "IAS 19 requires an entity to recognize: a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and an expense when the entity consumes the economic benefit arising from the service provided by an employee in exchange for employee benefits." IAS 19 also provides for post-employment benefits, that is, benefits other than "termination benefits and short-term employee benefits". *IAS 19 Employee Benefits.* https://www.ifrs.org/issued-standards/list-of-standards/ias-19-employee-benefits/. Accessed in 02 Jan 2018.

[843] *IAS 17 Leases. https://www.ifrs.org/issued-standards/list-of-standards/ias-17-leases/.* Accessed in 02 Jan 2018.

[844] Peter Walton (n 786) 76.

[845] *IFRS 8 Operating Segments*. https://www.ifrs.org/issued-standards/list-of-standards/ifrs-8-operating-segments/. Accessed in 02 Jan 2018.

[846] *IFRS 2 Share-based payment*. https://www.ifrs.org/issued-standards/list-of-standards/ifrs-2-share-based-payment/. Accessed in 02 Jan 2018.

[847] Peter Walton (n 786) 77.

[848] *IAS 12 Income Taxes.* https://www.ifrs.org/issued-standards/list-of-standards/ias-12-income-taxes/. Accessed in 02 Jan 2018.

of assets and liabilities carrying value",[849] that is, a deferred tax liability arises if the relevant entity pay less tax if it recovers "the carrying amount of another asset or liability; or has unsused tax losses or unused tax credits".[850] Both standards are considerably similar, nonetheless its detailed application can present some differences. IAS 28 provides for investment in associate companies (Investment in Associates), where the investor has "significant influence (equity investments in the United States)". Under US GAAP such rule requires the investors located within the 20% - 50% corridor of voting stock to be recognised.[851] An associate company is an "entity over which the investor has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of the investee without the power to control or jointly control those policies".[852] IAS 29 addresses hyperinflationary economies and provides the following indicators of hyperinflation: (i) cumulative inflation over three year approaches or exceeds 100%, (ii) interest rates, wages and prices linked to price index, (iii) purchases and sales are quoted on prices that compensate for expected losses, (iv) the general population maintains its wealth in non-monetary assets (properties, for instance) and (v) the population regards monetary amounts not in terms of local currency but in term of a stable foreign currency.[853] US GAAP approach follows a two-step assessment: (1) a quantitative analysis of the relevant cumulative inflation rate (cumulative inflation rates above 100% on a three year period is deemed as hyperinflationary), and (2) is the inflationary rate is less than 100% on a three year period, judgement is applied on the historical inflation rate trends and other relevant economic factors. [854] Other differences such as to transactional requirements.

	IFRS	**US GAAP**
Financial Statement Presentation	***(1)*** Requires ***no*** special format of the income Statement (only a minimum presentation).[855]	***(1)*** Requires income statement to be presented in a Single step format [856] or under Multiple step format.[857]

[849] Peter Walton (n 786) 77.
[850] IAS 12 Income Taxes (n 84).
[851] Peter Walton (n 786) 78.
[852] *IAS 28 Investments in Associates and Joint Ventures.* https://www.ifrs.org/issued-standards/list-of-standards/ias-28-investments-in-associates-and-joint-ventures/. Accessed in 02 Jan 2018.
[853] *Hyperinflationary economies. IFRS Institute*. Nov 16, (2017). http://www.kpmg-institutes.com/institutes/ifrs-institute/articles/2017/11/hyperinflation-accounting-under-ifrs-us-gaap.html. Accessed in 02 Jan 2018.
[854] *Hyperinflationary economies* (n 853).
[855] Minimum presentation of items in the income statement: ***method*** (nature or function), ***revenue***, ***finance costs***, ***tax expense***, ***periodical loss or profit*** etc.
[856] **Single step format:** his format factors in all expenses and classifies them by **function**. The expenses, in this case, are deducted from the total income to outline the income before tax.
[857] **Multiple step format:** This is where the expense of sales is deducted from the sales to show the gross profit. Other income and expenses are also outlined in order to give the income before tax. Regulations of the **SEC require that the registrants should categorize their expenses by function.**

	(2) Expenses categorized according to their ***function*** or ***nature***.	***(2)*** Expenses categorized according to their ***function***.
Standard's list	IAS 1	Subtopic 205-30 Subtopic 855-10 AU 341 AU-C 570
Consolidation	***(3)*** Necessary if the PC has control over the associated company regardless if it has the majority of voting shares or not. ***(4)*** Government-related entities are allowed to provide less information of related party contracts.	***(3)*** Necessary if the PC has ownership of the majority of voting shares of the associated company. ***(4)*** No partial disclosure exemption for government entities that preparing statements under US GAAP.
Standard's list	IAS 24	Topic 850
Revenue Recognition	***(5)*** Extensive and detailed guidance according to the relevant industry, types of contract etc.	***(5)*** Revenue is recognised based on general principles applied to the relevant transaction.
Standard's list	IAS 11 IAS 18 IFRIC[858] 13 IFRIC 15 IFRIC 18	Topic 605, Subtopic 905-605, Subtopic 920-605, Subtopic 922-605, Subtopic 926-605, Subtopic 928-505, Subtopic 932-605, Subtopic 944-605, Subtopic 946-605, Subtopic 952-605, Subtopic 975-605, Subtopic 980-605, Subtopic 985-605, Subtopic SAB Topic 13
Nonfinancial Assets	***(6)*** Internal research costs only expensed when incurred. ***(7)*** Advertising and promotional expenditure expensed when incurred.	***(6)*** Internal R&D costs is expensed when incurred. ***(7)*** Advertising and promotional expenditure expensed when certain criteria are met.

[858] International Financial Reporting Interpretation Committee (IFRIC).

	(8) Specific definition for investment property (land or building or both).	***(8)*** No specific definition for investment property.
Standard's list	IAS 38 SIC-32 IAS 40 IAS 16 IFRIC 1 IFRIC 18	Subtopic 340-20, Topic 350, Subtopic 720-15, Subtopic 720-35, Topic 730, Subtopic 985-20, Topic 360, Subtopic 360-10, Subtopic 410-20, Subtopic 720-15, Subtopic 720-40, Subtopic 845-10
Impairment	***(9)*** Goodwill allocated to CGUs or groups of CGUs that are expect to benefit from interactions between business combinations. ***(10)*** Carried amount of goodwill is grossed up for impairment test. ***(11)*** Impairment reversal recognised in profit or loss. [859]	***(9)*** Goodwill allocated to RU [860] that are expected to benefit from interactions between business combinations. ***(10)*** Carried amount of goodwill not grossed up for impairment test. ***(11)*** Reversals not recognised.[861]
Standard's list	IAS 36 IFRIC 10	Topic 350 Subtopic 360-10
Financial Instruments	***(12)*** Impairment rules in respect to derecognition based on a risk and reward approach.	***(12)*** Impairment rules in respect to derecognition based on control.
Standard's list	IAS 32 IAS 39	Subtopic 320-10, Subtopic 410-30, Subtopic 505-10, Subtopic 815-10, Subtopic 820-10, Subtopic 825-10, Topic 860, Subtopic 946-320
	(13) As an exception, certain "puttable instruments and instruments, or components of	***(13)*** The fact that the entity is publicly or privately owned determines the accounting for a puttable

[859] IFRS Compared to US GAAP. An overview (n 800) 51.
[860] Reporting Unit.
[861] IFRS Compared to US GAAP. An overview (n 800) 51.

Liabilities and Equity	instruments, that impose on the entity an obligation to deliver a pro-rata share of the net assets of the entity (…) are classified as equity if certain conditions are met." [862]	instrument and whether is conditionally or unconditionally puttable.
Standard's list	IAS 1 IAS 10 IAS 32 IAS 39 IFRIC 17	Topic 815, Subtopic 470-20, Subtopic 480-10, Subtopic 505-20, Subtopic 505-30, Subtopic 810-10, para 480-10-S99-3,268, CON6)
Provisions and Contingencies	***(14)*** Contingent liabilities are obligations which carries an uncertainty either due to its outflow probability or to the outflow's amount ***(15)*** Contingencies not recognised "except for those that represent obligations in a business combination"[863] ***(16)*** Provisions measured at the "best estimate" of the relevant expenditure.	***(14)*** Loss Uncertainties are uncertain obligations, both recognised an unrecognised. [864] ***(15)*** Contingencies may be recognized or unrecognized. Moreover, contingent liabilities are recognised "in a business combination only when the acquisition date fair value is determinable within the measurement period." [865] ***(16)*** Provisions measured using a "reasonable estimate. Nonetheless, "under some Codification topics obligations that would be deemed a provisions under IFRS are measured

[862] On the one hand, the financial instrument may be classified as liability if instrument's issuer is required to pay cash or another capital in return for redeeming or purchasing the relevant instrument. On the other hand, if the puttable financial instrument imposes on the issuer an obligation to pay a pro-rata share of the entity's net assets only on liquidation, the instrument shall be deemed as equity and not liability. IFRS Compared to US GAAP. An overview (n 800) 105.
[863] Ibid 54.
[864] Ibid 54.
[865] Ibid 54.

		at fair value, unlike IFRS." [866]
Standard's list	IAS 37 IFRIC 1 IFRIC 5 IFRIC 6 IFRIC 21	Topic 450, Subtopic 410-20, Subtopic 410-30, Subtopic 420-10, Subtopic 460-10, Subtopic 720-40
Pensions	***(17)*** Post-employment benefits are payable "after the completions of employment (before of during retirement". [867]	***(17)*** Post-employment benefits are "divided into 'post-retirement benefits' (provided during retirement) and 'other post-employment benefits' (provided after cessation of employment but before retirement). The accounting for post-employment benefits depends on the type of benefit provided, unlike IFRS". [868]
Standard's list	IAS 19 IFRIC 14	Topic 715, Subtopic 710-10, Subtopic 712-10
Leasing	***(18)*** Lease guidance applies to plant, equipment, property and other assets (limited exclusions). [869] ***(19)*** A lease of land and a building are treated separately and may be "be classified differently." [870] ***(20)*** In order to be classified as a lease, it is mandatory that all risks and rewards incidental to ownership have been transferred from the lessor to the lessee. [871]	***(18)*** Lease accounting guidance applies only in relation to property, plant and equipment. [872] ***(19)*** A lease of land with a building is treated as two leases only if "the fair value of the land is at least 25 percent of the fair value of the leased property as a whole."[873] ***(20)*** If the lease do not transfer substantially all the rewards "incidental to ownership of the leased asset can be a capital (finance) lease in

[866] IFRS Compared to US GAAP. An overview (n 800) 52.
[867] Ibid 68.
[868] Ibid 68.
[869] Ibid 76.
[870] Ibid 77.
[871] Ibid 76.
[872] Ibid 76.

		certain circumstances." [874]
Standard's list	IAS 17 IFRIC 4 SIC-15 SIC-27	Topic 840, Subtopic 958-840
Other Issues	***(21)*** Companies required to disclose *judgements* made by management in respect to information regarding aggregation criteria (products and services, geographic areas, major customers etc). [875] ***(22)*** Grant date is that when both company and employee have a "shared understanding of the terms and conditions of the arrangement". [876] ***(23)*** Deferred taxes not recognised if not generated "from the recognition of an assets or liability (…) that is not a business transaction". [877] ***(24)*** Deferred tax recognised if probable (net approach). [878] ***(25)*** No special requirements for partnerships and similar entities in determining	***(21)*** Companies *not* required to disclose *judgements* made by management in respect to information regarding aggregation criteria(products and services, geographic areas, major customers etc). [880] ***(22)*** Contrary to IFRS, "employees should (…) benefit from or adversely affected by changes in the entity's share price". [881] ***(23)*** No exemption from "recognising a deferred tax asset or liability." [882] ***(24)*** Deferred taxes recognised regardless if realised or not (gross approach). [883] ***(25)*** Contrary to IFRS equity method applied to partnerships and similar entities "unless the investor has virtually no influence over the

[873] IFRS Compared to US GAAP. An overview (n 800) 77.
[874] Ibid 76.
[875] Ibid 80.
[876] Ibid 80.
[877] Ibid 80.
[878] Ibid 56.
[880] Ibid 72.
[881] Ibid 55.
[882] *IFRS Compared to US GAAP. An overview*. KPMG. Pag 55.
[883] *IFRS Compared to US GAAP. An overview*. KPMG. Pag 56.

	equity method applicability. ***(26)*** Financial statements of a foreign operation located in a high inflationary State adjustments "are made to its financial statements before translation into a different presentation currency. (…) However, if the presentation currency is not the currency of a hyperinflationary economy, then comparative amounts are not restarted." [879]	investee's operating and financial policies". [884] ***(26)*** Financial statements of a foreign operation located in a high inflationary State "measured as if the parent's reporting currency were its functional currency". [885]
Standard's list	Operating segments – IFRS 8. (21) Share-based payments – IFRS 2. (22) Income taxes – IAS 12, SIC-25. (23), (24) Associates and equity method – IAS 28. (25) Foreign currency translation – IAS 21, IAS 29 (26)	Operating segments – Topic 280. (21) Share-based payments – Topic 718. (22) Income Taxes – Topic 740, Subtopic 830-740. (23), (24) Equity-method investees – Subtopic 272-10, Topic 323, Subtopic 808-10, Topic 970. (25) Foreign currency translation – Topic 830 (26)

The table above is merely a complement to previous comments and are not intended to provide a full and detailed comparison of both US GAAP and IFRS, but only an overview on how both standards may differ.

[879] IFRS Compared to US GAAP. An overview (n 800) 26.
[884] *IFRS Compared to US GAAP. An overview*. KPMG. Pag 40.
[885] *IFRS Compared to US GAAP. An overview*. KPMG. Pag 26.

2. *From IAS to IFRS (Regulation 2002/1606) and the importance of Financial Accounting for creating a full internal market within itself*

Professional accounting bodies eventually came to the conclusion that it was necessary to reconstitute a private body such as the Financial Accounting Standards Board (FASB),[886] whose standards would be written by a selected group of tax experts ("IOSCO voted to accept the standards as the basis of reporting where a company had a secondary listing").[887] The reconstituted private body was named International Accounting Standards Committe (IACSA), whose purpose was to "develop a single set of global accounting standards".[888] On 2001, one of IASC's first decisions was to rename IASC to International Accounting Standards Board (IASB), and also proceeded to rename International Accounting Standards to (IAS) to International Financial Reporting Standards (IFRS), which should "whenever possible (...) a high degree of transparency and comparability for financial reporting in the Community".[889] In other words, it was imposed on "all European listed companies to use IAS from 2005 onward (...) countries that are not part of the EU such as Switzerland had already been using international standards voluntarily for listed companies, while others such as Norway decided to switch to maintain comparability with the rest of Europe.

[886] "If you did not know that Canada had decided in 2006 to switch to International GAAP in 2011, and Japan, Brazil, China, South Korea, and India were doing the same, you could well ask, how could that happen? The answer, in headline terms, is that it is a combination of two standards. Principally, since the 1960s, business has become more and more global and has lost a significant part of its national identity. Once you have global players reporting to global finance markets, it makes sense to have global financial reporting rules. The other strand is some loss of confidence in GAAP. This was part of the fallout from the Enron crash: before then U.S. regulators thought, with some justification, that U.S. GAAP were the best, most rigorous accounting standards in the world. Enron and others demonstrated that even U.S. standards could be manipulated dramatically. The (...) International Financial Reporting Standards (IFRS) (...) go back to the beginning of the 1970s when partners in what are now Deloitte and PricewaterhouseCoopers observed that businesses were making more and more international transactions. They thought this called for a common understanding of how the transactions should be measured. They brought together the American Institute of Certified Public Accountants AICPA) and professional accounting bodies from eight other countries to create a voluntary body to write what, at the time, they called International Accounting Standards (IAS). A collection of standards was built over the following decades, primarily influenced by the Anglo-American approach to financial reporting. As these standards increased, they were used by many national standand-setters as a model for their own national standards. A key development started in 1987 when the International Organization of Securities Commissions (IOSCO) agreed to work with the international standard-setter to develop rules for international listings. The SEC is a founding member of IOSCO, which brings together securities regulators from all the major capital markets. At that time each market had its own rules, and companies that were listed on several national exchanges had to follow different accounting and other requirements in many of them. IOSCO had the idea of creating a listing "passport." Companies would report according to the listing requirements of their home or primary exchange as usual. But if they wanted to be listed elsewhere, all the exchanges where they had a secondary listing would ask them to meet the same set of IOSCO requirements and not national rules. There followed 10 years and more detailed work on extending and improving the IAS. The year 2000 was the next turning point." Peter Walton (n 786) 1.

[887] Ibid 2.

[888] Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 19 July 2002 on the application of international accounting standards. L 243/1. Preamble (7).

[889] Regulation (EC) No 1606/2002. Preamble (7).

Australia and South Africa decided to adopt IFRS in 2005 as well, with New Zealand making adoption voluntary in 2005 but compulsory from 2007 onward (...) more than 100 countries around the world, including all of Europe, currently require or permit IFRS reporting. Approximately 85 of those countries require IFRS reporting for all domestic listed companies."[890]

The best way in reaching a true internal market is without a doubt through harmonisation. A number of Directives were enacted before Regulation 2002/1606 came into play (first Council Directive 68/151, fourth Directive 78/660/EEC on annual accounts of certain companies, then the seventh Council Directive 83/349/EEC on consolidated accounts – repeled by Directive 2013/34 -, followed by Directive 86/635/EEC on annual accounts and consolidated accounts of banks and other financial institutions and finally Direcive 91/674/EEC on annual accounts of insurance companies). In sum, it was acknowledged by the Commission that there was a need to adopt a higher level of "transparency and comparability of financial reporting from all publicly traded Community companies" in order to build an "integrated capital market which operates effectively, smoothly and efficiently" [891] while maintaining the protection of investors, and more importantly, a uniform and global reporting language recognised internationally. The fact of the matter is that without IFRS, "comparisons are limited and inefficient companies are enabled to survive because their performance cannot be compared to efficient companies that report under different rules. Comparability should therefore make for greater transparency and greater efficiency. Some people may think that all fi nancial reporting rules would measure profit and net assets in the same way. At a broad level, they do. Also, within the subset of Anglo-Saxon accounting there is a high level of common thinking. Even so, just a small difference in rules can impact earnings and equity. Prior to its adoption of IFRS, the United Kingdom used a quite different approach to deferred tax than was used in GAAP. This would sometimes throw up substantial differences for UK companies that reconciled their UK earnings and equity to GAAP for SEC purposes. If everyone is using the same rules, then the movement from one year to another is comparable, and the annual earnings should be comparable, although there is still the effect of management judgment on amortization, depreciation, and provisions".[892] Here a few remarks on financial accounting and managerial accounting relevent to be drawn. Accounting, in general, entails the: (1) recording, (2) estimating, (3) organising and (4) summarising financial and operational information. *Financial accounting* has a retrospective approach, that is, what actually happended in the company in order to inform the public (inverstors, creditor's etc) the company's financial health. Managerial accounting is future oriented, that is to say, it emphasizes decisions affecting the company's future strategy. The table bellow will put such concepts into a better perspective.

[890] Peter Walton (n 786) 1.
[891] Regulation (EC) No 1606/2002. Preamble (7).
[892] Peter Walton (n 786) 6.

Accounting (general)	*Managerial Accounting*	*Financial Accounting*
1. Recording; ***2. Estimating;*** ***3. Organising; and*** ***4. Summarising financial and operational data.***	- Internal focus – needs of managers and others within the organisation; - No mandatory rules, that is, managers are free to use whatever methods make sense in their business; - Includes both financial and non-financial information (hours used, units produced, quality, etc; - Subjective information often used only if relevant; - Future – oriented-emphasis decisions affecting the company's future - Detailed information about products, departments used for detailed decisions (focused on segments) -Multidisciplinary (economics, production, science etc) - Reports are internally used in order to budget , targets, planning etc	- External focused – needs of external users (investors, creditors, regulatory agencies etc) - Mandatory rules (US GAAP or IFRS) set by FASB, SEC or IASB - Focuses on financial information - Emphasises objective information that is verifiable Past-oriented-shows financial consequences of past decisions - Summaru information about whole company – used for decisions about investing in firm as a whole - More self-contained - Reports: Balance Sheet, Income Statement, Cash Flow Statement, Statement of Owners' Equity

Now, in order to assess tax liability "tax accounting is required for producing the accounting data that is needed for determining the statutory tax liability of a company".[893] Different accounting methods results a different tax liability, in fact, there is a certain paradox (or cinism, if you will) concerning business accounting, that is, for taxation purpuses "the economic incentinve is to minimise income in order to mininise or postpone a tax liability, whereas for

[893] COM (2001) 582 final 318.

accounting purposes the economic incentive is often to minimise or smooth earnings in order to satisfy the investors". [894] This relationship between "accounting and taxation" can be classified into two different structures, namely, "independent structure" and bein a "dependent structure".[895]On the oner hand, *Independent structures* operates under the assumption that income determination is independend from accounting purposes, that is to say, enterprises may "choose different accounting policies for tax and for financial accounting purposes and the use of special tax facilities is not linked to applying these facilities in the financial accounts",[896] although such independency "is never total: Accounting rules will take into account structures which may have been set up for tax purposes and the other way round. The separation of tax accounts and financial accounts is somwaht typical for common-law countries applying an 'over-riding principle' of a 'true and fair view' in accounting law." [897] On the other hand, *dependent structures* denotes that income is determined by the choices made in financial accounts or that the relevant financial accounts pursues tax rules. In other words, income computation for tax purposes follows "*financial accounting standards* and the financial principles of proper bookkeeping" [898] (principle of authoritativeness – *Maßgeblichkeit* und *Grundsätze ordnungsmässiger Buchführung*). [899] However, accounting judgements made under tax law can only (or at least should) be "exercised to the extent that the same treatment has been followed in the financial accounts", which has as its ultimate ratio preventing companies to present various truths to different entities (the company is deemed as deficitary to tax authorities, but nonetheless extremely profitable to invertors) [900] (reverse authotitativeness principle – *umgekehrte Maßgeblichkeit*). [901] It is also important to note that individual accounts are a pre-requisite for dependency, and this is mainly because consolidated accounts are not used as a basis for assessing tax liability. Nevertheless, tax rules may cause an impact on consolidated accounts in jurisdictions where dependency is dominant. Commonly, PCs are likely to prepare "consolidated accounts in a manner which takes out as much tax influence as possible." [902] According to the study on "Company Taxation in the Internal Market", *independence* between tax and accounting is prevalent in Denmark, Ireland, the Netherlands and in the UK, whereas *dependency* is a more common approach in the majority of jurisdictions, for example, Germany. In order to harmonize and deal with such problems, a number of accounting Directives were enacted concerning consolidated and annual of limited companies, insurance undertakings, banks and other financial institutions etc. The first Council Directive 68/151/EEC acknowleged the necessity of safeguarding and urgency back then to in abolishing restructions of the "freedom of establishment (…) especially in regard to companies limited by shares or

[894] COM (2001) 582 final 318.
[895] F. Abraham, J. Stuyck, and F. Vanistendael. *Tax Policy and the Impending Economic and Monetary Union*,. (Eds.), Leuven Law Series 12. Leuven University Press. Pag 117-126 (1999).
[896] COM (2001) 582 final 319.
[897] Ibid 319.
[898] Ibid 319.
[899] F. Abraham, J. Stuyck, and F. Vanistendael (n 895).
[900] COM (2001) 582 final 319.
[901] F. Abraham, J. Stuyck, and F. Vanistendael (n 895).
[902] COM (2001) 582 final 319.

otherwise having limited liability, since the activities of such companies often extend beyond the frontiers of national territories",[903] thus it determined MSs to adopt provisions concering disclosure, and validity of obligations undertaken by companies, with the ultimate goal of safeguarding the interest of third parties. The Fourth Council Directive 78/660/EEC on the annual accounts of certain companies was also an important step in the harmonizations of company accounts within the Internal Market. Article 2 of that Statute provided for that annual accounts should comprise the balance sheet, the profit and loss account and the notes on the accounts, moreover, in was stated on the Directive valuation principles such as prudence and consistency in the application of valuation methods (Article 31(1) 78/660/EEC). Nevertheless, due to the impact that Directive would cause on MSs' revenues, the Directive could not have been "seriously amended".[904] The seventh Council Directive provided MSs the option of allowing "tax coloration" in undertaings financial statements, for example, "depreciation is accounted for in the parent-company individual account but normal depreciation in the consolidated account".[905] Artice 29 (1) 83/349/EEC provides that liabilities and assets must be "included in consolidated accounts" and be valued according to "uniform methods and in accordance with Articles 31 to 42[906] and 60[907] of Directive 78/660/EEC." The fourth (78/660/EEC), seventh (86/635/EEC) and 91/674/EEC (insurance companies) Council Directives required annual accounts or consolidated accounts be audited by a person

[903] First Council Directive 68/151/EEC of 9 March 1968 on co0ordination of safeguards which, for the protection of the interests of members and others, are required by Member State of companies within the meaning of the secong paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community.

[904] COM (2001) 582 final 320.

[905] COM (2001) 582 final 320.

[906] Articles 31 to 42 Directive 78/660/EEC relates to valuation rules, such as principles of consistency and prudency when valuating (Article 31), items shown in annual accounts must be valued based on the principle of purchase price or production cost (Article 32), valuation by replacement methods (instead of liquidation value methods) for fixed tangible assets with limited useful economic lives and for stock, revaluation of tangible fixed assets and financial fixed assets, publish in the notes on the accounts a table depicting the amount of revaluation reserve at the beinning of the financial year (revaluation reserves an accounting term generally applied when a company includes a line item on is balance sheet, due to the fact that a certain asset was re-evaluated) (Article 33), rules on the inclusion of expenses (Article 34), valuation of fixed assets – fixed assets should be valued at purchase price or production costs - (Article 35), consts related to R&D should also be included, goodwill application etc (Article 37), permition to MSs in allowing investment companies setting off value adjustments to investment directly against "Capital and reserves" (Article 36), rules on demonstrating tangible fixed assets, raw materials and consumables (Article 38), current assets valuation – valued at purchase or production costs - , readjustments etc (Article 39), *fungible items* including investments should be calculated either on a basis of weigthed avarege prices or by "first in, first out" (FIFO) method, "last in, first out" (LIFO) method, or a similar method (Article 40), repayable amounts received greater than the actual debt, should be shown separately in the balance sheet or in the notes on the accounts as an asset (Article 41) and provisions for liabilities and charges should not exceed the sums which were necessary (Article 42). Directive 78/660/EEC.

[907] "Pending subsequent coordination, the Member States may prescribe that investments in which investment companies within the meaning of Article 5(2) have invested their funds shall be valued on the basis of their market value. In that case, the Member State may also waive the obligation on investment companies with variable capital to show separately the value adjustments referred to in Article 36". Directive 78/660/EEC Article 60.

"entitled to carry out such audits".[908] The conditions for approval for such persons responsible to carry out auditing activites were laid down in the eighth Council Directive 84/253/EEC[909] which was ultimately repealed by Directive 2006/43/EC[910] due to the fact that it lacked a "comprehensive set of rules to ensure an appropriate audit infrastructure, such as public oversight, [911] disciplinary systems of quality assurance,[912] and because it" *did* "not provide specifically for regulatory cooperation between Member States and third countries".[913] An interesting feature of Directive 2006/43/EC is that it not only provides for the approval of statutory auditors and audit firms, but also to the continuing educations and mutual regognition of auditors in order to maintain a

[908] Directive 2006/43/EC on the Statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349 EEC and repealing Council Directive 84/253/EEC. L 157/87. Preamble (1).

[909] Eighth Council Directive 84/253/EEC based on Article 54 (3) (g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents.

[910] Directive 2006/43/EC of the European Parliament and the Council on statutory audits of annual accounts and consolidated accounts.

[911] Article 32 provides that Member States should organize "an effective system of public oversight for statutory auditors and audit firms (Article 32(2)) on the basis of home country control." Basically, a system of *public oversight* has the purpose for the oversight of: "(a) the approval and registration of statutory auditors and audit firms; (b) the adoption of standars on professional ethics, internal quality controlo of audit firms, and (c) continuing education, quality assurance and investigative and disciplinary systems." (Article 32(4))". The "regulatory arrangements for public oversight should make possible effective cooperation at Community level in respect of the Member States' oversight activities. The public oversight system should be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. These non-practitioners may be specialists who *have never been* linked with the audit profession or former practitioners who have left the profession. Member States may, however, allow a minority of practitioners to be involved in the governance of the public oversight system (Article 32(3)). Competent authorities of Member States should cooperate with each other whenever necessary for the purpose of carrying out their oversight duties on statutory auditors or audit firms approved by them. Such cooperation can make an important contribution to ensuring consistently high quality in the statutory audit in the Community. Since it is necessary to ensure effective cooperation and coordination at European level among competent authorities designated by Member States, the designation of one entity, responsible for ensuring cooperation, should be without prejudice to the ability of each single authority to cooperate directly with the other competent authorities of the Member States". Directive 2006/43/EC. Preamble (20).

[912] The Commission also acknownledge that regular inspections "are a good means of achieving a consistently high quality in statutory audits. Statutory auditors and audit firms should therefore be subject to a system of quality assurance that is organised in a manner which is independent from the reviewed statutory auditors and audit firms (Article 29 (1)(a)). For the application of Article 29 on quality assurance systems, Member States may decide that if individual auditors have a common quality assurance policy, only the requirements for audit firms need to be considered. Member States may organise the system of quality assurance in such a manner that each individual auditor is to be subject to a quality assurance review at least every six years. In this respect, the funding for the quality assurance system should be free from undue influence (Article 29(1)(g)(h)). The Commission should have the competence to adopt implementing measures in matters relevant to the organisation of quality assurance systems, and in respect of its funding, in cases where public confidence in the quality assurance system is seriously compromised. The public oversight systems of Member States should be encouraged to find a coordinated approach to the carrying-out of quality assurance reviews with a view to avoiding the imposition of unnecessary burdens on the parties concerned." Directive 2006/43/EC. Preamble (17).

[913] Directive 2006/43/EC of the European Parliament and the Council on statutory audits of annual accounts and consolidated accounts. Preamble (34).

certain quality to the services rendered. Article 3 provides that a statutory audint can only be carried out by auditors or audit firms approved by MSs, considering Articles 4 (Good repute),[914] 6 (Education qualifications),[915] 7 (Examination of professional competence), [916] 8 (Test of theoretical knowledge), [917] 9 (Exemptions)[918] and 10 (Practical training)[919] of the same Directive are satisfied. To conclude the topic, regard must be given to Direcive 2013/34, which is a product of the Commission's work in providing a "better regulation programme, and, in particular, the Commission's Communication entitled 'Smart Regulation in the European Union', which aims at designing and delivering regulation of the highest quality whilst respecting the principles of subsidiarity and proportionality and ensuring that the administrative burdens are proportionate to the benefits they bring".[920] It is important to keep in mind that the purpose of financial statement is not "merely to provide information for investors in capital markets but also to give an account of past transactions and enhance corporate governance", [921] and to that end, there is a need to find the proper balance between the interests of the addressees (capital markets, investors, authorities etc) and the undertakings *per se* by being overloaded with costly and unefficient reporting requirements.

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[914] Only natural persons with good repute may be granted approval.

[915] Mandatory that a natural personbe "approved to carry out a statutory audit only after having attained university entrance or equivalent level, (…) completed a course of theoretical instructions, undergone practical raining and passed an examination competence of university final or equivalent examination level, organized or recognized by the Member State concerned". Directive 2006/43/EC Article 6.

[916] Only after sitting the relevant "examination of professional competence" is the natural person competent to "apply such knowledge in practice". Directive 2006/43/EC Article 7.

[917] The examination should test the candidate's knowledge on the following subjects: "(a) general accounting theory and principles; (b) legal requirements and standars relating to the preparation of annual and consolidated accounts; (c) international accounting standards; (d) financial analysis; (e) cost and management accounting; (f) risk and management and internal control; (g) auditing and professional skills; (h) lega requirements and professional standars relating to statutory audit and statutory auditors; (i) international auditing standars; (j) professional ethics and independence" and also cover the following topics insofar there are relevant to auditing, mamely, "(a) company law and corporate governance; (b) the law of insolvency and similar procedures; (c) tax law; (d) civil and commercial law; (e) social security law and employment law; (f) information technology and computer systems; (g) business, general and financial economics; (h) mathematics and statistics; (i) basic principles of the financial management of undertakings". Directive 2006/43/EC Article 8(1)(2).

[918] Natural persons who has passed a university or "equivalent examination or holds a university degree or equivalent qualification in one or more (…) subjects referred to in Article 8 may be exempted from the test of theoretical knowledge in the subjects covered by that examination or degree" or if that person received practical training in "those subjects attested by an examination or diploma recognized by the State". Directive 2006/43/EC Article 9(1)(2).

[919] Added to the theoretical knowledge test, the person must also "c,plete a minimum of three years'practical training in, (…), the auditing of annual accounts, consolidated accounts or similar or financial statememnts. At least two thirds of such practical training shall be completed with a statutory auditor or audit firm approved in any Member State." Directive 2006/43/EC Article 10(1)(2).

[920] Direcive 2013/34/EU of the European Parliament and of the Council of June 26 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and relealing Council Directives 78/660/EEC and 83/349/EEC. Preamble (1).

[921] Direcive 2013/34/EU. Preamble (4).

Directive 2013/34/EU is also in tune with the principle "think small first" which can be translated as: *simpler rules to small undertakings and more complex rules to large undertakings*, so that disproportionate administrative burdens on small undertakings are avoided[922] (small and micro-undertakings have limited resources to comply with "demanding regulatory requirements").[923] According to Article 3, in order to be classified as a *micro-undertaking*, the company's balance sheet must not exceed the limits of at least two of the following criteria: (a) balance sheet total of EUR 350 000; (b) net turnover EUR 700 000 and/or (c) average number of employees during the financial year must not surpass 10. *Small undetakings* shall not exceed the limits of at least two of the subsequent measures: (a) balance sheet of EUR 4 000 000, (b) net turnover of EUR 8 000 000 and/or (c) average number of employees below 50 during the financial year.[924] *Medium-sized* undertakings "shall be undertakings which are not micro-undertakings or small undertakings and which on their balance sheet dates do not exceed the limits of at least two of the three following criteria: (a) balance sheet total: 20 000 000; (b) net turnover: EUR 40 000 000; (c) average number of employees during the financial year: 250." To conclude, in order to be classified as a *large group* (PC and subsidiaries included in the same on a consolidated basis) the group must exceed at least two of the following criteria on the balance sheet date of the parent undertaking: (a) balance sheet total of EUR 20 000 000; (b) net turnover of EUR 40 000 000 and/or (c) average number of employees during the financial fiscal year of 250.[925] As previously studied in other parts of this investigation small undertakings are in fact in an unfavourable positions when compared to large undertakings, that have more resources to penetrate the relevant market, therefore unquestionably posses the *wheather gage.* In sum, such approach is part of the Commission's *system segmentation regulation.* In other words more complex rules to more complex companies and less complex rules to simpler companies. Recommendation 94/390/EC provides for possible growth problems encountered by SMEs within the internal market, namely: (i) administrative complexity and compliance costs, (ii) inability in producing guarantees in order to raise capital, (iii) continuation problems (death of a partnership owned by a single natural person) and (iv) difficulties in conducting cross-border operations. Improving the fiscal environment for small

[922] "Small, medium-sized and large undertakings should be defined and distinguished by reference to balance sheet total, net turnover and the average number of employees during the financial year, as those criteria typically provide objective evidence as to the size of an undertaking. However, where a parent undertaking is not preparing consolidated financial statements for the group, Member States should be allowed to take steps they deem necessary to require that such an undertaking be classified as a larger undertaking by determining its size and resulting category on a consolidated or aggregated basis. Where a Member State applies one or more of the optional exemptions for micro-undertakings, micro-undertakings should also be defined by reference to balance sheet total, net turnover and the average number of employees during the financial year. Member States should not be obliged to define separate categories for medium-sized and large undertakings in their national legislation if medium-sized undertakings are subject to the same requirements as large undertakings." Direcive 2013/34/EU. Preamble (12).

[923] Direcive 2013/34/EU. Preamble (13).

[924] "Member States may define thresholds exceeding the thresholds in post (a) and (b) (...). However, the thresholds shall not exceed EUR 6 000 000 for the balance sheet totqal and EUR 12 000 000 for the net turnover". Directive 2013/34/EU Article 3 (2).

[925] 2013/34/EU Direcive Article 3(7).

and medium sized enterprises by tackling such limitations certainly enhances the chances of survival of SME, to the ultimate benefit of the EC as a whole. Now, back to Directive 2013/34/EU. According to the Directive, the *principle of materiality* should govern the "recognition, measurement, presentation, disclosure and consolidation in financial statements",[926] that is to say, if a certain information is considered immaterial, it may simply be aggregated in the financial statement (no need to separate it as an independent item).

Items must be recognised in annual financial statements "on the basis of the principle of purchase price or production cost to ensure the reliability of information in financial statements", although MSs are allowed to permit the "revalued fixed assets in order that mode relevant information may be provided to the users of financial statements". [927] The Directive also stresses the importance of transparency regarding the numerous financial statement layouts, that is, MSs should offer the relevant enterprise a choise of choosing the most suitable layout and if necessary, allow that layout be modified. Member States should also allow undertakings to present a balance sheet wich distinguishes current[928] and non-current items (Article 11). The nature of expenses and a profit and loss account layout shall should also be permitted by MSs. Moreover, MSa should also allow undertakings to present a statement of performance instead of a profit and loss account.[929] It is important to point out that some items in financial statements are based on estimates, that is to say, since it is not possible to value and asset accurately, undertakings must use their best judgement when recognising, measuring, presentating, disclosuring and consolidating a certain item, so that the best estimation is reach which gives a "true and fair view of an undertakings's assets and liabilities, financial positions and profit and loss account".[930] Im sum, stimations must be based on an "prudent judgement of the management of the undertaking and calculated on an objective basis, supplemented by experience of similar transactions and, in some cases, even reports from independent experts". [931] The Directive also regulates the contents of management reports which are important "elements of financial reporting".[932] Such reports should be presented in a manner"consistent with the size and complexity of the business" and it should not be circumscribed to the relevant undertaking's financial aspects, that is to say, analysis on the "environmental and social aspects of the business necessary for an understanding of the understaking's development and performance or position"

[926] Direcive 2013/34/EU. Preamble (17).
[927] Direcive 2013/34/EU. Preamble (18).
[928] Current assets: I. Stocks: (a) raw materials and consumables; (b) work in progress; (c) finished goods and goods for resale. II. Debtors: (a) trade debtors; (b) Amounts owned by affiliated undertakings; (c) Amounts owned by undertakings with the company is linked by virtue of participating interests; (d) other debtors; (e) Subscribed capital called but not paid (unless national law provides that such called-up capital is to be shown as an asset; (f) prepayments and accrued income (unless national law provides that such item are to be shown as assets; III. Investments: (a) Shares in affiliated undertakings; (b) own shares (with an indication of their nominal value or, in the absence of a nominal value their accounting par value), to the extent that national law permits their being shown in the balance sheet; IV. Cash at bank and in land. Annex IV Direcive 2013/34/EU.
[929] Direcive 2013/34/EU. Preamble (20).
[930] Direcive 2013/34/EU. Preamble (9).
[931] Direcive 2013/34/EU. Preamble (22).
[932] Direcive 2013/34/EU. Preamble (26).

should be presented. Nonetheless, MSs should provide the possibility of exemption small companies from the obligation to "drawn up a management report".[933]

3. *Taxonomy*

Taxonomy,[934] which has no relation with *Taxidermy* whatsoever, is the study of an object's classification. Take biology taxonomy for instance, it is deemed as the ultimate life's filing system, a process through which all life is categorized, only to reach the conclusion that every living thing is related to other living things, an oak tree and a salmon for example, a blue whale and an apple. If one reads back long enough the evolutionary tree's branches, one will inevitably find the interconnectivity of all earthly *living* things. One must not loose sight of the fact that it is only by organizing and and by rightly classifying the studied object, that science is able to really grasp the true sense of things, for without structure, it would be (almost) impossible to associate its connectivity. *Carl Linnaeus*[935] (father of modern taxonomy) created the so called *phylogenetic tree* which illustrates the evolutionary relationship between all living things by distinguishing Spieces, Genus, Tribe, Family, Order, Class, Phylum, Kingdom and Domain (*Carl Linnaeus* identified only till Kingdom group).[936] Although the classification (grouping) applied by *Carl Linnaeus* was considerably arbitrary, he created a structure which resembles greatly the current way of classifying living organisms – finding comparables –testing their DNA. The term is also used in the business and economic fields respectively.

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[933] Direcive 2013/34/EU. Preamble (27).

[934] Taxon is a group of populations of organisms or a organism formed by taxonomists to form a unit.

[935] *Carl Linnaeu*, who did not know the still to come evolutionary theory (Darwin), was a Swede botanist, who invented his surname for it was unsual for peasents to carry surnames back then (actually, this is due to the fact related to the fact why most Jewish names (ashkenasi) are german related, for Austria enacted a law obliging Jewish people to carry a surname – before that they were calles, Rebecca the dougther of Jacog, Jacob the son of Moises etc).

[936] The human species (homosapiens) are divided into ***sapiens*** (species) and ***homo*** (genus). Within the ***genus*** category are the Neanderthals. After that are chimpanzees (troglodites), placed under the Hominiea ***tribe***. Then, comes the Gorilla, which is a member of the Hominidae ***family*** (great apes). Then the baboon, belonging to the primate ***order***. Then we arrived at the mamals ***class*** (animals that have fur, provide milk for their offspring etc), which may or may not be a primate, polar bears, blue whales, for instance, are not primates. After mamals are the Vertebrates and Chordates, which is a more generical classification arrangement which relates more to the actual formation of the animal, that is, where their digestive system is, eyes, mouth, brain etc, which are basically arrangmend in the same manner. These are all under ***phylum***. Going one step further, we find ourselves in a more generical classification, namely, the animal ***kingdom*** (reptiles, jelly fish etc). Then we arrive at ***domains***, namely *Eukarya* (Fungi – heterotrophs; Plants – autotrophs; Animals – heterotrophs and Protista – both Heterotrophs and Autotrophs), which are all organisms formed by cells with complex estructures. *Archea domain* (different cell membranes), which do not have complex cell structures and *Bacteria domain*. As for *viruses*, scholars still datable whether or not can be considered a living organism, for they depend on other forms of life to reproduce). Note that the further one scales the tree, the greater the physical differences between humans and its ancestors are, nonetheless, the connectivity is easily recognizable.

4. *XBRL (eXtensible Business Reporting Language)*

Extensible Business Reporting Language or XBRL is a language both understandable by *homosapiens* and machines alike (at first, XBRL was named as eXtensible Financial Reporting Markup Language –XFRML, and changed to XBRL after the XBRL community saw that the language "had a broader use beyond the realm of financial reporting."[937] The matter of taxonomy is intimately related to efficiency, transparency and comparability. Imagine the following scenario, a company has to send financial information to an audit firm, which will imput the information provided by the company on the undertaking's balance sheet. Now, consider that all information is sent in a number of different formats, for instance, the company has to gather chunks of information regarding the company's operation in numerous PDF documents, WORD documents, HTML,[938] PLAIN TEXT, EXCEL, METADATA etc, which ultimately are time consuming thus enhancing the company's costs. Corporate investor relation websites, are also formatted in HTML; "published in Adobe Acrobat, Microsoft Word, Excel or Porwerpoint or embedded in an Adobe Flash movie."[939] The fact of the matter is that "electronic paper formats are weak in their presentation of metadata",[940] and here lies the "underlying logic of XBRL", to solve such problems and to "provide high uality matedata about facts in business reports on the Internet or on intranets".[941]

The essence of a business report is to compare and contrast.

The folowing bellow depicts more clearly the use of metadata in business reporting. A MNE tramsfers corporate performamce reports including fincncial statements and reports of the board of directors from the group to a certain secutiries regulators. The groups financial statement is in tune with the relevant accounting standards (US GAAP, NZ GAAP, IFRS etc). The securities regulator then proceeds to transfer such aggregated and consolidated information to a national statistics office and to the central bank. The financial statement is ultimately transferred in its "raw" form. Therefore, the relevant authorities, upon receiving such information will transform and standardize the financial statement data. Using and transforming such data

According to the XBRL International Inc. (XII) XBRL is "a language for the electronic communication of business and financial data which is revolutionizing business reporting around the world. It provides major benefits in the

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[937] Roger Debreceny, Carasten Felden, Bartsz Ochoki, Maciej Piechocki, Michael Piechocki. *XBRL for Interactive Data. Engineering the Information Value Chain.* Springer-Verlag Berlin Heidelberg (2009). 41.

[938] Hyper-Text Mark-up Language (HTML).

[939] Roger Debreceny, Carasten Felden, Bartsz Ochoki, Maciej Piechocki, Michael Piechocki (n 937) 2.

[940] METADATA is, in sum, a set of data, that is to say, it allows us "to understand the meaning of facts and put them into context (…) the International Standart Book Number (ISBN) provides simple metadata on the publisher of book and book-like products. The thirteen digits of the ISBN has data on the country, publisher and title together with a chech digit. From the ISBN we can navigate to much more information about a product. The ISBN in included on bar codes elsewhere." Roger Debreceny, Carasten Felden, Bartsz Ochoki, Maciej Piechocki, Michael Piechocki (n 937) 2.

[941] Roger Debreceny, Carasten Felden, Bartsz Ochoki, Maciej Piechocki, Michael Piechocki (n 937) 2.

preparation, analysis and communication of business information. It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using financial data".[942]

The main idea of XBRL is to treat business reports as information blocks, that is to say, XBRL tags each line to an individual item "making it computer readable".[943] XBRL is substantially similar to "bar-coding physical products. Each reported business fact, including numbers and blocks of text, has its own barcode. Software application can then work with this unique barcode."[944]

In 2007 Deloitte launched a prototype of XBRL to prepare its clients financial reports. The consulting firm initial pilot tested "XBRL applications indicated processing time for the preparation of financial reports and regulatory returns could be reduced by up to 70 percent", and according to Peter Willians (CEO of the Eclipse Group, a Deloitte Subsidiary and founder of Deloitte Digital) "In time, as this technology matures the interaction between business and government will be made easier by eliminating the need to report more than once and replicating tailored financial information according to reporting requirements."[945]

> "A taxonomy means a catalogue or a set of rules for classification. We all recognize taxonomies of plants, animals and diseases. In XBRL, the taxonomy is a dictionary, with three principal components. First, the taxonomy containscomputer-readable definitions of business reporting terms (concepts). Second, the taxonomy sets out relationships between the concepts in the dictionary. Finally, the taxonomy connects these concepts to human-readable resources. A typical taxonomy consists of a schema (or schemas) and linkbases. The role of the taxonomy schema is to define the reportable concepts - the equivalent of the words in a dictionary. The role of linkbases is to describe the relationships between the concepts and couple with human readable documentation. (…) A set of taxonomy files (schemas and linkbases) that can be discovered from one entry point is called a Discoverable Taxonomy Set (DTS). The DTS term is importantbecause taxonomies often consist of more than one taxonomy schema and several linkbases. Recent XBRL taxonomies employ several hundreds of files bound together in several DTSs for different reporting scenarios. (…) In many reporting environments, the core taxonomy may not meet all the needs of reporting entities. As the term extensible in the XBRL name suggests, XBRL supports taxonomy extensions that add concepts and modify the relationships among the concepts in the core (base) taxonomies. Thus taxonomy extensions support specific reporting requirements in given accounting jurisdictions, in given industries, or for a given company. Taxonomy extensions consist of a set of taxonomy schemas and/or linkbases that augment a DTS that includes the base taxonomies. An instance document is a business report set out in the XBRL format. It contains tagged business facts (tagged according to concepts defined in the

[942] Roger Debreceny, Carasten Felden, Bartsz Ochoki, Maciej Piechocki, Michael Piechocki (n 937) 37.
[943] Ibid 37.
[944] Ibid 37.
[945] Ibid 35.

underlying taxonomy). At the same time the instance document provides information on the context in which the facts appear and description of the measurement units. The instance document links the tagged facts to concepts specified in one or more taxonomies."[946]

IV. Corporate taxation within the European Union

"The difference between evasion and avoidance is the width of a prison wall"[947]

Dennis Hieley

A. Introduction[948]

Whether in *worldwide* or *territorial* systems, companies are treated as separate enterprises on both international and supranational levels, that is to say, both parent company's and subsidiary's tax liability is independently assessed [949] (each transaction is analysed separately). The *separate entity* approach allows companies to act independently in such a way, that profit distribution is halted by subsidiaries, leading to base stripping. Such measures gave rise to enactment of CFC legislation where the subsidiary's profits are taxed by the resident State at the hands of the PC.

Before diving into the chapter's main topic of discussion we first need to understand how the system of corporate profit distribution works within the internal market.

B. Domestic Profit Distribution

Long story short, profit is the surplus after subtracting all costs of a business venture (interest, tax, depreciation and amortization), it is the ultimate measure for business success and the reason for its existence. *Profits* have a number of different classifications, such as *gross profit*, *operating profit*, *residual profit*, *net profit*, *pre-tax profit*, *profit pooling*, *profit participating loan*, *profit ratio* etc. Although States have different approaches as to profit classification, "commercial law is (…) favoured by the existence of common accounting principles in the Member States and by the existence of common rules on the

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[946] Roger Debreceny, Carasten Felden, Bartsz Ochoki, Maciej Piechocki, Michael Piechocki (n 937) 43.

[947] Dennis Hieley. Former UK Chanceler.

[948] Extreme right-wing-parties are gradually becoming more relevant worldwide. The election of Donald Trump in the USA (taken as a highly improbable candidate months before taken office), the boost of before innocuous extreme right candidates in Brazil (Eduardo Bolsonaro – an ex-military Congressman to the State of Rio de Janeiro), the constant increase and adherence in Europe to right-wing-parties by its nationals, propelled by a growing insecurity of the international community due to the Syria and the refugee situation, has lead to a fragmentation of opinions, doubts and fears – terrorism, immigration, economic development etc.

[949] Transfer Pricing Guidelines (n 503) 18.

annual accounts of companies in the Member States"[950] eliminating therefore major interpretation problems.[951] Note that, in order to avoid the possibility of future discussions the CCCTB Directive Proposal established its own *profit* definition,[952] thus the legal and economic relations regulated by the *future* Directive will be governed according to the definition contained therein. The IBDF Glossary, for example, defines profit as "(…) *the excess of revenue over expenditure* (…)."[953]

Pursuing our discussion on profits, it is important to apply the ***broadest possible definition*** to the term so that any transfer of benefits between undertakings (dividends, royalties, interest or capital gains) be included. Basically, tax systems apply two systems to profits distribution, namely, *Classical System* and *Integration System*.

Classical System.[954] There is a complete separation between individual income tax and corporate income tax. The latter is properly taxed upon realization, whether distributed or invested back into the company, and if distributed, the shareholder who benefited from the dividends, will be also liable. Note that, if distributed, the income is taxed twice (CIT at the company's hands, and on the shareholder's hands).[955] The shareholder may however, benefit from the so-called *affiliation privilege* (*Schachtelprivileg*) if the shareholder meets a minimum shareholding percentage, holding period and acquisition costs.[956] Nevertheless, if a dividend withholding tax is levied, the shareholder may credit the withheld tax against his income, "***but he may not credit the corporation tax levied at the company level***".[957] Consider the following, a subsidiary resident of a classical high tax jurisdiction, finances its operation through debt,[958] benefiting from low interest rates of that Country due to its high credit score. Financial analysts define such a Company as being "*highly*

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[950] Guglielmo Maistro, Dennis Weber. *EU Income Tax Law: Issues for the Years Ahead.* IBDF (2013).

[951] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 140.

[952] "'profit' means an excess of revenues over deductible expenses and other deductible items in a tax year" CCTB Directive proposal. COM (2016) 685 final Article 4(8).

[953] IBFD Tax Glossary. IBFD.

[954] "Classical corporation tax system: a system under which little or no relief is provided for economic double taxation". Report of the Committee of Independent Experts on Company Taxation. Commission of the European Communities. Luxembourg: Office for Official Publications of the European Communities. March (1992) 18.

[955] Ben Terra and Peter Wattel (n 60) 165.

[956] According to the IBDF Tax Glossary, ***affiliation privilege*** is a "Tax relief accorded to a company in respect of distributions it receives from, or (in some instances) capital gains it realizes on certain shareholdings in another company, typically where the shareholding exceeds a certain minimum percentage or acquisition cost. A minimum holding period may also be required. The relief generally takes the form of an exemption from tax but can take other forms, such as a deduction from taxable income equal in amount to the benefited income. In some cases a small proportion of the income remains, in effect, taxed. The affiliation privilege may be restricted to shares in resident companies or may extend to shares in foreign companies. It is primarily intended to mitigate double economic taxation of income in the corporate sphere" *IBFD Tax Glossary. IBDF.* https://online.ibfd.org/kbase/#topic=doc&url=/highlight/collections/itg/html/itg_affiliation_privilege.html&q=%2522Affiliation+privilege%2522&WT.z_nav=Search. Accessed in 02 Jan 2018.

[957] Ben Terra and Peter Wattel (n 60) 166.

[958] Third-party resources/capital (leases, financial derivatives "*synthetic loans*", factoring arrangements, overdrafts, redeemable preference shares). Thin Capitalization Legislation (n 673) 14.

geared" or "*highly leverage*". By raising capital though debt, the Company is able to generate considerable amounts of interest expenses which ultimately will offset against the subsidiary's profits. Moreover, the company may also hold dividend distribution, for it will increase its tax liability. Thus, it is fair to conclude that classical systems discriminate against "equity financing, in favor of loan financing".[959] In order to deter excessive interest deductions governments may implement interest limitation rules. The matter will be properly studied in other parts of this investigation. In sum, classical systems are internationally neutral, that is to say, "foreign dividends and foreign shareholders are treated in the same manner as domestic profits, dividends and shareholders. However, from an internal point of view, a classical system is not neutral at all. It encourages the 'gearing' (…) of companies, since interest are deductible, and dividends are not". [960] However the same cannot be said in respect to integrations systems.

Integration Systems [961] are subdivided in four categories, either/or system, split-rate system, final withholding tax system, and imputation system.

Either/or integration system provides relief from the company's standpoint or the shareholder's standpoint or both,[962] in order to "eliminate or reduce the economic double taxation of profits *resulting from a purely classical system*".[963] According to Wattel/Terra, which "of these two approaches is chosen is largely immaterial to the total tax burden on profit if the corporation tax rate is equal or close to the individual income tax rate, but the relief level (company or shareholder) chosen makes quite a difference if these rates diverge substantially".[964] A ***full*** *shareholder* relief can be achieved simply by exempting the received dividends. From a *company's* perspective, a ***full*** relief would be reached by taxing only the retained "profits (either by allowing profit distribution to be deducted from the taxable profits, or by allowing a refund, upon the distribution of the profits (…)".[965] Under this system, tax authorities tend apply higher withholding tax on profit distributions due to two main reasons, (***i***) to prevent loosing revenue (shareholders may not declare received dividends) and (***ii***) to avoid loosing revenue due to dividends paid internationally, for the home Country collects no withholding tax upon distribution, either deducting or requesting a tax refund.[966]

A second *integration system*, namely, ***split-rate system***,[967] may be applied either from a company or shareholder perspective. This system provides for a ***partial*** relief to the shareholder *and* the individual income tax on dividends is subtantially lower when compared to other taxables (dual or schedule income

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[959] Ben Terra and Peter Wattel (n 60) 170.
[960] Ben Terra and Peter Wattel (n 60) 166.
[961] "Integration: any reduction or elimination of economic double taxation, whether granted at the company or individual level". Ruding Report (n 692) 18.
[962] Ben Terra and Peter Wattel (n 60) 166.
[963] Ibid 166.
[964] Ibid 166.
[965] Ibid 166.
[966] Ibid 167.
[967] "Split-rate system: normally a system analogous to a dividend deduction system whereby a lower corporation tax rate is levied on dividend distributions. (It is possible for a higher corporation tax rate to be levied on dividend distributions but the effects are different)". Ruding Report (n 692) 18.

tax, that is, different taxables = different rates, hence, split-rate). This system is more of a classical (with partial relief) nature.[968] From a company's perspective, the system may neutralize taxation on distributed dividends, "*limiting itself to corporation tax*".[969] In other words, distributed dividends are taxed at '*x*' and retained profits are taxed at 'x²', therefore distributed profits' refund will be paid at '*x*'. Note that only a ***partial*** relief is granted, that is to say, only a fraction of the distributed profit is refunded.[970] In sum, under this system, States may levy taxes at different rates, that is, one rate for the company's profits and another rate upon distribution.[971]

Countries such as *Austria* and *Belgium,* apply a *third integration system of profit distribution*, namely, a liberating, ***final withholding tax system*** (*FWT*).[972] After taxed, if the company distribute dividends "out of its after-tax profits, it is required to withhold, to the account of the recipient of the dividend, a percentage of the distribution". After that, the shareholder is not liable to tax on the received dividends.[973]

The *fourth sub-integration system*, namely, ***imputation system***,[974] provides ***full*** or ***partial*** relief. As the name infers, the system provides the shareholder an ***imputation credit***[975] generated by the CIT paid at the company level, that is to say, the CIT levied "(…) *functions as a withholding tax creditable against personal income tax*".[976] In other words, the *shareholder* deducts from its personal income tax the CIT "attributable to the profits out of which the dividend was paid". [977] The credit may represent a "percentage of the net dividend received by the shareholder[978] (…), or as a percentage of the underlying corporate income tax[979] (…), or it may be equal to the underlying corporate income tax".[980]The example bellow illustrates profit distribution under an *imputation system*. A certain company, operating in an imputation State, realizes gross profits of 120 in a certain year. The relevant State applies a 30% CIT (30% of 120 = 36). The company's tax liability divided by the postax profit (36/84) equals 0,43 (43% imputation credit).

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[968] Ben Terra and Peter Wattel (n 60) 167.
[969] Ibid 167.
[970] Ibid 167.
[971] Commentaries on the Articles of the Model Tax Convention 197.
[972] ***Final withholding tax*** (FWT) is commonly levied on passive sources of income.
[973] Ben Terra and Peter Wattel (n 60) 167.
[974] "Imputation system: a system whereby a (full or partial) tax credit is given to shareholders under the personal income tax for the amount of corporation taxes actually paid on profits distributed as dividends". Ruding Report (n 692) 18.
[975] "Imputation Tax: the term used to describe the mechanism by which Member States which operate an imputation system ensure that any dividend distribution which carries a tax credit has been subject to domestic tax at the corporate level. It includes précompte (france), Ausschüttungsbelastung (Germany), imposta di congualio (Italy), and advance corporation tax (Ireland and UK). Although therese taxes work in different ways, which in part reflects differences in the way the underlying system work in practive, they are intended to achieve the same objective". Ruding Report (n 692) 18.
[976] Ben Terra and Peter Wattel (n 60) 168.
[977] Ben Terra and Peter Wattel (n 60) 168.
[978] Finland, France, Spain, UK etc.
[979] Portugal.
[980] Ben Terra and Peter Wattel (n 60) 168.

Company			Shareholder		
		€ (000's)			€ (000's)
Gross Profit		**120**	Received Dividends (income)		84
Tax Liability		(36)	Credit		36
Tax Rate	30%		Income		120
Profit after tax		84	Income Tax	50%	(60)
Imputation Credit	43%[981]	36	Credit		36
Distributed Dividends		84	Taxable Income		(24)[982]
Credit		36	Net after tax		96
Tax Burden		60[983]			
Net After Tax Dividend		60[984]			

If we multiply the imputation credit 43% by 84 (postax profit), the result equals the company's tax liability, 36. In such scenario, the shareholder benefited from ***full relief***. However, if the company (and shareholder) are residents of a ***partial imputation*** jurisdiction, where only a fraction of the credit is imputed, say 76%, then, instead of benefiting from a credit of 36, the shareholder may only receive a 27,36 imputation credit.

Company			Shareholder		
		€ (000's)			€ (000's)
Gross Profit		**120**	Received Dividends (income)		84
Tax Liability		(36)	Credit		27,36
Tax Rate	30%		Income		111,36
Profit after tax		84	Income Tax	50%	(55,68)
Imputation Credit	43%[985]	27,36	Credit		27,36
Distributed Dividends		84	Taxable Income		(28,32)[986]
Credit		27,36	Net after tax		83,04

[981] 36/84 = 0,43 (43% of net distribution).
[982] (i) (60 – 36).
[983] 36 + 24.
[984] (120 – 60).
[985] (36/84) 0,76.
[986] (55,68 – 27,36).

Tax Burden	64,32[987]
Net After Tax Dividend	55,68[988]

When we compare the former example against the latter, one immediately notices: (***1***) the reduction of the company's net after tax dividend from a 60 to a 55,68 figure, (***2***) the reduction of the shareholder's net after tax income from a 96 to an 83,04 figure. *Partial* imputation relief may also be grated if the relevant State levy a *surcharge* on the CIT which is ultimately not credited, that is to say, the imputation ratio 43% remains unaltered while the tax rate raises.

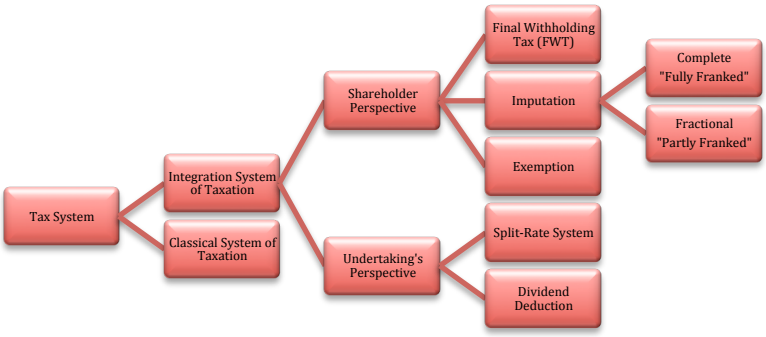
Now, if the CIT is lower than 30% (say 15%) while the imputation ratio remained at 43%, the company would be entitled to a refund of 25,86. The balance bellows demonstrates the case numerically.

Company			**Shareholder**		
		€ (000's)			€ (000's)
Gross Profit		**120**	Received Dividends (income)		102
Tax Liability		(18)	Credit		43,86
Tax Rate	15%		Tax Liability		145,86
Profit after tax		102	Income Tax	50%	(72,93)
Imputation Credit	43%		Credit		43,86
Distributed Dividends		102	Taxable Income		(29,07)[989]
Credit		43,86	Net after tax		116,79
Tax Burden		47,07[990]	Refund		25,86[991]
Net After Tax Dividend		72,93[992]			

To conclude, we present a graph that demonstrates in a simplified manner both systems of profit distribution (classic and integration).

Figure 6

[987] 36 + 28,32.
[988] (120 – 64,32).
[989] (72,93 – 43,86).
[990] (18 + 29,07).
[991] (43,86 – 18).
[992] (120 – 47,07).



C. International Profit Distribution

The integration systems' complexity clearly supersedes that of the *classical*. Nonetheless, both systems present *advantages* and *disadvantages* in respect to both, *domestic* and *international* profit distribution.

Domestic distribution. Contrary to classical systems, ***full imputation systems*** do not discriminate against equity financing over debt financing, treating interest and dividends equally. Full imputation systems are domestically neutral.

International distribution. Internationally, classical systems are neutral, that is, foreign profits, "foreign dividends and foreign shareholders are treated in the same manner as domestic profits, dividens and shareholders".[993] However, *full imputation systems* discriminate foreign shareholders, foreign dividends and foreign profits.[994]

Foreign shareholders do not benefit from imputation credits due to one simple reason, foreign shareholders (non-resident taxpayers) do not pay tax on the received dividends in *that State*, consequently, there is *no economic double taxation*.[995] Nonetheless, shareholder pay tax upon receiving the dividends in the country where the shareholder resides, thus one way or the other, profit distribution will be double taxed. Moreover, there is possibility that the foreign shareholder receives a smaller amount than domestic shareholders, even though they have an equal amount of shares. *Imputation Countries* apply a higher CIT (or broader tax bases) than *classical States*, for they have to compensate for the individual's imputation credits. Another reason which corroborates to the fact of Countries not granting non-resident shareholders imputation credits, is that it is difficult for tax Jurisdictions to ascertain whether the shareholder will keep the dividends or redistribute them. This distortion is somewhat mitigated, in some cases, by DTAs. In sum, it is not recommended "extending imputation credits to non-residends, since such extension amounts to paying out domestic corporate tax revenue, which is at odds with the source-country entitlement principle".[996]

Foreign dividends. Dividends received from non-resident undertakings were not distributed out of domestic profits, therefore if the shareholder receives foreign dividends, he will not receive any tax credit. Discriminating foreign dividends results in international economic double taxation, for the same income is taxed twice (CIT before distribution and on the hands of the

[993] Ben Terra and Peter Wattel (n 60) 169.
[994] Ibid 172.
[995] Ibid 170.
[996] Ibid 171.

shareholder – after distribution). This approach may influence shareholders to acquire shares from domestic companies instead of international companies in order to benefit from company's imputation credit. This discrimination persists even if the "underlying corporation tax was (partly) domestic".[997] Consider the following example. A Danish undertaking derives profits through its PE in Italy and is taxed in that State. Under the Danish-Italian DTA, Denmark will not tax such profits, for they were already taxed in Italy. If, however, the PC established in Denmark distributes dividends to Italian shareholders, no imputation credit will be granted, even though CIT was levied in Italy.[998] According to *Wattel/Terra*, "[I]mputation systems usually define the 'nationality' of dividends solely on the basis of the place of residence of the distributing company, and ignore the geographical origin of the profits out of which the dividends are paid. One reason for this is that the imputation State is not able to verify the 'nationality' of the profits out of which dividends from non-resident companies are paid".[999]

Following this decision, Finland, the UK Germany and France opted to abolish the tax credit method in order to limit the amount of "foreseeable claims for tax refunds*".*[1000]

Foreign profits. Tax credits are only granted if CIT is paid domestically, otherwise, the relevant tax authority would relinquish its tax revenue thus compromising the *integrity of its tax system*, for there would be no direct link between the credit and future revenue. In order to tackle the problem, tax administrations levy an ***equalization tax*** upon the profit distribution[1001] to undo that credit.[1002] According to *Wattel/Terra,* countries are repealing "(…) equalization taxes. (…) Italy, France and Germany (…) unilaterally repealed their equalization taxes. (…) UK abolished its ACT (advanced corporation tax). Ireland switched to a classical system. (…) Obviously, an equalization tax does not make a country attractive for location of intermediate holdings companies; it is an obstacle to the distribution of dividends from foreign subsidiaries for which exemption or credit was granted to prevent international double taxation. (…) since the repeal of equalization tax, these countries have usually denied imputation credit for distributions of foreign-source income*."*[1003]

Case C-292/04 Meilicke, Weyde, Stoöffler v. Finanzamt Bonn-Innenstadt

1- Wienand Meilike, a german citizen living in Germany owned shares of a company established in the Netherlands and in Denmark. Between 1995 and 1997, Mr. Meilike received a total of EUR 20 263,17. According to Paragraph 27(1) of the *Körperschaftssteuergesetz*, dividends distributed by companies fully taxable in Germany, are subjected to 30% tax, ultimately resulting in a

[997] Ibid 171.
[998] Ibid 171.
[999] Ben Terra and Peter Wattel (n 60) 171.
[1000] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 71.
[1001] According to *Wattel/Terra,* there are three main categories of profit that have not been taxed domestically: exempt profits (tax holidays, T-Zones etc), domestic profits "against which a loss carry-forward is offset" and profits derived internationally subjected to tax relief. Ben Terra and Peter Wattel (n 60) 172.
[1002] Ben Terra and Peter Wattel (n 60) 172.
[1003] Ben Terra and Peter Wattel (n 60) 172.

distribution of 70% of the pretax profits with a tax credit of 30/70 (3/7 of the total dividends received). Paragraph 37(2)(3) EStG provided that tax credits would only be granted if the dividends received were paid by capital companies fully taxable in Germany, therefore dividends received by foreign companies did not qualify. In 2000, Mr. Meilike claimed the 3/7 tax credit, ultimately rejected by the Finanzamt, for only companies "fully taxable for corporations tax purposes in Germany could be set off against income tax".[1004] After the appeal, the Finanzgericht remitted the case to the ECJ for a preliminary ruling.

2- Can a provision restricting a tax credit for dividends from foreign companies paid to a german citizen resident in Germany, be deemed as compatible with Articles 56 (1) EC[1005] and 58 (1) (a)[1006] and (3) EC?[1007]

3- No.

4- According to the Court's ruling "during the relevant years, the rate of corporation tax was 34% in Denmark and 35% in the Netherlands. In its observations before the Court, the applicants in the main proceeding maintained that the application to the German tax authorities should have been understood as being a claim for a tax credit not of 3/7 of the income (…), but of 34/66 of that income for the dividends of Danish origin and of 35/65 for those originating from the Netherlands.[1008] For its part, the German Government (…), states that (…), the fraction of 3/7 of the dividends under the German legislation does not constitute a flat-rate set-off but is linked to the corporation tax of 30% on the distribution of dividends. In this case of a distribution of dividends of foreign origin, one could not therefore grant a tax credit of 3/7 of the dividend recived because ir would not be linked to the tax rate applicable to theprofits distributed (…).[1009] (…) It is settle in case-law, although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law[1010] (…). However, tax legislation such as that (…) constitute a restriction within the meaning of Article 56 EC.[1011] (…) Conversively, that legislation is liable to have a restrictive effect as regards those companies, in that constitutes an obstacle to their raising capital in Germany. Since dividends of non-Geman origin receive less favourable tax treatment then dividends distributed by companies established in Germany, the shares of companies

[1004] Case C-292/04 Meilicke. Para 11.
[1005] "Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between the Member States and between Memebr States and third contries shall be prohibited." Article 56 (1) EC.
[1006] "The provisions of article 56 shall be without prejudice to the right of Member States: (a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;" Article 58 (1) (a).
[1007] "The measures and procedures reffered to in paragraphs 1 and 2 shall not constitutes a means of arbitrary discrimination or a disguise restrictions on the free movements of capital and payments as defined in Article 56". Article 58 (c).
[1008] Case C-292/04 Meilicke. Para 16.
[1009] Case C-292/04 Meilicke. Para 17.
[1010] Case C-292/04 Meilicke. Para 19.
[1011] Case C-292/04 Meilicke. Para 20.

established in other Member States are less attractive to investors residing in Germany (…).”[1012] The Court also concluded that, although granting a tax credit reduces the MS’s revenue, it argued that “it has been consistently held in the case-law that *reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is, in principle, contrary to the fundamental freedom*”[1013] (*emphasis added*).[1014]

When choosing *integration* or *classical* systems, MSs must consider a number of variables, both technical and political, such as “inter-relations with the applicable tax rate, the treatment of ‘small’ shareholders and the precise design of the system”.[1015] The fact is that MSs tend to apply biased measures in order to protect domestic economic activity. Here, the ECJ’s role is paramount in maintaining the market’s neutrality. The dis(advantages) of both *classical* and *integration systems* are summarized bellow.

	Advantages	***Disadvantages***
Classical System	***(1)*** Internationally neutral (foreign shareholders, foreign dividends and foreign profits are equally treated as domestic). ***(2)*** Shareholders may be exempt of corporate income tax on dividends (affiliation privilege). ***(3)*** Shareholder may credit the dividend *distribution tax withheld*, against his income. ***(4)*** Easy to apply and comply.	***(1)*** Discriminate equity financing over debt financing, thus creating *thin capitalization* incentives. ***(2)*** Double taxation of profits (in the hands of the company and after distribution, in the hands of the shareholder). ***(3)*** Shareholder may *NOT* credit the CIT against his income.
Integration System	***(1)*** Provides *NO* double taxation domestically (full ***or*** partial relief). ***(2)*** Shareholder may credit the CIT against income tax. ***(3)*** Dividends and interest are equally treated.	***(1)*** Higher withholding tax. ***(2)*** Discriminate foreign shareholders, foreign dividends and foreign profits for it generates NO imputation credits. ***(3)*** Create distortions when dividends are paid internationally. ***(4)*** Difficult application.

In a *perfect world*, taxation on profit distribution would be domestically (“equal tax treatment of equity and loans”)[1016] and internationally (“equal treatment of domestic and foreign shareholders and dividends”)[1017] *neutral*, with no difficulties whatsoever when assessing tax liability (“administrative predictability”).[1018] Till now, we have concentrated our efforts on domestic profit distribution. The next section will study profit distribution wthin the EU.

[1012] Case C-292/04 Meilicke. Para 24.
[1013] Case C-292/04 Meilicke. Para 30.
[1014] After the Court’s decision, German tax authority had to change its procedural law. The imputation system applied before *Meilicke* was replaced for a partial income system “whereby 60 percent only of the dividends received are subject to tax in the hands of the shareholder”. The system was mainly changed in order to avoid claims for tax refunds. Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 71.
[1015] COM (2001) 582 final 326.
[1016] Ben Terra and Peter Wattel (n 60) 173.
[1017] Ibid 173.
[1018] Ibid 173.

D. Interest, royalties and dividend taxation

The great number of tax legislations within the EU enhances complexity for undertakings conducting cross-border operations, that is, different tax bases, having to cope with different tax systems, consequently raising costs for undertakings operating across the EU. The Interest and Royalties, Parent-Subsidiary, Merger, Mutual Assistance and Recovery Directives, Double Tax and Arbitration Conventions, as well as the ECJ, have a fundamental role in controlling and tackling such deleterious effects by imposing upon MSs (and parties) the duty not to impose discriminatory measures (whether direct or indirect) unless the discriminatory treatment is a matter of public interest, considering that such measure is *appropriate*, *necessary,* and *proportional,* that is to say, under proper assessment of the *Rule of Reason* (See section xx). This part of the investigation will bring to the discussion the ***material*** or ***substantial scope*** of those Directives, Conventions as well as a number of key ECJ rulings, and its practical effects over economic transactions within and outside the Internal Market.

1. Interest and royalties

One can define ***interest*** as a source of income originated from an outstanding debt-claim, such as securities, bonds (*Anleihe*), debentures and any other debt related income.[1019] The OECD *Model* defines interest as *"*(…) *income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures.* (…)*."*[1020] As for the ***Royalties***, the Interest and Royalty Directive 2003/49/EC, defines royalties as any kind of payment for the use or the right to use copyrights of literary, artistic or scientific works, patents, trademarks, designs, models, plans, secret formulas or processes. Payment for the right to use scientific or commercial equipment may also be paid as royalties.[1021]

Source. According to the Interest and Royalty Directive, for a company to benefit from the Directive's exemption, the associate company must be a *resident of a MS for tax purposes*, be *listed in the Directive's Annex* and be *subjected to tax that State*. Such requirements have already been properly discussed in other parts of this investigation.

The economic advantages for companies operating under the Directive's protection are enormous. For instance, currently Austria has a 27,5% withholding tax on interest income and a 10% withholding tax on royalty income paid by companies of third States.[1022] According to Article 1(3), a payment made by a PE, must "represent a tax-deducible expense" in the source State, otherwise

[1019] Council Directive 2003/49/EC of June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. (OJ L 157, 26.6.2003, p49). Article 2 (a).
[1020] OECD Model Article 11(3).
[1021] Council Directive 2003/49/EC Article 2 (b).
[1022] *Withholding tax Rates 2017*. International Tax. Updated March (2017). https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-taxwithholding-tax-rates.pdf. Accessed in 05 Jan 2018.

MSs may deny the Directive's exemption. However, the same condition is not applied to companies (subsidiaries). It it suggested whether the provision is contrary to EU's fundamental principles such as non-discrimination.[1023]

Beneficial Ownership. A company may be treated as the beneficial owner of a payment as long as the payment is received for the company's own benefit "and not as an intermediary, such as an agent, trustee or authorised signatory, for other person".[1024] To be treated as a beneficial owner, PEs must fulfil the following requirements: (a) the PE must have an *effective connection* with the payment, that is to say, an *economic link* between the outstanding debt-claim "or the right to use from which the interest or royalty payment"[1025] and (b) the PE must be liable to tax in that State.

As previously mentioned, in order to benefit from the Directive, companies must be listed in the *annex,* be resident for tax purposes and subjected to tax in that State. The payment must also be characterized as a debt-claim (interest) or be related to the use of IP rights (royalty). Nevertheless, Article 4(1) of the Directive provides a list of excluded payments (hybrid financial instruments, for instance, Article 4(1)(a) states that source payments shall not be obliged to ensure the directive's benefits if "(a) payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State". Note that, under a hydrid instrument, the payment is distributed as exempt dividends at the source and be exempt at the resident State. By excluding the benefits for such payments, the legislator consciously intended to prevent ***double-dip instances***, where the paid interest is not liable to tax in the MS of the e payee, and deducted by the payer.[1026] According do *Dimitar Hristov*, if the relevant payment is considered to have been originated from a hybrid financial instrument, thus excluded from the Directive's exemption benefits, a proper and more deep analysis in a cases-by-cases basis could allocate the payment under the auspices of the Parent-Subsidiary. Article 4(1)(b) Interest Royalty Directive excludes "profit-sharing loans", that is, "debt-claims that carry a right to participate in the profits of the debtor (…) profit-participating loans, participating bonds, juissance rights and silent partnerships" etc, are from the Directive's benefits.[1027] Article 4(1)(c) exclude "debt-claims that entitled the creditor to exchange his right to interest for the right to participate in the profits of the debtor" [1028] (convertible notes, bonds etc) and lastly Article 4(1)(d) excludes "super-matuity debt and perpetual debt" which "contain no provisionfor repayment of the principal amount or where the repayment is due more than 50 years after the date of issue".[1029]

2. Dividends (Shareholder Taxation)

The current EU's system of dividend taxation creates upon the internal market serious obstacles to economic integration. One could argue that the best

[1023] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 196.
[1024] Interest and Royalty Directive Article 1(4).
[1025] Interest and Roalties Directive Article 1(5)(a) and (b).
[1026] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 193.
[1027] Ibid 194.
[1028] Ibid 194.
[1029] Interest and Royalties Directive Article 4(1)(d).

possible solution would be the *harmonization approach* instead of a *mutual legislation recognition approach*. If ***Home State taxation System*** (harmonization approach) were to be implemented, undertakings would apply only one tax code to the whole group, therefore reducing compliance costs and uncertainties when assessing tax liability. In other words, "all intra group dividends would be treated as domestic".[1030] Nonetheless, under *Home State Taxation*, problems regarding the payment of cross-border dividends would still arise if the payee is a resident of a MS which operates under an *imputation system* paying its shareholders in other MSs.[1031] Moreover, in case the subsidiary distributes dividends to third-countries, the company would have to comply with two different sets of rules when distributing dividends to *minority shareholders*.[1032] The matter could also be tackled on a case-by-case basis by the ECJ or be covered on "the agreement to participate in Home State taxation".[1033]

According to the Parent-Subsidiary Directive, the State of residence of the Parent Company will only *refrain from taxing profits*[1034] (dividends), if such profits were not deducted by the associated entity at the source State. In other words, deduction in the Source State results *in taxation in the foreign State*. Non-deduction in the source State *results in* non-taxation in the foreign State. ***If the profits were not deducted, they were taxed***.

a. Imputation System and Indirect (underlying) Credits[1035]

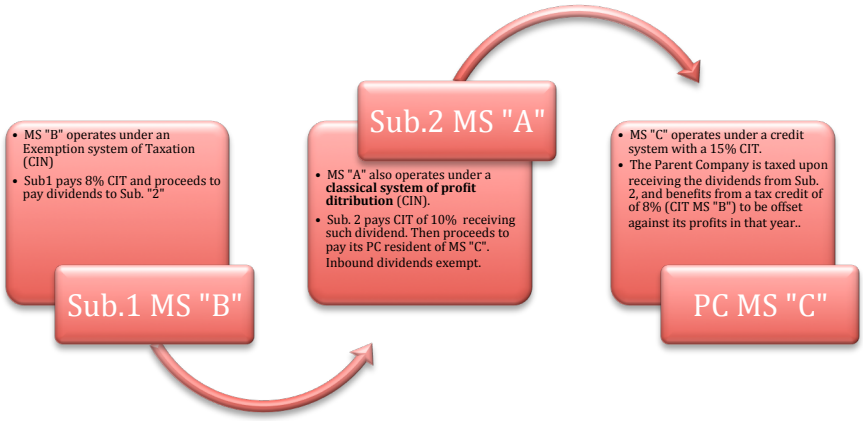
Member States are free to opt for a classical or integration systems, nonetheless, MSs end up using both systems. Neither the classical nor integration systems provide full tax neutrality in respect of distribution of profits (dividends). If "*credit MSs"* were to extent national treatment to foreign dividends, therefore granting a tax credit to foreign dividends, MSs would have to levy some sort of equalization tax to undo such credit, for foreign dividends are paid out of foreign profits.[1036] On the other hand, if MSs apply a classical system, inevitably double taxation would occur (given that no affiliation privilege – *Schachtelprivileg* - was granted). This ***system parallelism*** leads to double taxation. Consider for example: a certain pharmaceutical MNE has more than 275 operating companies in over 60 Countries. The PC resident of a certain MS receives dividends from a number of other subsidiaries, which also received dividends from other *subsubsidiaries*, which received dividends of other *subsubsubsidiaries* and so on, on a perpetuation of the payment chain. Now, consider that all associated companies are tax residents of both classical and integration/imputation system jurisdictions. Question: Will the MNE be able to fully neutralize DT? Well, If dividends were paid out of an exemption State (CIN) which grants ***no credit*** to outbound dividends to an integration/imputation

[1030] COM (2001) 582 final 387.
[1031] COM (2001) 582 final 387.
[1032] "The 'imputation' problem arises because the minority shareholder in the subsidiary would continue to expect his dividend to be paid under the subsidiary's 'local' rules – not under the rules of its parent's Home State, and the subsidiary therefore has to comply with two sets of legislation each time a dividend is paid." COM (2001) 582 final 387.
[1033] COM (2001) 582 final 387.
[1034] Parent Subsidiary Directive Article 4(1)(a).
[1035] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 143.
[1036] Ben Terra and Peter Wattel (n 60) 174.

State (CEN) which grants tax credits out of CIT levied *domestically* (inexistent in this case), the imputation MS could "attach imputation credits to foreing dividends received by their residents on the same footing as theu do domestic dividends received by residents", nonetheless, the MS would have to either levy an imputation tax to undo the credit.[1037]

Dividends, when paid to other companies within the EU, will inevitably suffer some sort DT. One solution would be to simply liquidate the undertaking,[1038] thus no payment is made! Member States are not permitted to grant exemption on profit distributions from liquidated subsidiaries. According to *Wattel/Terra*, such reasoning lies in the difficulty of assessing whether such liquidation is in tune with the Directive's (Parent-Subsidiary) aim ("facilitating trans frontier co-operation, investment and grouping together of companies").[1039] Other solution would be granting taxpayers an ***indirect credit***, where tax administrations allow a tax deduction according to the lowest CIT paid by the associated enterprise resident of that MS (further tier Subsidiary).[1040] The example bellow portraits the scheme. Sub.1 resident of MS "B" (exemption MS), transfers dividends to an associated enterprise (Sub.2), resident of MS "A" (exemption MS). Then, Sub. 2 distributes dividends to its Parent Company resident of MS "C" (imputation MS).

Figure 7



Note that Sub. 2 paid 10% CIT when receiving (not deductible) the dividends. Parent Company paid 7% CIT over such dividends (15% - 8% = 7%). Since MS *A*, *B* and *C* operate under different relief systems (exemption x credit), MS "C" grants an ***indirect credit*** to the Parent Company of 8% CIT (the lowest income tax between MSs "A" "B" and "C".[1041] Now consider that the tax administration and company (group) have 50 or 60 jurisdictions to assess. The higher the number of States involved, the higher the complexity.

[1037] Ben Terra and Peter Wattel (n 60) 174.
[1038] Member States are not permitted to refrain from taxing profits deriving out of liquidated subsidiaries. Parent Subsidiary Directive Article 4 (1).
[1039] Ben Terra and Peter Wattel (n 60) 355.
[1040] Listed in the Annex of the Directive, be a resident of that MS and be subjected to corporate taxes without the possibility of an option or of being exempt. Parent-Subsidiary Directive Article 2(a)(i)(ii)(iii).
[1041] Parent Subsidiary Directive Article 4(1)(b).

It is important to note that credit jurisdictions do not refund domestic tax if the CIT at source is higher than the resident MS, they grant "only a so-called ordinary credit (as opposed to full credit)".[1042] If the tax rate at the source *A* is 20% and 30% in resident State *B,* State *B* should tax only the difference of 10%. On the other hand, if the source State has a higher tax (say 30%), and the resident State (20%), the source State would only grant a credit for the difference (***ordinary credit*** of 10%) for the "credit cannot exceed the amount of corporation tax the parent State would levy itself, because if it did, then the parent State would be refunding tax on domestic income".[1043]

Again, there is no such thing as a ***full equalizing credit method***,[1044] which equalizes (neutralize) differences of tax rates within the Common Market. The Parent-Subsidiary Directive does not cover instances such as the one just mentioned (excess tax credit), so it is left to tax administrations and legislations of the relevant MSs to deal with the matter.[1045]

b. Charges and deductions of foreign Holdings

Member States applying exemption methods (CIN) may deny deductions of charges and losses of foreign holdings of the subsidiary. Such prohibition seems reasonable, for allowing deduction of foreign charges from proceeds not taxed in the home-State may compromise fiscal coesion of that State (Bachmann case). According to Wattel/Terra "(…) some Member States fix the amount of non-deductible management chargers, in respect of shareholdings to which a participation exemption applies, on a percentage of the dividends received from the subsidiary. This practice is compatible with the Directive, provided the percentage is fixed at an amount no higher than 5% of the dividends received (Art.4(2)). The result is that only 95% of the dividends received are exempt."[1046] However, according to Article 4(3) Parent Subsidiary Directive, MSs can grant charge deductions (management charge over a holding company) up to 5% of the distributed profits, which consequently, will be equalized by a reduction of the same figure (5%) on the exempted profits (classical system States) or a reduction over the credit (integration/imputation system States).[1047] Hypothetical question: a *foreign* holding raises capital through debt in order to finance its

PC x PE (branch)	***PC x Subsidiary***
PC's branch operation in another State. ***Status*****:** Non-Resident taxpayer financed by the Source State (PC). PC is legally and fiscally exposed in the other State.	Subsidiary operation in another State. ***Status***: resident and independent taxpayer in the other State. Separate entity. Parent Company is neither legally nor fiscally exposed in the other State.

[1042] Ben Terra and Peter Wattel (n 60) 348.
[1043] Ben Terra and Peter Wattel (n 60) 348.
[1044] "There is a trend to get rid of equalization taxes. Some years ago, Italy, France, and Germany (then an imputation State) unilaterally repealed their equalization taxes. (…) (1999), the UK abolished its ACT (advance corporation tax). Ireland switched to a classical system". Ben Terra and Peter Wattel (n 60) 172.
[1045] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 143.
[1046] Ben Terra and Peter Wattel (n 60) 350.
[1047] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 143.

subsidiary's operation. The PC (resident of another MS) files its return and requests deduction for the charges "related to the holding in the subsidiary, for instance, management charges and interest cost on the financing of the participation". [1048] The deduction is ultimately *denied* by the relevant MS although the MS grants deduction of charges and interest to *domestic* holdings. The PC appeals the tax administration's decision on a non-discrimination basis: considering the ECJ's position on the matter: did the MS discriminate against foreign and resident companies provided that it grants the benefit to domestic PCs? Well, in the *Bachmann* case the ECJ ruled that an economic connection, that is to say, a direct link between the deductibility of the contributions and the possibility of future taxation is fundamental in order to maintain and preserve fiscal cohesion (***integrity of the tax system***). Granting deductions over interest and charges in respect of loans that will only generate income in another MSs, compromises the fiscal cohesion within national tax systems. [1049] In sum, deductions are only possible if there is a direct link between the deduction and the "corresponding taxable item of income".[1050] Now, if a PC wishes to finance the subsidiary's operation through its foreign holding, the fact that the PC will not be able to offset the holding's expenses against its income may be a deal-breaker.[1051] Nonetheless, MSs may justify such discrimination on grounds of fiscal cohesion: "the charges related to a branch must be attributable to the branch's State taxing Jurisdiction, both by the company's State of residence and by the branch State, then charges related to a comparable subsidiary should likewise be attributable to the subsidiary's taxing jurisdiction by both the parent State and the subsidiary State. Proceeds and attributable charges should fall in the same taxing jurisdiction; they should be match territorially, both in the case of a branch and in the case of a subsidiary."

The fiscal coherence defense is reasonable from a MS's perspective. Nevertheless, if the charges (interest and management) were borne out of the MS other than that where future proceeds will derive, there is a lack of economic link between the deduction and the possibility of future revenue. According to *Wattel/Terra*, the Subsidiary's MS should accept the deduction of "external chargers borne by the parent for the benefit of the subsidiary, just as it accepts similar external charges incurred by a foreign company to finance and manage a domestic branch". [1052] Such solution, although elegant is likely to present administrative issues, especially in cases where the Subsidiary is not fully owned by the Parent company.[1053]

c. Taxation on Imputation Credits

Should one consider the payment of an imputation credit by an imputation State to a foreign parent company receiving dividends from a subsidiary in that imputation MS, as profit distribution, thefore liable to taxation? The payment of the credit is in fact a partial refund in respect to the CIT paid by the subsidiary

[1048] Ben Terra and Peter Wattel (n 60) 350.
[1049] Ben Terra and Peter Wattel (n 60) 351.
[1050] Ibid 351.
[1051] Ibid 352.
[1052] Ibid 353.
[1053] Ibid 353.

"which is paid for by the Treasury of the State, and not a distribution of profits by the subsidiary",[1054] consequently, there is no reason whatsoever that would prevent the MS from levying withholding tax on the credit. On the other hand, such credit may also be characterized as profits derived by the subsidiary, and therefore must be considered as (indirect) profit distribution, thus it cannot be taxed under the Directive's provisions or under the relevant DTC.[1055] In the *Oce Van Der Grinten case,* the ECJ confirmed the possibility of levying withholding tax on credit repayments for withholding tax credits cannot be "assimilated to the application of withholding tax on distributed profits". [1056]

Case C-58/01 *Oce Van Der Grinten* v.

1- In 1992 and 1993 *Oce* UK paid approximately 13.000.000,00 GBP to its parent company as well as ACT to the UK Inland Revenue in respect to such amount. The UK Inland Revenue Service consequently granted *Oce* UK a credit of 2.174.000,00 GBP over the ACT and applied another 5% tax over that credit (approximately 761.000,00) due to Article 10(3)(a) of the DTC UK/The Netherlands. Therefore *Oce* UK had a final credit of roughly 1.400.000,00 GBP.
2- Is such a charge (5%) a withholding tax on profits within the meaning of Article 5(1) of the Parent-Subsidiary Directive? If the answer to such question is affirmative, is its effect preserved as a consequence of Article 7(2)[1057] of the Directive?
3- Yes.
4- Although such 5% constitutes a withholding tax on profits distributed by the subsidiary to a parent company within the meaning of Article 5(1) of the Directive, it does not constitute a withholding tax on profits distributed by a subsidiary to a parent company in so far as it is applied over the tax credit. Consequently, its effect should be preserved for it is consistent with the Parent-Subsidiary Directive, even where it constitutes a withholding tax.

According to *Tizzano*,[1058] although the levy constitutes withholding tax on profits, "in so far as it is applied to dividends, (…) it does not constitute a tax in so far as it is applied to the tax credit".

In order to fall under Article 5 Parent-Subsidiary Directive, three conditions must be cumulative met: "(***i***) the chargeable event of the distributed dividends is relevant proper payment; (***ii***) the taxable amount is the income derived from those assets and (***iii***) the taxable entity is the rightful owner of the relevant shares*."[1059]*

[1054] Ben Terra and Peter Wattel (n 60) 355.
[1055] OECD Model Article 13(5).
[1056] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 147.
[1057] "This Directive shall not effect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends". Parent-Subsidiary Directive Article 7(2).
[1058] Opinion of Advocate General Tizzano delivered on 23 january 2003. Case C-58/01. http://curia.europa.eu/juris/showPdf.jsf?text=&docid=48009&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=168951.
[1059] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 147.

d. Inbound Dividends (*PC*)

The Parent-Subsidiary Directive provides that a MS may not levy taxes on after-tax distributed dividends derived out a qualifying PE or subsidiary. The relief may be granted either through exemption (CIN) or granting a tax credit (CEN).[1060] It is under the discretionary power of the relevant MS to apply whichever method according to the applicable circumstance.[1061] The treatment of inbound dividend has been analysed by the ECJ, where the "compatibility with EC law of national mechanisms, aimed at avoiding or mitigating economic double taxation of dividens in the hands of the shareholders, but restricted either to residend shareholders or to dividends distributed by resident companies" were questioned, for example, in the *avoir fiscal case*, a tax credit granted to French resident shareholders was extended to non-residents branches, [1062] or preferiential treatment granted by a MS to a third country (USA), "partly denied to a German branch of a French company, on the ground that the DTC applied only to German companies and companies subjected to unlimited tax liability in Germany".

In sum, the court it is the understanding of the ECJ that "as far as the exercise of the power of taxation so allocated is concerned, the Member States nevertheless may not disregard Community rules…although direct taxation is a matter for the Member States, they must nevertheless exercise their taxation powers consistently with Community law".[1063] The *Saint-Gobain* case, German tax authorities had to extent a more favourable regime provided for in a double tax convention contracted with a third State to a company established in the EU. The fact of the matter is that, if the tax treatment of the distributed profits is more favourable under a regime provided in a DTC, or under domestic law than by the Directive the PC may "opt for the application of either regime instead of that provided for in the Directive".[1064]

e. Outbound Dividends (Subsidiary)

There are a number of reasons why States choose a tax system over the other (classical or integration/imputation), that is, either for political or technical reasons. Classical systems are internationally neutral and easy to apply (foreign dividends, foreign profits and foreign shareholders are equally treated as domestic), integration/imputation systems are domestically neutral but highly complex. In sum, if the resident State exempts foreign dividends, no tax is levied thus no credit os given. If the resident States grants "both a direct tax for the withholding and an *indirect tax credit* for the *underlying corporate tax* due in the source country in respect of the dividend, the credit will often exceed the amount of national tax due and such excess credit will be lost", nevertheless,

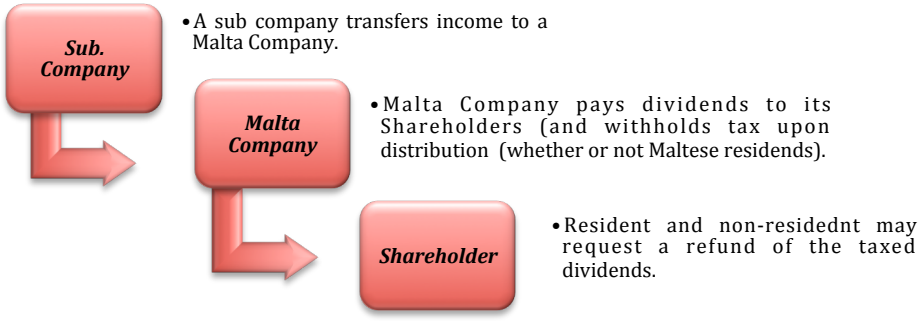
[1060] Parent-subsidiary Directive Article 4(1) (a) (b).
[1061] If the ETR of both States are comparable, the State where the Parent Company resides may simply apply CIN (exemption). On the other hand, if a DTA is in force, the State may apply CEN (credit). Ben Terra and Peter Wattel (n 60) 347.
[1062] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 70.
[1063] French CGI , Art. 158 bis, Art. 158 ter CGI and Art. 204 CGI. Para. 56-57.
[1064] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 154.

some sort of relief is ultimately provided thus avoiding "*distortions caused by the border crossing of dividends*".[1065] To conclude, Article 5 Parent-Subsidiary Directive provides that "Profits which a subsidiary distriutes to its parent company shall be exempt from withholding tax", therefore there is no doubt whatsoever that source States must provide relief through ***exemption***: "Member States are not permitted provisionally to levy a dividend withholding tax at the time of the distribution and refund it to the parent company only after it has applied in writing for a refund and has demonsrated that it is a qualifying parent company".[1066]

f. Procedural Issues.[1067]

According to the Directive's wording, profits (dividends) distributed to its parent company must be exempt from withholding tax.[1068]However the text do not provides how such exemption should be granted. Owing to the variety of systems within the Common Market (classic and integration systems), the legislator chose to leave to MSs themselves to regulate the matter according to its domestic legislation ("The Directive shall not affect the application of domestic or agreement-based provisions designed to ***eliminate or lessen economic double taxation of dividends*** (…)" (emphasis added)).[1069] For that matter, we propose a short example. The Maltese tax laws (full imputation system) dividends paid by a Maltese company are also taxed according to the relevant CIT (35% flat tax rate). In order to provide relief to double taxation, Malta applies a *refund system*, meaning that the shareholder has "the right to claim a refund of all or a part of the Malta tax paid on the qualifying profits out of which the dividend was distributed and, as result, may reduce the effective tax rate in Malta to 0%-10%".*[1070]* Nevertheless, the refund scheme is only applicable if the company is incorporated under Maltese law or if not incorporated under Maltese law, the companies must be managed or controlled in Malta.

Figure 8



[1065] Ben Terra and Peter Wattel (n 60) 169.
[1066] Ben Terra and Peter Wattel (n 60) 356.
[1067] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 145.
[1068] Parent-subsidiary Directive Article 5.
[1069] Parent-Subsidiary Directive Article 7(2).
[1070] International Tax. Malta Highlights 2017. Deloitte. https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-maltahighlights-2017.pdf. Accessed in 05 Jan 2018.

In respect to outbound dividends, there is no withholding tax "(except for certain untaxed dividends where a non-resident person is owned and controlled by, or acts on behalf of, an individual ordinarily resident and domiciled in Malta".[1071]

3. The Treatment of Dividends according to the OECD Model

The OECD Model defines dividends as the "income of shares, 'jouissance' [1072] (genussrechtskapital) shares, or 'jouissance' rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other shares by the laws of the State of which the company making the distribution is a resident".[1073] According to Article 10 OECD Model, although dividends shall be taxed the other State, it may be taxed at the source State to 5% of the gross amount of the dividend if the beneficiary owns at least 25% of the capital of the company (other than a partnership). In all other cases, the source State may levy 15% on the gross amount of the dividend. The percentages thresholds stated on the Model's text are not binding, that is to say, it merely intents to provide guidance to Contracting States.[1074]

Are dividends deductible? In imputation systems, ***YES*** (from a shareholder perspective). In classical systems, ***NO***.

Interest (debt) may be used by the payer as a deductible expense, and must be taxed on the hands of the payee (either in classical or integration/imputation systems). Contrary to interest, dividends are not deductible in classical systems but may be offset against the shareholder's tax liability.

The rule of law "only becomes legitimate through its practical use (…)"[1075] and here the ECJ has played a major role in assessing the compatibility of MSs' laws and measures with the Treaties and Union's freedoms. In 1986 the ECJ ruled that the French tax authority could not discriminate PEs of non-residents against resident companies by not granting the former a tax credit for distributed dividends.[1076] This is one of the many ECJ's rulings which ascertained the Court's importance in removing tax obstacles through negative integration. From 01.2011 to 04.2011, the Commission opened consultation proceedings in order to learn possible solutions to cross-border dividend distribution. Such assessment intended to enhance the Commissions' understanding on the consequences of "levying and crediting withholding taxes on dividend payments

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[1071] Withholding tax (2018). Deloitte. https://www.taxathand.com/resources/Malta/3642/Malta/2018/Withholding-tax. Accessed in 05 Jan 2018.

[1072] Right to *enjoy* the Cooperation's profits without being liable to its debt.

[1073] OECD Model Article 10 (3).

[1074] "Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State." OECD Model Article 10 (5).

[1075] Jose Carlos Nicola Ricci (n 304) 65.

[1076] Case-270/83. *Commission v France* "avoir fiscal".

to non-resident portfolio and individual investors in the EU".[1077] One of the consultation's contributors proposed a rather interesting approach in order to solve the matter: "[T]he Commission could (…) issue a ***recommendation*** to all Member States: (a) to incorporate, in the bilateral tax conventions concluded between themselves according to the OECD Model, an arbitration clause that could be activated by taxpayers (in line with Art. 25 of the Model after the 2008 revision) to overcome cases of unrelieved juridical double taxation; b) to abstain from introducing, in their domestic law, amendments that would risk jeopardizing the purpose on an already existing double tax conventions".[1078]

The ECJ ruled in several withholding tax cases taxes on dividend payments to non-residents. According to case law, the Commission established that MSs may not "levy higher taxes on ***inbound dividends*** than on domestic dividends" and likewise, may not "levy higher taxes on ***outbound dividends*** than on domestic dividends."[1079] According to the OECD Model, dividends may be taxed in the resident State of the recipient (general rule), and in the source State, considering that "the beneficial owner of the dividends is a resident of the other Contracting State (…)".[1080] By including the term "beneficial owner ot the dividends"in the Model's text, the OECD Model ruled out third parties from the transaction (agents, nominees, conduit companies[1081] etc) appointed by the final recipient of the dividends,[1082] who could serve as an intermediary party to the actual owner.[1083] Although the recipient State has the taxing rights to such

[1077] Consultation. Taxation problems that arise when dividends are distributed across borders to portfolio and individual investors and possible solutions. (2011) http://ec.europa.eu/taxation_customs/consultations-get-involved/tax-consultations/taxation-problems-that-arise-when-dividends-are-distributed-across-borders-portfolio-individual-investors-possible-solutions_en. Accessed in 05 Jan 2018.

[1078] Consultation on taxation problems when dividends are distributed across borders. Individual n 17. (2017). https://circabc.europa.eu/sd/a/70029f21-0d6d-4f50-9b59-f166dfe6b05b/Individual%2017.pdf. Accessed in 05 Jan 2018.

[1079] Communication from the Commission to the Council, European Parliament and the European Economic and Social Committee "*Dividend taxation of individuals in the Internal Market*", COM(2003) 810 final of 19.12.2003. 13.

[1080] OECD Model Article 10 (2).

[1081] "***Conduit Entity*** - an intermediate entity whose participation is disregarded in whole or in part under the regulations. Under the proposed regulations, a district director would be authorized to treat an intermediate entity as a conduit entity (and disregard its participation for withholding tax purposes) where three conditions are met. First, the intermediate entity's participation in the financing arrangement must reduce U.S. withholding tax liability. Second, the intermediate entity's participation must be pursuant to a tax avoidance plan. Third, either the intermediate entity must be related to the financing entity or the financed entity, or the intermediate entity would not have participated in the arrangement on substantially the same terms but for the fact that the financing entity entered into the transaction with the intermediate entity." Mark L. Lubin *Anti-conduit regulation issued*. March (1995) http://archives.cpajournal.com/old/16762563.htm.

[1082] A Canadian undertaking paying dividends to a Dutch company owned by a company in the UK (49%) and a Swedish company (51%) entered into an agreement that 80% of the dividends should be distributed to them. Eventually, since the Dutch company was not part to such agreement, it was concluded that the company should be considered the beneficial owner of the dividends. (2009 FCA 57, The Queen v Prevost Car Inc.).

[1083] An Indonesian company proceeds to issue bonds in the international market in order to raise capital to finance its operation (bonds are debt instruments and issued in a foreign country's currency which are expected to generate interest payments on specific intervals and liquidated by the issuer when the bond reaches its maturity). Such company entered into a contract with an American bank registered in London, which would serve as a trustee of the respective bonds.

income, the source State may also levy tax up to 15% (***limited taxing rights***), and if the parent company holds at least 25% of the stock of the company, the limitation drops to a 5% figure[1084] (such rule is particularly important for it does not over burden already taxed profits and ultimately enhance international investment).[1085]

4. Capital Gains

Do capital depreciation (inflation) constitute a loss? Can currency variations also be deemed as a financial loss and therefore be offset against profits in order to reduce tax liability? Should tax authorities allow deduction of unrealized capital losses (negative differences between present x purchased value of an asset)? Is inflation deductible?[1086]

According to the Indonesian law 20% should be retained as withholding tax had the interest been paid directly to the UK. Nonetheless, the Indonesia company established a company in the Mauritius Islands (special purpose vehicle – "SPV" – issuer of the loan notes). According to the late Mauritian-Indonesian DTC (revoked in 2004 by the Indonesian government on grounds of "tax treaty abuses") the Indonesian government shoud be entitled to 10% withholding tax. Due to the termination of the Mauritian-Indonesian DTC, the SPV proceeded to redeem the notes although resisted to liquidate them on grounds that the SPV could benefit from The Netherlands-Indonesia DTC. Nonetheless, the dutch company would have to be classified as the *beneficial owner* for the purposes of the DTC. Ultimately, the court ruled that the Dutch company could not be deemed as the beneficial owner of such income due to its conduit nature, that is to say, the company served only as an administrator of that income*. Indofood International Finance Lt v JP Morgan Chase Bank NA London Branch* [2006] STC 1195.

[1084] "2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends; b) 15 per cent of the gross amount of the dividends in all other cases. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid." OECD Model Article 10 (2) (a) (b).

[1085] Commentaries on the Articles of the Model Tax Convention 187.

[1086] "***Accounting income*** or loss recognizes realized gains and losses, and does not recognize unrealized gains and losses. ***Economic income*** or loss recognizes all gains and losses, whether realized or unrealized. Gains and losses are realized only when the related transaction is settled or completed. Until a transaction is completed, any gains or losses related to that transaction are considered unrealized. Unrealized gains and losses are also called paper gains or paper losses, because the nominal value of the asset or liability has changed, but the cash has not actually changed hands. ***Accounting Conservatism.*** Accounting income or loss does not incorporate unrealized gains and losses because of the convention of conservatism. When accountants confront uncertainty in regard to method or procedure, they conventionally choose the option that is least likely to overstate income or asset value. In the case of realized versus unrealized gains and losses, it is more conservative to exclude increases or decreases in value that have not yet been actualized. ***Accounting Income*** vs. ***Economic Income*** example (…). Imagine Ralph earns $50,000 dollars per year salary, after tax, and has $10,000 dollars invested in the stock market. At the end of the year, his stock market investment is worth $15,000.Because Ralph has not yet sold his stock and collected the profits, the increase in value of the investment is considered unrealized. It is a paper profit. At the end of the year Ralph has a realized income of $50,000 from his salary. His total realized income is $50,000. He has unrealized profits of $5,000 dollars. His combined realized and unrealized incomes equal $55,000.In this example, Ralph's accounting income would be $50,000 and his economic income would be $55,000. According to accounting income, the increased value of the stock investments do not count as actual income because

Recently, in the *X AB* case, the ECJ was requested a preliminary ruling on whether the realization of capital losses on the disposal of shares were deductible insofar it is related to losses on currency variations. According to Sweden legislation, capital gains and capital losses over the disposal of certain shareholdings are not subjected to tax. Such approach is beneficial to those companies that realized gains, however unfavorable to companies facing losses when disposing of shares. The matter would be easily solved if both companies were residents of Sweden (the PC and the subsidiary), for "(…) In accordance with Chapter 25a, Paragraph 5(1) of the Swedish Law on income tax (inkomstskattelag 1999:1229), a capital gain realised on the disposal of such shares is, in principle, not to be taken into account. On the other hand, in accordance with subparagraph 2 of that provision, a capital loss on disposal is deductible only if a corresponding capital gain would have been taxable."[1087] In other words, since the "corresponding capital gain" in this case is not taxable, the ***corresponding capital loss may not be deducted***.

According to Article 4(1) Parent-Subsidiary Directive, a MS shall refrain from taxing distributed profits (exemption) or tax while authorizing the PC and the PE to deduct from the tax due that "fraction of the corporation tax related to those profits and paid by the subsidiary and any-lower-tier subsidiary" (tax credit) ***except if the subsidiary is liquidated***. According to *Wattel/Terra*, such reasoning lies on the fact on the difficulty on the assessment of whether such liquidation is in tune with the Directive's goals.[1088]

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the investor has not actually sold the stock, completed the transaction, and collected the profits. According to economic income, the increased value of the stock investments to count as actual income because the real value of the assets has gone up. The assets are worth more now then they were at the beginning of the year. In this sense, Ralph has earned the full $55,000 income. ***Mark to Market Accounting Income***. There are exceptions to the methodology of reporting net income, based solely on the historical cost of acquired assets. US GAAP includes the principle of "Mark to Market Accounting." Under this accounting principle, valuation of commodities, securities and other financial instruments on a company's balance sheet are based on the market values of such assets. For example, if the cost of a precious metal acquired by a company for use in its production process, such as using silver to produce a catalyst used by the petrochemical industries was $10 per troy ounce and the market value of silver increases to $ 15 per troy ounce, the he company would value the silver on its balance sheet at $15 per troy ounce, and report the increase in inventory value as an element of its net income for the period being reported. GAAP vs IFRS Another development in the financial arena is the move towards "IFRS" or International Financial Reporting Standards, which have been adopted by European companies, and which US companies will move to, in order to provide a common measuring stick when comparing earnings per share of publicly traded companies. IFRS mandates adjustment of many assets to a market value, which adjustments would be/are included in the calculation of accounting income." James Willkinson. *Accounting Income vs Economic Income*. (2013) https://strategiccfo.com/accounting-income-vs-economic-income/. Accessed in 05 Jan 2018.

[1087] Opinion of advocate general Kokott of 22 January 2012 (1). Cases C-686/13. http://curia.europa.eu/juris/document/document.jsf;jsessionid=9ea7d0f130d5cac71c75073643ac9c318807092d1cf6.e34KaxiLc3eQc40LaxqMbN4PaN0Te0?text=&docid=161621&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=554874.

[1088] Ben Terra and Peter Wattel (n 60) 355.

E. Treatment of losses in the Internal Market

1. Domestic losses

The principles of taxation dictate that only profits may be liable to tax. The realization of undertaking's losses, may be offset against its income. In other words, if the company reaches the end of the fiscal year with a negative result, it should not collet tax over inexistent income (net income basis). [1089] Loss is a common enough fact of any business activity, heavy pre-operational costs, unfavourable economic conditions etc. Nevertheless, associated companies that constantly realize losses, while its parent company its profitable, may raise questions over whether aggressive tax planning is being applied by the relevant MNE in such a way that it is able to avoid taxation. It is fair to assume that either independent or associated enterprises would not continue to undertake business in a particular market with zero profitability. Economic theorists usually assume that economic efficiency demands the maximization (at least an equilibrium) of an asset's cost.[1090] Nevertheless, loss can be both real or artificial. Some tax planning schemes have the sole purpose on creating artificial losses for tax deductions. Such approach is a matter of great concern amongst tax authorities and tax policy officials. [1091] The Assistance Directive obliges MSs to spontaneously provide information to other MSs in case it suspects of any artificial transfer of profits within groups of enterprises.[1092] As will properly discussed in the next topic, the treatment of cross-border PEs and subsidiaries losses (PE's profits/losses are generally transferred to its parent company, whereas the subsidiary's profits/losses are not), influences investment decisions of MNEs that will opt for one company form over the another according to the investment strategy. A company may chose to initiate its operation with a PE due to expected start-up losses, so that, when becoming profitable the group may opt to incorporate the entity into a subsidiary (late PE incorporation). Pre-operational entities (start-up) can offset its losses against the PC's profits[1093] (to

[1089] In countries with high inflation rates, such as Brazil, the inflationary pressure weakens the currency, therefore reducing the buying power of its population. To that effect, Brazilian Courts acknowledged that the effects of inflation over contractual obligations may be adjusted by the average inflation index value serving consequently as a ***deduction factor***. The Brazilian Supreme Court has recently ruled upon the matter. "As contas do balanço da empresa deverão refletir a variação do poder de compra da moeda, de modo a espelhar o demonstrativo contábil da empresa a realidade, em virtude dos grandes efeitos provocados pelo processo inflacionário. (...) A correção monetária, na medida em que influi na determinação do "quantum" arrecadado, constitui elemento imprescindível para determinação da base de cálculo e alíquotas dos tributos devidos pela pessoa jurídica, sendo de rigor o atendimento aos princípios constitucionais tributários. AG.REG. NO RECURSO EXTRAORDINÁRIO 644.185 19/08/2014 "The company's annual statement must reflect currency fluctuations, so that the nearest possible actual result be demonstrated. (...) Currency variations, to the extent that influences tax liability, constitutes an essential element in determining the tax base and the applicable rates, owed by the company, according to the general tax principles." (free translation).

[1090] Consumers desire to enhance utility (happiness or satisfaction), companies intent to maximize profits, politicians work to maximize vote, the "*State*" wishes to maximize its size (Leviathan Model). Robert Cooter and Thomas Unlen (n 15) 12.

[1091] Corporate Loss Utilisation through aggressive Tax Planning. OECD, Publishing, Paris (2011). Introduction.

[1092] Ben Terra and Peter Wattel (n 60) 408.

[1093] COM (2001) 582 final 251.

certain sectors, such a banking, retail trade etc, restrictions may apply).[1094] The treatment of losses differ greatly between MS,[1095] for instance "the definition of various categories of income, the recognition of business expenses for tax purposes, the interrelation between specific (positive or negative) elements of the tax base and the deductibility of the overall loss" [1096] remain highly controversion within the Common Market. Some difficulties in ascertaining the treatment of losses are summarized in the box bellow.[1097]

Loss definition

– Are capital gains and losses included in the definition of "loss"?
– What about imputed costs[1098] (e.g. the theoretical income from letting a house occupied by the owner)?
– Are representation costs deductible?[1099] To what extent?
– Can revenue in all income categories be offset with expenses from all income categories or are there limits (e.g. between "active" and "passive" categories of income)?
– Which is the tax period for assessing the revenue and for assessing the deductible expenses?
– When are revenues and expenses (gains and losses) realized, i.e. accounted for, for tax purposes?
– What is the territorial scope for revenues and expenses (gains and losses) to be taken into account?

Some countries do not separate the various sources of income when applying loss relief, meaning that irrespective of its nature, it may be used to offset profits. Nevertheless, some jurisdictions may limit the offsetting of losses against profits according to its source, such approach is called ***scheduler taxation***. This system divides *income*[1100] from *gains*[1101] according to its source, where only losses that originated from the same income source may be deducted,[1102] therefore, *sideway loss relief* is thus not permitted. [1103] The fact is that without a uniformed European taxation approach to loss consolidation, MNEs will not be properly taxed according to its overall result consequently preventing the attaintment of the objectives contained in Article 3 TEU.[1104] Moreover, a lack of a proper legislation regulating the matter utimatly

[1094] COM (2001) 582 final 251.
[1095] Tax deduction is possible "for a write down in the carrying value of its investment in a subsidiary" in the event of losses, limited to the value of the investment properly informed in the balance sheet. COM (2001) 582 final 246.
[1096] COM (2001) 582 final 247.
[1097] The box is a variation of the one presented in the Study "Corporate Taxation in the Internal Market". COM (2001) 582 final 251.
[1098] Imputed costs or opportunity cost. Costs that the person could have realized, but due to business strategy, decided to use its resources in a different way. In sum, opportunity costs represent an alternative.
[1099] Representation costs, costs related to entertainment – banquets.
[1100] Net of revenue minus expenses.
[1101] Profitability of a peripheral activity.
[1102] Trade-loss may only be offset against trade-income. Setting off non-trade income against trade-loss is not permitted.
[1103] COM (2001) 582 final 247
[1104] "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment (…)" TEU Article 3 (n 26).

discriminates between domestic and foreign undertakings, which will be at a disadvantageous position in relation to domestic companies that are able to consolidate and compensate its results in that MS.

2. Domestic Consolidation of National Groups

The domestic offsetting of losses between undertakings (headquarters and subsidiaries) is permitted by tax authorities, although MSs apply different relief rules. As far as domestic profit consolidation is concerned, companies may consolidate their profits and losses on a *downstream* or *upstream vertical* basis (Parent Company x Subsidiaries or vice-versa) as well as on a *horizontal* basis (Subsidiary x Subsidiary).[1105] Bellow, one can better visualize how ***domestic consolidation*** of profits/losses operates. Besides Canada, Switzerland, Belgium, Czech Republic, Greece, Lithuania, Hungary and Slovakia[1106] countries in general provide such group consolidations schemes.[1107]

Figure 9



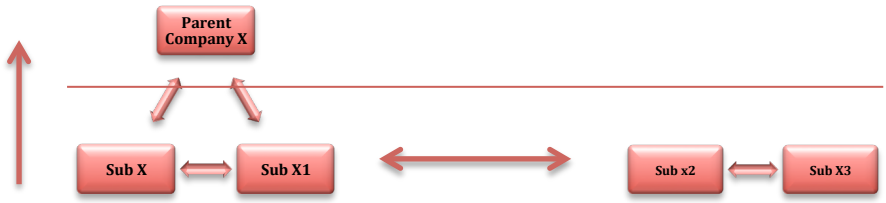
Within the EU, MSs that allow for group consolidation, that is to say, where "profits and losses of companies belonging to the same group are aggregated and taxed"[1108] are Austria, Denmark, France, Germany, Italy, the Netherlands, Spain, Ireland, Norway and Sweden. Denmark is the only country where group consolidation is mandatory.[1109] Other requirements may also apply, such as minimum control thresholds, whether the PE/Subsidiary operates as the group's head, consolidation election periods, methods of consolidation etc.[1110] Again Canada, Switzwerland, Belgium, Czech Republic, Greece, Lithuania, Hungary and Slovakia[1111] ***do not allow ANY group consolidation regimes*** (neither domestic nor cross-border),[1112] thereore each undertaking is taxed independently.[1113]

[1105] COM (2001) 582 final 243.
[1106] These States do not allow any form of group consolidation, neiher domestically not cross-border). COM (2011) 121 final. 13.
[1107] Australia, Austria, Denmark, France, Germany, Italy, Mexico, The Netherlands, New Zealand, Spain and the USA.
[1108] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 31.
[1109] Ibid 27.
[1110] Ibid 31.
[1111] COM (2011) 121 final. 13.
[1112] COM (2011) 121 final. 13.
[1113] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 32.

3. Cross-Border Group Taxation

Within the single market, only four MSs allow cross-border consolidation, namely, Austria, Denmark, France and Italy. A cross-border group consolidation scheme is properly described bellow.

Figure 10



Note that cross-border loss compensation is a ***one-way road***. If *Parent Company X* realize profits and its subsidiaries *X*, *X1*, *X2* and *X3* losses, *X*, *X1*, *X2* and *X3* losses will be pooled against PC *X's* profits (WWS).[1114] Nonetheless, if Parent Company *X* realize losses whereas its subsidiaries *X*, *X1*, *X2* and *X3* profits, *X* will not be able to transfer its losses to its subsidiaries. Cross-border loss compensation is not allowed due to lack of proper legislation. Generally, there is no provision for offsetting the subsidiary's profits against the PC's losses. The absence of a more general group loss consolidation has long been the subject of great discussion, for it creates impediments to the better functioning of the internal market. Moreover, it infringes fundamental freedoms such as the freedom of establishment previously studied in this investigation. Nevertheless, MSs approach the matter differently, for example, Austria, Denmark, France and Italy, provide consolidation regimes with diferent specifications. Austria[1115] and Denmark,[1116] allow the group's head be a non-resident company under the condition that "the shareholdings in the consolidated subsidiaries are effectively connected to the PE", whereas France and Italy require the enterprise be a resident in those MSs. Lastly, Austria, Denmark and Italy disregard the pre-consolidation of losses for deduction purpuses, whereas France *ring-fences* the loss to the relevant company.[1117] When consolidating profits, a parent company will add its PE profits in its annual statement but may not transfer its losses to its PEs. At the time the European Commission released its study on Company taxation in the Internal Market (2001),[1118] only Denmark and France permitted cross-border loss relief in relation to subsidiaries, [1119] under the both the *deduction/reintegration method*.

Cross-border loss compensation was first brought before the ECJ in the *Futura Participations* case, [1120] where "it held that Luxembourg was entitled to demand that losses of a French company with a permanent establishment in

[1114] Worldwide system of taxation.
[1115] Minimum of 50% of shareholding threshold required.
[1116] Full control required.
[1117] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 33.
[1118] COM (2001) 582 final 246.
[1119] After the Austrian tax Reform in 2005, the offsetting of losses was permitted under the deduction/reintegration method. COM (2001) 582 final 246.
[1120] C- 250/95.

Luxembourg should have an economic link with its territory in order to be taken into account".[1121] The ECJ ruled the *Futura Participations* case under *the rule of reason*[1122] (justifications in relation to differential treatment may be accepted on grounds of public interest[1123] (effectiveness of fiscal supervision, maintenance on the integrity of the tax system (fiscal coherence), the prevention of possible abuses, territoriality, balanced allocation of taxation rights, tax neutralization in other States). In other words, "the carry-forward of losses for branches of non-resident companies"[1124] must be economically linked to the taxpayer's income in Luxembourg. The court, however, did not imposed upon non-residents the duty to keep accounts "complying with national rules to justify the carry forward of losses". [1125]

The AMID case,[1126] brought before the court in the year 2000, is another example of cross-border loss incurred in the "State of residence by a company which had a permanent establishment in another Member State". [1127] In worldwide tax systems, losses realized by a company resident of Belgian were "set-off against the profits of its foreign permanent establishment, which were normally exempt according to the DTC. This compensation led economically to Belgian (double) taxation of the Luxembourg profits, since the Belgian loss could not be carried forward to be deducted from future Belgian income. The Court compared companies having all their branches in Belgium with companies with one or more foreign permanent establishments. The Court held that by setting off domestic losses against profits exempted by treaty, the legislation of that Member State established a differentiated tax treatment as between those two categories incompatible with EC law". [1128] Although Belgium has not changed its legislation in relation to loss consolidation of a resident undertakings, tax authorities of that State comply with the ruling.[1129]

4. Carry-over of losses (Forward and Back)

When realizing losses, companies may offset negative against positive results. Generally, the fact that companies are permitted to deduct its losses over time (carry-forward), provides economic gains that allow undertakings to

[1121] COM (2001) 582 final 252.
[1122] "It could only be otherwise if the measure (violation to the right of establishment) pursued a legitimate aim compatible with the Treaty, and were justified by pressing reasons of public interest. Even if it were so, it would still have to be of a such a nature as to ensure achievement of the aim in question and not go beyond what is necessary for that purpose (…)" C- 250/95 *Futura Participations* para. 26. Michael Lang. *Direct Taxation. Recent ECJ Developments.* Klumer Law International (2003). 20.
[1123] Public interest may also be read as: consumer protection, prevention of unfair competition, protection of the environment, improvement of working conditions, protection of public health, product safety, promotion of culture. Ben Terra and Peter Wattel (n 60) 31.
[1124] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 55.
[1125] Ibid 55.
[1126] According Belgian rules for deducting losses, losses that were realized in Belgium, must first be offset against profits realized in Belgium, then with PE located in countries where Belgium had no tax treaties, and lastly against profits realized in PEs located in a tax treaty States. ECJ C-141/99 [2000].
[1127] Ibid 52.
[1128] Ibid 52.
[1129] Ibid 53.

continue operating. Very few States allow carry-back of losses[1130] due to administrative difficulties and budgetary reasons.[1131]Carry-forward of losses are generally accepted by all tax authorities. Contrary to loss carry-back, loss carry-forward is not as complex to administer and have a very low budgetary impact.[1132] Moreover, they do not reauire "the re-opening of a taxpayer's tax assessment".[1133] The carry-over of losses is an important step in the improving tax neutrality and enhancing the international trade of goods and services. Nevertheless it is vital for the proper functioning of such system that the relevant loss be "offset against income economically derived by the ***same person*** across taxable periods".[1134] As we shall study in other parts of the present investigation, MNEs, by aggressively planning their tax structures circumvent restrictions on the carry-over of losses (backwards and forward) imposed by jurisdictions, for instance, by creating artificial losses, shifting profits to a loss making company or even creating double dip instances, where the same economic loss is deducted in two or more undertakings. Nonetheless, there are limitations to such rule, that is, MNEs are not allowed to carry-over losses (backwards and forward) to its full value, and moreover, on an unlimited time basis,[1135] for the burden of reopening already closed annual accounts (***losses carry-back***), possibly even granting a tax refund, would certainly result in administrative and assessment difficulties. Nevertheless, losses carry-over ensure tax neutrality and also provide a "macroeconomic benefit because the possibility of using the loss means that viable companies continue in operation".[1136] Such approach is particularly important in economic crises, where the ability to remain competitive, or even operational is threatened due to external risks, for example, the United States, the UK, Norway and the Netherlands, have applied special tax incentives to companies that realized losses in the years that followed the 2008 Subprime crisis by allowing companies to carry-back losses two years (Norway and the UK) and five years (USA).[1137] ***Losses carry-forward***, on the other hand, and as previously mentioned, are easier to manage due to the fact that it is not required

[1130] Canada (3 years), France (3 years), Ireland (1year), The Netherlands (1 year), UK (1 year), USA (2 years).

[1131] France amended its Finance Act in 2011, changing and limiting the amount of losses companies were able to offset. Companies may ***carry-forward losses*** without time limitation (limited to 1 million EUR of taxable profit, plus 60% of the relevant year's taxable profit) and ***carry-back*** to the fiscal year immediately preceding that in which the losses were realized. Italy, allow start-up companies to carry-forward losses (*start-up tax losses*) indefinitely with no value limitation, as long as they are created by a new business activity and incurred in the first three fiscal years after the company was incorporate. The offset of ordinary losses may only deducted against 80% of the taxable income of the relevant fiscal year.

[1132] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 27.

[1133] Ibid 27.

[1134] Ibid 26.

[1135] Countries such as Australia, Austria, Denmark, France, Germany, Ireland, New Zealand, Norway, Sweden and the UK (as long as the relevant losses are offset against profits of the same trade), allow an indefinite ***loss carry-forward***. Nevertheless, in an eventual change of ownership or activity, restrictions are applied. Contrary to carry-forward losses, only a few number of jurisdictions allow the ***carry-back of losses***, for instance, Canada (3 years), France (3 years), Germany (1 year), Ireland (1 year), The Netherlands (1 year), the UK (1 year) and the United States (2 years). Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 34.

[1136] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 27.

[1137] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 37.

that the taxpayer's annual account be reopened.[1138] Nonetheless, restrictions may apply.

	Advantages	***Drawbacks***
Carry–back losses	- Reduces taxpayer tax liability in respect to past fiscal years. - Generate tax refund to taxpayers. - Ensures tax neutrality. - Positive macroeconomic impact.	- May create administrative difficulties when reopening annual accounts. - Negative impact on the relevant jurisdiction's budget.
Carry–forward losses	- Easy to manage. - Limited impact on the relevant jurisdiction's budget. - No time limit. - Ensures tax neutrality.	- Time limitation may influence negatively investment decisions as to whether or not "take an economic risk in a country."[1139]

Commonalities to both *carry-forward* and *carry-back* are: (***i***) deductibility limitations, which may vary according to the relevant country (Austria, for example allow the loss carry-forward be deducted up to 75% of the taxable income whereas in Germany, the deduction is reduced to 60%),[1140] (***ii***) a change of control or ownership may prevent loss being deducted, and (***iii***) tax jurisdictions may also deny undertakings future or past loss offsetting due to a change of activity (Australia, Austria, Ireland, Italy, Mexico, The Netherlands, Swtzerland and the UK).[1141]

5. Foreign Subsidiary losses

Although the general rule dictates that losses of a foreign subsidiary may not be used to reduce a parent company's tax liability, four MSs allow group consolidation schemes, namely Austria, Denmark, France and Italy. Nonetheless, countries such as Ireland, Sweden and the UK, ***allow the deduction of losses realized by a foreign subsidiary resident within the European Economic Area*** (EEA). Within the US, losses and profits may be "passed through or otherwise recognized by the US owner of a foreign entity if in the US, the foreign entity is treated as a disregarded entity, partnership, or other flow-through entity." [1142]

The OECD study on the utilization of corporate loss through aggressive tax, discusses the possibility of whether CFC losses should be offset against resident shareholders' profits. However, this is not the case in many tax jurisdictions, for instance, the UK and Germany do not attribute CFC losses to resident shareholders. On the other hand, countries such as Denmark, France, Italy, Norway and Sweden, allow CFC losses to be carried-forward when "determining the income of the foreign entity".[1143] Spain provides a limitation to CFC's passive income attributed to resident shareholders at a pro rata basis, limited to the CFC's net income. [1144] New Zealand, for example, allow the CFC's profits be offset

[1138] Ibid 27.
[1139] COM (2001) 582 final 249.
[1140] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 27.
[1141] Ibid 27.
[1142] Ibid 39.
[1143] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 39.
[1144] Ibid 39.

only against the losses of that entity under the condition that such loss/profis were accrued in the same jurisdiction.[1145]

In sum, the absence of a group consolidation scheme within the single market is most certainly detrimental to the economic development of the region, for in many cases "the subsidiary makes losses in excess of the parent company's profits, i.e. the group is in an overall loss position, but tax is still due because the parent company is unable to relieve the losses against the profits and reports a taxable profit."[1146]

6. Foreign PE losses

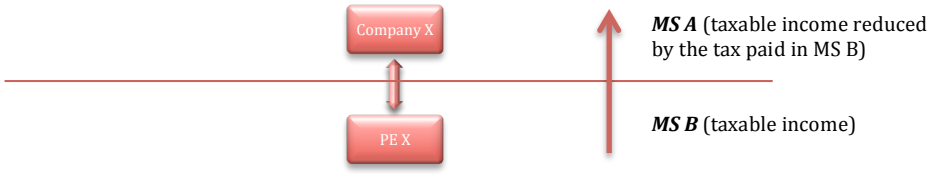
Losses of permanent establishments are normally connected to the relief method which the relevant State operates, for PEs are intimately dependent on its parent company, which is legally and fiscally exposed in the other State**.** Jurisdictions applying the credit method (described bellow), assess the PE's loss and profit account when determining the PC's tax liability (States applying credit method are: Canada, Ireland, Italy, Mexico, New Zealand, Norway, Sweden, the UK and the USA).[1147] Nevertheless, as previously studied, cross-border taxation must be approached strategically, that is to say, first one must assess whether Union law is applicable and only apply the relevant DTC insofar the transaction fall outside EU's regulations.

7. Loss relief Methods

There are three methods in which company headquarters are allowed tax relief in respect to ***foreign branches*** (PE), namely, *Credit Imputation Method*; *Deduction/Reintegration Method* and the *Exemption Method*.

Credit Imputation Method. Company X, resident in MS A, has a PE in MS B. After the PE is taxed, the tax paid by the branch generates a tax credit to Company X in the resident State.[1148]

Figure 11



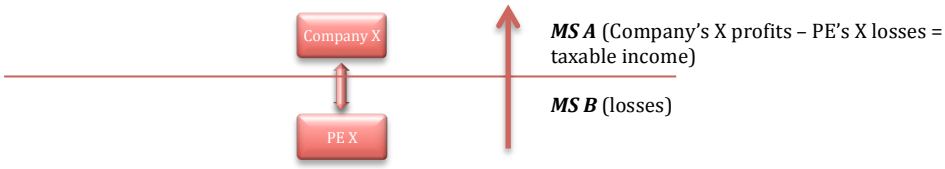
Note that, according to the example above, before PE X transfers its profits to PC X, PE X pays CIT and the parent company State will grant a tax credit on the tax paid by PE X. The same system is also used to eliminate ***double economic taxation*** (same income taxed in the hands of two or more entities),[1149] where the resident State shall allow a deduction from the tax paid by the associated company in the other State, on an equal amount to the *income* or *capital* tax paid in the other State, insofar the deduction do not exceed the tax previously

[1145] Ibid 39.
[1146] COM (2001) 582 final 246.
[1147] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 38.
[1148] COM (2001) 582 final 244.
[1149] Michael Lang (n 461) 29.

computed before the concession of the deduction,[1150] and if exempt, the State shall take into account the exempted *income* or *capital* when assessing the remaining tax liability.[1151] Another example: Company A resident in MS A realize losses in a certain fiscal year and PE "B", resident in MS B, profits. Company A may carry-forward its losses as long the profits accrued by PE B were deducted.

Deduction/Reintegration Method. The same systematic as described in the credit imputation method is used in the deduction/reintegration, however no credit is created for the PE tax, that is to say, the PE's losses are ***deducted*** against the parent company's profits. In other words, the results of the associated company are ***(re)integrated*** into the PC's accounts. Consider the following example. In year 1, Company X (MS A) realize profits at the end of the fiscal year, whereas its PE X (MS B), losses. The profits of company X are then offset against the losses realized by the its PE, therefore reducing its tax liability in that jurisdiction. On the other hand, had Company X realized losses whereas its PE profits, no tax credit would be generated. Nonetheless, PE X would still be liable to tax on its profits in MS B.

Figure 12

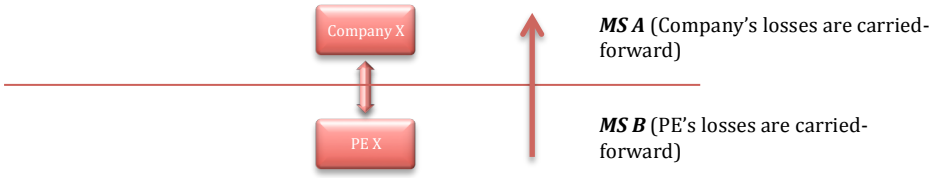


Now, assume that both Company X and PE X accrued profits during a certain fiscal year, if the "combined Head Office and Permanent Establishment tax liability is less than the local tax suffered by the Permanent Establishment part of the tax credit may be lost".[1152] Most MS do not grant carry-forward of unused credits, meaning that if the PE realizes profit, and the tax liability is lower than the tax that would have brrn due by the parent company, the credit may not be used to subsequent years. Some MSs limit the "tax credit relief to the hypothetical domestic tax which would have been due on the Permanent Establishment profits had it been a domestic branch rather than a foreign Permanent Establishment". [1153]

Exemption Method. MSs do not recognize a PE's losses and "given that in many cases a newly established Permanent Establishment will make losses in early years, followed by profits, this may be less advantageous than the other two methods where recognition is immediate",[1154] nevertheless the PE's MS may (as an exception) exempt the PE's profits in the first years (business maturity).[1155] In other words, ***there is no offsetting whatsoever of the PE's profits or losses against that of its parent company***. The graph bellow better illustrates such approach.

[1150] Article 23B (1) OECD Model.
[1151] Article 23B (2) OECD Model.
[1152] COM (2001) 582 final 245.
[1153] Ibid 245.
[1154] Ibid 245.
[1155] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 27.

Figure 11



In the example above, the PE will not be able to transfer its losses to Company X (deduction/reintegration method), nor gain a tax credit if eventually transfers income to its parent company located in the other MS (credit method).

F. Transfer Pricing

The OECD/G20 BEPS Project developed a set of 15 action plans in order to tackle domestic and international tax avoidance and aggressive tax planning. Action 8 to 10, specifically cover theoretically as well as empirically the basis for intra-group deals regarding tangibles, intangibles, services and financial transactions. The main goal of BEPS Action Plan 8-10 is "to assure that transfer princing outcomes are in line with the value creation in relation to intangibles, including hard-to-value ones, to risk and capital, and to other high-risk transactions"[1156] therefore preventing the transfer of intangibles from high tax jurisdictions to low tax jurisdictions, the transfer of risk and allocation of capital. Transfer prices can be defined as the charged price of an intangible, tangible or service sold or acquired by companies of the same Group. Transactions between members of the same group cannot be priced under simple demand and supply prices, for controlled parties will enter into controlled transactions, therefore "a ***transfer price*** has to be established". [1157]As already studied in other parts of this investigation, in order to the characterized as a member of the same Group, or an associated enterprise, the undertaking must fulfil the criteria of Article 9 of the OECD Model.[1158]Price transfers between domestic undertakings will not be subjected to a deeper analysis. As a matter of fact, the OECD Model covers only international price transfers, which are considerably more difficulty to assess for sometimes involve various jurisdictions. Nonetheless, in the event of a price disagreement, the jurisdiction that proceeded with the price adjustment (not at arm's length), attracts the burden of proof to itself, thus it will have to prove that the its ***price*** reflects the true ***value*** of the property. Article 9 of the OECD Model is particularly important for it provides for price adjustments in respect to the arm's length principle.[1159] The fact that companies are treated as separable

[1156] BEPS Actions. Base Erosion and Profit Shifting. http://www.oecd.org/tax/beps/beps-actions.htm. Accessed in 10 Jan 2018.
[1157] Michael Lang (n 461) 146.
[1158] The enterprise shall be considered as a group member if it participates directly or indirectly in the management, control or capital of the other enterprise, or if the same persons who manage that enterprise participate directly, indirectly in the management, control or capital of that other enterprise. OECD Model Article 9.
[1159] "Where (…) conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxes accordingly." OECD Model Article 9.

enterprises instead as one single Group, allows tax authorities to assess controlled transactions (transactions between companies of the same Group) against uncontrolled transactions (between independent undertakings) in such a way that, if the controlled transaction's conditions deviate from the conditions which would have been contracted were the companies unrelated (comparability analysis), then the transaction will not be at arm's length (not recognizable) and ultimately will need be adjusted, that is, the accounts of the parties to the deal would have to be re-written in order re-assess the transaction's price and consequently the tax liability.[1160]

Comparable transactions are not always easy to assess. For instance, trades of highly specialized goods, unique intangibles and specialized services. The main purpose of applying the arm's length principle properly, is to avoid the risk of double taxation. OECD members clearly support this approach and contribute to its refinement. Although the ALP is viewed by some as faulty due to the fact that the "separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses"[1161] ALP "(…) has been found to work effectively in the vast majority of cases".[1162] Alternatively, the ALP do not solve all transfer pricing issues, and are sometimes are substantially complex in respect to documentation.

1. Arm's Length Principle (ALP) x Global Formulary Apportionment (GFA)

When conducting commercial (purchase/selling of property) or financial operations, companies will try to optimize as much as possible their profits. This is true in the vast majority of contracts entered into by independent companies. Alternatively, when associated enterprises deal with each other, market forces applied to uncontrolled transactions (supply and demand, geographical limitations, competition, cost of production etc) are disfigured. The reason for such phenomena is that associated companies are not *only* interested in maximizing profits, but also, amongst other interests, in reducing each other's costs and liabilities. Note that, if two or more ***independent undertakings***[1163] were to conduct business together, their intention would be focused on getting the best possible deal for themselves, and for its counterpart, for no independent enterprise would enter into a transaction that would make them worse off at its

[1160] Transfer Pricing Guidelines (n 503) 36.
[1161] Transfer Pricing Guidelines (n 503) 36.
[1162] Ibid 36.
[1163] The TP guidelines present and interesting example of neutral economical transactions between independent companies. "(…) for example, the sale of a risky income-producing asset may reflect in part a preference of the seller to accepted a lower but more certain amount of nominal income and to forgo the possibility of higher anticipated nominal income it might earn if it instead retained and exploited the asset. In a without-recourse debt factoring arrangement between independent enterprises, for example, the seller discounts the face value of its receivables in return for a fixed payment, and so accepts a lower return but has reduced volatility and laid off risk. The factor will often decide to take on risk and to decide on how to respond to the risk, including by diversifying the risk and having the functional capabilities to mitigate the risk and generate a return from the opportunity. Neither party will expect to be worse off as a result of entering into the arrangement, essentially because they have different risk preferences resulting from their capabilities in relation to the specific risk than the seller and terms acceptable to both parties can be agreed. " Transfer Pricing Guidelines (n 503) 64.

conclusion,[1164] that is to say, the company would not sell a product at a certain price if someone else is willing to pay more (although the economic assessment of an transaction can often times be very intuitive, the context of the transaction must also be evaluated, for third parties do not necessarily limit themselves to a single purchase).[1165] Here, an interesting parallel with Nash's *Game Theory* will help us to understand the mechanical process of decisions making where the outcome of the game is decided upon other parties' strategies and decisions. As mentioned before, it is expected of *independent enterprises* to act according to its *individual ambitions*, nonetheless, would these same enterprises act according to their *individual ambitions* were they related? Not necessarily. Associated enterprises have ***common interests*** therefore their transactions cannot be analysed without reserves. Tax administrations should not always assume that that the controlled transaction's aim was contracted to generate some sort of abusive benefit to the enterprises involved[1166] (shifting profits to low tax jurisdictions, creation of artificial losses, transfer pricing exploitation etc), for determining the true cost of a property (especially due to the difficulty encountered by enterprises to valuate unique intangibles), can sometimes be difficult to assess (the issue of valuating intangibles will subjected to further discussion in other parts of this investigation). Although the ALP is today, according to OECD members, the best international transaction (price) assessment system available, some scholars suggests that the *Global Formulary Apportionment (GFA)* could be employed as a parallel system of corporate income apportionment (FA system is used in the ***USA*** and ***Canada***).[1167] The

[1164] Independent enterprises, when contracting, ensure that the agreed terms are contracted according to the interest of both parties, that the contract will be properly performed and if not, any change related to its terms will only be possible in common agreement. Transfer Pricing Guidelines (n 503) 49.

[1165] Ibid 46.

[1166] Ibid 33.

[1167] In *Joann Martens Weiner*'s paper on "CCCTB and Formulary Apportionment: The European Commission Finds the Right Formula", the scholar stressed the fact that, "[E]mpirical research conducted on the US states and Canadian provinces, which are the jurisdictions that employ formulary apportionment, (…) found that even after controlling for differences in wages, natural resources, and industry competition, small differences in state corporate tax tax system could explain some variantion in business investment. (…) The non-uniform situation in the US states led researches to examine how relative uniformity in corporate taxation in the Canadian provinces affected business investment decisions. In contrast to the US states, which have largely set their own base, formula and rates, the Canadian provinces have used a common formula using payroll and sales and a common federal tax base but have applied their own tax rates. This uniformity came about in part because the provinces designed the system from scratch when they regained the right to tax corporate income after ceding that authority to the federal government during the World War II and in part because the federal government agrees to incur the collection costs in exchange for the provinces adopting common rules. Over time, that uniformity has remained primarily because business have come to accept the benefits of uniformity. This uniformity in formula, however, does not stifle tax competition. (…) Canadian provinces (…) compete for investment by cutting tax rates or offering post-apportionment tax credits within a common formula and common tax base. The provinces are able to compete for tax base because Canada does not allow consolidation across legal entities. Thus a company that wants to shift income from one province to another could do so by setting up a separate company in the other province and shift income there. (…) The prohibition against consolidation in Canada allows companies to 'shift' income to low-tax province through strategic lending and borrowing. (…) tax competition is thriving in the Canadian provinces despite the general uniformity in the Canadian apportionment system." Denis Weber (n 45) 265.

applicability of the ALP is intimately connected with the separate entity approach, that is, each undertaking's transactions are analysed separately. The global formulary apportionment is applied in a consolidated basis, where the undertaking's tax liability is assessed on a Group basis, thus it does not recognize that an associated enterprises realized losses whereas a parent company realized profits separately. This *unity* characteristic of the GFA renders no flexibility in order to deal with geographical differences of Parent x Subsidiary, company individual efficiencies etc.[1168] If opting tfor a GFA, jurisdictions would have to enter into an agreement to harmonize their accounting system and agree upon a formula to assess the Group's tax liability. The problem is that each, besides the fact that each Country measures its tax base differently (broad x narrow bases), governments would want to "(...) *include different factors in the formula based on the activities or factors that predominate in its jurisdiction*" in order to enhance its revenue, which makes this alternative (GFA) unlikely to occur.[1169] Another feature of GFA is that, there is a complete abolition on the necessity of consolidated profits regarding intra-group transactions (Group assessment). When analysing the exchange rates on the product's prices, the ALP has a better approach on such assessment, for it deals with the economic consequences of such variations in respect to specific facts and situations regarding the undertaking.[1170] On the other hand, the GFA deals with costs in order to assess price, therefore any currency variation will influence significantly the profit of associated companies (a greater portion of the profit would be gained by the undertaking located in the jurisdiction with a stronger currency). This event could lead to a future "*downward pressure on profits*", for a stronger currency influences exports in a negative manner.[1171] The shifting of production factors is already a matter of great concern under the ALP rule, and under a GFA, is likely to be even more troublesome. The possibility of tax evasion and avoidance schemes, would still be possible, for instance, associated enterprises can artificially shift "the production factors used in the formula (e.g. sales, capital) to low tax countries. There could be tax avoidance to the extent that the components of the relevant formula can be manipulated, e.g. by entering into unnecessary financial transactions, by the deliberate location of mobile assets, by requiring that particular companies within an MNE group maintain inventory levels in excess of what normally would be encountered in an uncontrolled company of that type" etc.[1172] In sum, the use of a GFA system would require a complete and full cooperation of tax jurisdictions worldwide, and due to the reasoning above, most countries have rejected it as a viable system. [1173]

[1168] Transfer Pricing Guidelines (n 503) 42.
[1169] Ibid 40.
[1170] Ibid 41.
[1171] Ibid 41.
[1172] Ibid 40.
[1173] "Global formulary apportionment has been promoted as an alternative to the arm's length principle by advocates who claim that it would provide greater administrative convenience and certainty for taxpayers. These advocates also take the position that global formulary apportionment is more in keeping with economic reality. They argue that an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE

2. ALP and Comparability Analysis

The comparability analysis is an assessment system which compare transactions concluded by independent undertaking, and analogous contracts entered into by associated enterprises. One have to agree that, comparing tangible transactions is generally easier than comparing transactions on intangibles [1174] for valuating intangibles (services, patents, copyrights, trademarks etc), tends be more complex than valuing tangibles (commodities). Moreover, the issue of finding comparable intangibles for valuation purposes cannot be underestimated. The ALP is based on the proper assessment on the transaction's comparability.[1175]In order to assess that, one must ***first*** identify the *commercial/financial* relations between the associated undertakings, and then (***second***) compare the "conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economic relevant circumstances of comparable transactions between independent enterprises" (comparability analysis).[1176]

Commercial/Financial relations. In order to identify the extent of the commercial/financial relation between enterprises, one must first identify the relevant industry (tech, pharmaceutical etc), and the variables that eventually could influence the undertaking's performance in that industry (strategy, markets, risks etc).[1177] After identifying the industry as well as its operational risks, one must assess the undertaking's *niche* (distributor, production etc). [1178] The *economic characteristics of the transaction*, will allow us to contrast the most appropriate uncontrolled transaction against the controlled transaction in order to verify if the transaction is at AL, or if some adjustment to the transaction's price is necessary to equalize the controllable with the uncontrollable transaction.[1179]

Comparability process. Searching for comparables is not the only task when performing a comparability analysis. As mentioned in the paragraph above, tax auditors, taxpayers or foreign tax authorities, must conduct a thorough analysis of the companies involved to the transaction before searching for "information on potentially comparable uncontrolled transactions" for "the process of identifying comparables is dependend upon prior analysis of the taxayer's controlled transaction and of the economically relevant characteristics or

group. Apart from these arguments, advocates contend that global formulary apportionment reduces compliance costs for taxpayers since in principle only one set of accounts would be prepared for the group for domestic tax purposes." Transfer Pricing Guidelines (n 503) 39.

[1174] Finding comparable transactions in some industries are easier than others. In the diamond industry, for example, although the price of a stone is intimately related to its cut (stone cutter's ability - intangible) after 1970, the Gemological Institute of America began, to publish grading certificates with standard characteristics allowing a more objective evaluation of stones.

[1175] Transfer Pricing Guidelines (n 503) 43.

[1176] Ibid 44.

[1177] Ibid 44.

[1178] Ibid 44.

[1179] Ibid 46.

comparability factors". [1180] A typical comparability analysis process was summarized in the OECD Transfer Pricing Guidelines: [1181]

> ***Step 1.*** *Deliminating the years of assessment.* Analysing the contractual terms of a transaction is a good starting point in determining the years which will be analysed. However, some transactions do not match the exact contract's terms.
> ***Step 2.*** *Taxpayer analysis*. A taxpayer analysis assesses the industry in which the entity operate, competition, economic and regulatory factors that may influence risk, business strategy etc..[1182]
> ***Step 3***. *Analysis of the controlled transaction.* Contractual risk analysis and a functional analysis are conducted in order to ascertain the most appropriate TP method to the peculiarities of the case.
> ***Step 4.*** *Assessment of internal comparables* (if existent). Internal comparables may have a "more direct and closer relationship to the transaction under review than external comparables",[1183] and demand (in most cases) less resources in order to be obtained. However, internal comparables must also "satisfy the ***five comparability factors*** in the same way as external comparables" (see bellow). The reliability of internal comparables was tested by the TP Guidelines with the following example: "Assume for instance that a taxpayer manufactures a particular product, sells a significant volume thereof to its foreign associated retailer and a marginal volume of the same product to an independent party. In such a case, the difference in volumes is likely to materially affect the comparability of the two transactions. If it is not possible to make a reasonably accurate adjustment to eliminate the effects of such difference, the transaction between the taxpayer and its independent customer is unlikely to be a reliable comparable."[1184]
> ***Step 5.*** *Assessment of available external sources of information*. There are a number of information sources from where potential external comparables can be extracted, for instance, commercial databases, foreign source or non-domestic comparables and information undisclosed to taxpayers (held by tax administrations, for example).[1185]
> ***Step 6.*** *Selection of the most appropriate TP method* will consider the strengths and the weaknesses of each TP's methods, the availability of information in respect to comparables etc. It is important to stress the fact that no TP method must fit perfectly to the relevant transaction. The ALP do not require more than one method be applied. In most cases, the use of one method alone will be able to provide a proper estimation of an AP price or margin and if not "a flexible approach would allow the evidence of various methods to be used in conjuction" in determining an AL price.[1186]

[1180] Transfer Pricing Guidelines (n 503) 147.
[1181] Ibid 148.
[1182] Ibid 51.
[1183] Ibid 155.
[1184] Ibid 156.
[1185] Ibid 156.
[1186] Ibid 100.

Step 7. *Identification of possible third-party comparables.*[1187] Comparables may be identified according to two possible approaches, the ***additive approach*** where both internal and external comparables are listed according to a pre-determined comparability criteria, that is, by the potential that the relevant third-party have to have concluded comparable transactions ("all the transactions retained in the analysis are carried out by well-known players in the taxpayer's market"),[1188] and the ***deductive approach*** where a set of companies with similar "broad functions" and economic characteristics will be listed. The list then is narrowed down according to information collected from databases, internet sites, information on known competitors etc. [1189] Is is imperative that the process of identifying comparables be transparent, systematic and verifiable for it consists as one of the "most critical aspects of the comparability analysis".[1190] Both approaches (***additive*** and/or ***deductive***) may be used for the best possible result.

Step 8. *Adjusting comparables.* Being comparable means "that none of the differences (if any) between the situations being compared could materially affect the conditions being examined in the methodology or that ***reasonably accurate adjustments*** can be made to eliminate the effect of any such differences". [1191] Comparability adjustments may include "accounting consistency designed to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions; segmentation of financial data to eliminate significant non-comparable transactions; adjustments for differences in capital, functions, asses, risks" etc.[1192]

Step 9. *Determining the AL remuneration*. If after all previous steps, it is established that the controlled transaction is at AL (price or margin), no adjustment will be imposed. However, if it was established that the price or margin "falls outside the arm's length range asserted by the tax administration, the taxpayer should have the opportunity to present arguments that the conditions of the controlled transaction satisfy the arm's length principle, and that the result falls within the arm's length range" and if the relevant tax administration is unable to established that the transaction

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[1187] All potential comparables are assessed qualitatively as well as quantitatively. ***Qualitative assessment*** is found in product portifolio, business strategies etc. ***Quantitative assessment*** evaluates the "[S]ize criteria in terms of Sales, Assets or Number of Employees. The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability. Intangible-related criteria such as ratio of Net Value of Intangibles/Total Net Assets Value, or ratio of Research and Development (R&D)/Sales where available: they may be used for instance to exclude companies with valuable intangibles or significant R&D activities when the tested party does not use valuable intangible assets nor participate in significant R&D activities. Criteria related to the importance of export sales (Foreign Sales/Total Sales), where relevant. Criteria related to inventories in absolute or relative value, where relevant. Other criteria to exclude third parties that are in particular special situations such as start-up companies, bankrupted companies, etc. when such peculiar situations are obviously not appropriate comparisons." Transfer Pricing Guidelines (n 503) 160.

[1188] Ibid 159.

[1189] Ibid 160.

[1190] Ibid 161.

[1191] Ibid 162.

[1192] Ibid 162.

falls within AL "the tax administration must determine the point within the arm's length range to which it will adjust the condition of the controlled transaction".[1193]

3. Relevant Comparability Factors

The transaction's economic comparability characteristics ***must be assessed according to five factors***: (***i***) *Contractual Terms of the transaction, (**ii**) Functional (performance) analysis, that is, what was the exact contribution of each company, regarding the assets and risks assumed in the transaction (**iii**) What was the transferred property? Tangible, Service or Intangibles?*, (***iv***) *What were the economic circumstances of the parties related to the transaction?* and *lastly, (**v**) What is the business strategy of the companies involved?* The reason for such extent analysis is that if one were to assess the commercial/financial tansaction only according to its contractual terms, companies and tax authorities would probably fail to grasp to a full extent each associated company's contribution to the operation. A complete analysis should cover not only the contracted terms, but also the property to the transaction, the circumstances in which the transaction was carried out etc. [1194]

a. Contractual Terms of the transaction

We will discuss three different situations. On the first one, the agreed contractual terms between the parties correspond to their actual conduct, therefore the relevant contractual terms are sufficient and provide a full TP analysis. The conduct of the parties in the second transaction does not correspond to the actual terms of the contract. And on the third, there is no contract whatsoever.

Situation 1. Subsidiary A located in MS X, fully owned by Parent Company A, resident of MS Y, acts as a agent for PC A in MS X selling its products and marketing its brand in MS X. The contract between PC A and Sub. A does not specify how Sub. A should sell and advertise PC A's products and brand. Nevertheless, Sub. A decided to invest on a major advertising campaign in order to market PC A's products at its own accord. Although the terms of the agreement are not specifically covered (not unusual between associated companies), Sub. A independently covers all costs when advertising the product. Note that the contact's terms do not consist with the exact commercial relation of both undertakings, nevertheless, such transaction could be characterized as a transfer pricing transaction due to the conduct of the parties.[1195]

Situation 2. Subsidiary A located in MS X, fully owned by Parent Company A, resident of MS Y, enter into a contract with Sub. A. PC A in MS X provides Sub A. a license to use its patent, which will be properly compensated by royalties. Nevertheless, PC A enters into other contracts with third-party service providers so that Sub. A, is properly provided with all technical support to perform its business activities with its customers, ultimately demanding that PC A be included in Sub. A's contracts even though the third party service fees are fully

[1193] Transfer Pricing Guidelines (n 503) 165.
[1194] Ibid 46.
[1195] Ibid 48.

payable to Sub A. Note that in this situation, although Sub. A is fully licensed to provided full service to its consumers, it cannot, at least on its own, perform such contracts without PC A.. The risk is indirectly transferred to PC A which becomes also the main service provider.[1196] Although the contractual terms are consistent with commercial relation of the parties, it should not solely be defined according to its terms, but rather on the parties' functions, for the "*risks assumed by the parties are not consistent with the written license agreement.*"[1197]

Situation 3. A third-party provides tech services to Company A. Nonetheless, the third-party also provides services for Company's A Sub A with no additional cost, thus Sub A do not have the cost of such service and therefore do not reimburse it to PC A. Note that, there is no contractual relationship between Sub. A and PC A in respect the that service, nevertheless, the third-party service certainly aggregated some commercial/financial potential benefit, or actual value to its operation. Therefore, PC A also transferred (indirectly) value to Sub A's operation. This third and final example presumes that, despite the fact that no written contract exists, value was added to the Group's operation, which contributes to the fact that assessing only the contractual terms of the transaction are not sufficient to ascertain the commercial and financial relations between associated undertakings.[1198]

b. Functional (performance) analysis, that is, what was the exact contribution of each company, regarding the assets and risks assumed in the transaction

The function (performance) analysis is perhaps the most important factor to be assessed, for it delineates each parties' contribution and responsibility (risk, assets used and business strategy) to the transaction.[1199] The functional analysis will allow a proper evaluation and differentiation of each parties' operation to the product's chain of creation.[1200] A detailed and proper delineation of such risks, assets, strategy etc, will certainly provide an appropriate answer as to whether the transaction is under ALP.

Risk Management[1201] is not the same as ***risk control*** (a investor may enter into an agreement with a fund manager who will manage the fund's day-to-day operations, under a number of predefined contractual rules).[1202] In order to assess whether or not a company has ***control*** over the operation's risk, one must ascertain if the relevant company is (***1***) proprietary of the decision making process, that is, it has the power to decide whether to undertake or to decline a certain risk and if it (***2***) is capable of making decisions which may influence that risk (mitigate or enhance that particular risk). By being able to assume such risks, it is expected that the company responsible for making the decision to have evaluated the potential return of taking such risk. The party responsible for

[1196] Transfer Pricing Guidelines (n 503) 50.
[1197] Ibid 50.
[1198] Ibid 51.
[1199] Ibid 51.
[1200] Ibid 53.
[1201] *CTRL Case (risk management)* (2016) 17 http://www.gsd.harvard.edu/wpcontent/uploads/2016/06/pollalis-case-CTRL-V52.pdf. Accessed in 10 Jan 2018.
[1202] Transfer Pricing Guidelines (n 503) 55.

managing the operation (the risk owner) may also decide to mitigate its risk by dividing it with a third-party that will not be able to manage such risk, but to mitigate it (Company A outsources its quality control to Company B). Therefore, ***risk mitigation*** is ***NOT*** an assessment tool to evaluate whether of not the company is entitled to manage risk, but evaluates whether or not the company has ***control*** over that risk.[1203] Undertakings may also take financial risks when financing its operation (***equity*** *or* ***debt)***, for instance, Company A may enter into an agreement with its Sub A, where Company A will finance the operation of Sub A by exploiting the rights of an income-generating intangible – *equity* – Company A issues debentures in order to raise capital to finance Sub A's operation - *debt*. Note that in either case, Company A is merely financing Sub A's operation, whereas the commercial risk remains under Sub A's authority. [1204] By adding a third element to risk assessment, namely, (***3***) the capability to mitigate risk in such a way that the company is able to influence the outcome of a transaction, the company goes up a step, now it does not only control risk, but has the ***power to manage it***.

That are a number of different definitions for risk according to area of study, nevertheless, as far as transfer pricing is concerned, risk can classified as the effect of uncertainty in respect to business planning. One can find some definitions of risk in the *European International Contractor*'s white book.[1205] Although the EIC's white book presents only risks related to that industry, one can apply such risks to other industries, regardless the party status (private or public). The book provides for: (***i***) public risks; (***ii***) financial risks; (***iii***) marketplace risks; (***iv***)construction risks; (***v***) infrastructure and operational risks, (***vi***) environmental risks, (***vii***) revaluation risks and (***viii***) hazard risks.

According to *Marcos Barbosa Pinto*, contractual risks should be allocated according to the following criteria: (***i***) Risks should be allocated according the party's ability to deal with such risk. Who is likely to provide the more efficient solution to the problem, at the lowest possible cost? (***ii***) Risks should be allocated according to the party's ability to transfer that risk at the lowest possible cost, (***iii***) Risks should be allocated according the lowest possible insurance price (in Public-privat Partnerships (PPP) [1206] if the insurance costs are lower from the State's level, the risk should be allocated with the State, if not, with the private party) and lastly, (***iv***) the Risk should be allocated to the party that is more likely to experience such risks.[1207]This part of the study will define such risks.

[1203] Transfer Pricing Guidelines (n 503) 56.
[1204] Transfer Pricing Guidelines (n 503) 56.
[1205] *European International Contractors. EIC white book on BOT/PPP*. Berlin (2003). 21. https://www.yumpu.com/en/document/view/4788248/eic-white-book-on-bot-ppp-european-international-contractors. Accessed in 10 Jan 2018.
[1206] Öffentlich-private Partnerschaft (ÖPP).
[1207] Marcos Barbosa Filho. *Repatriacao de Riscos nas Parcerias Publico-Privadas*. Revista do BNDS, Rio de Janeiro, V.13, N. 25, P. 155-182, Jun. (2006). 168. https://web.bndes.gov.br/bib/jspui/bitstream/1408/10056/1/RB%2025%20Repartição%20de%20Riscos%20nas%20Parcerias%20Público-Privadas_P_BD.pdf.

c. Public risks

Public risks are generally connected to the country in which the associated undertaking operates (political instability, judicial and regulatory uncertainties). In still developing economies, political risks may pose greater concern than in more develop countries. In 2006 Evo Morale's Bolivia nationalized its oil and gas industry for the third time in 70 years. Companies such as Repsol YPF, Petrobras and British Petroleum (BP) lost billions of dollars of investments.[1208] Judicial insecurity risks are also relevant and must be account for in business operations. The effect of government policies may also create uncertainties to the operation, for instance, a country may impose upon an undertaking price control on a certain good (oil and gas), thus influencing the final price of that good. Moreover, governments may also also intervene in such a way to prevent the relevant undertaking from transferring income to its parent company located in another MS. This last situation was exactly what occurred recently in Venezuela, when the administration of that State imposed restrictions when transfering profits (royalties, interest, dividends etc) on MNEs, which ultimately closed their operations in that State due to lack of political and economical security [1209] (Kimberly-Clark, Harvest Natural Resources, Bridgestone Corp., General Mills, General Motors, Proctor & Gamble and others).

d. Economic and Financial risks

Financial risks influences the undertaking's ability to "*manage its liquidity and cash flow, financial capacity and creditworthiness*" (microeconomic perspective).[1210] Alternatively, the company's financial health may be influenced by currency variations (inflation and foreign currency exchange),[1211] economic shocks and credit crises etc (macroeconomic perspective). In sum, financial and economic risks may be a result of inadequate regulations and weak policies, expensive financing conditions due to the operation's high risk and poor domestic capital markets which are not able to provide a long term finance plans.[1212]

[1208] Carin Zissis. *Bolivia's Nationalization of Oil and Gas.* (2006) https://www.cfr.org/backgrounder/bolivias-nationalization-oil-and-gas. Accessed in 10 Jan 2018.

[1209] Clifford Krauss, Nicholas Casey, Bill Vlasic. *Amid Venezuela Protests, G.M. Plant is seized, and Company Exits.* (2017) https://www.nytimes.com/2017/04/20/business/venezuela-general-motors-business-protests.html?mcubz=1. Accessed in 10 Jan 2018.

[1210] Transfer Pricing Guidelines (n 503) 61.

[1211] Currency variations risks cannot be underestimated. Before 1999 Brazil applied a fixed exchange rate against its *peg* (dollar). In 1998, Russia's economic crisis (mainly caused by political instability, weak tax administration and institutions) caused a great capital flight from Brazil, which ultimately lowered its dollar reserves. The *pegged exchange rate* could no longer be applied by the State, obliging Brazilian Government to abandon the system. Companies that had debts in dollars saw their liability abruptly increase overnight (at that time, Russia was a young "*democracy*" and had to build its legal, political and economical institutions "*from scratch*" after the collapse of Mikhail Gorbachev's Soviet Union in 1991).

[1212] European International Contractors (n 1205) 21.

e. Market risks

Risks caused by entities other than the company itself (economic, environment, political, competition, technological advance etc).[1213] Potential risks on foreseeing demand risks fall under this category. The Channel Tunnel Rail Link project[1214](CTRL) was procured under a Build-operate-transfer (BOT) concession contract due to its high value (projected cost of 5.2 billion pounds and its costs surpassed the 80% of that figure).[1215] The most important term of the concession was the ownership of Eurostar UK Limited (before Eurostar, Union Railways operated the concession). The company managing the CTRL operation failed to foresee the competition risks against low cost sea transportations. After five (5) years of active operating the line, the train transported only 45% of BOT's suggested studies. [1216] The final cost of Denver's (USA) airport which ultimately opened in 1995, also surpassed 200% the initial forecast of 5 billion dollars and passenger traffic at the opening years did not reach half of the projected number.[1217]

f. Construction risks

Construction risks are basically geologically related, and if not properly assessed may delay the conclusion of the deliverable, therefore imposing upon the undertaking extra costs to its operation. Construction contracts are generally considered as a high risk operation due to its high value. Securities play a major role in mitigating such risks (*bid bonds*, *maintenance bonds*, *completion bonds* and *insurance* are guarantees commonly imposed by parties upon contracting such operations). [1218]

[1213] Transfer Pricing Guidelines (n 503) 61.

[1214] The project created a new rail line connecting London to the Channel Tunnel, and Paris.

[1215] Bent Flyvbjerg, Nils Bruzelius. *Megaprojects and Risk: An Anatomy of Ambition*. Cambrigde University Press (2003) 3.

[1216] Kleber Luiz Zanchin. *Contratos de Parceria Publico-Privada (PPP): Risco e Incerteza*. Sao Paulo: Quartier Latin (2012). 115.

[1217] Bent Flyvbjerg, Nils Bruzelius (n 1215) 3.

[1218] Adding securities to the transaction also mitigates risks, for example, by adding ***bid bonds*** (collateral used in construction contracts – tender contracts – before the contract is signed or executed) the contractor mitigates the risk of the contractee not signing the construction contract after winning the tender (lack of capital, change in business strategy etc), by adding ***advanced payment bonds*** (guarantee of payment against default – down payment) the contractor certifies that the contractual obligation is performed, by adding ***performance bonds*** (guarantee that the contract will be properly performed, if not, properly compensated by a third party – bank, insurer etc) the contractor is compensated if the other party does not perform/conclude the contract, by adding ***maintenance bonds*** (generally used by real-state developers in order to guarantee the quality of the goods and services) the contractor is properly compensated if the product's standards are bellow average, by adding ***retention payment bonds*** (in the event of a default of the contractee – often a percentage of the contract's economic value) the contractor retain fees paid in advanced in case the other party fails to perform, by adding ***completion bonds*** (generally applied in *Project Finance* - long-term complex finance structured projects, where cash flow is used instead of balance sheet etc - guarantee that the project will be delivered according to contractual terms) the contractor mitigates the risk of delays due to high complexity, finance etc, by adding ***insurance*** (third-party guarantee due to eventual economic loss) the contractor mitigates possible potential losses due to default. Wanderley Martins. *Contratos empresarias: fundamentos e principios dos contratos empresarias*. 2 ed. Sao Paulo. Saraiva, (2012) 469.

g. Operational and Maintenance risks

The risk of an enterprise not executing its operation properly will ultimately influence its market capitalization. For example, not bringing a certain product to market on time, being unable to meet demands or producing products or providing services bellow acceptable standards, will definitely enhance the company's ability to generate income. On the other hand, timely decisions as well as better quality control is likely to reduce such risk and enhance the company's marketable reputation.[1219] Infrastructure risks are generally not related to the undertaking's operation, but to external factors that may compromise the company's performing ability (organic laws which prohibits the transport of heavy trucks in certain times of the day, outsource companies failing to provide its deliverables in time, strikes etc).

h. Environmental risks

Contrary to construction risks (generally geologically related) environmental risks are a result of the company's operations in that particular area (wind turbines – the turbine sails may hit migrating birds that seek food and flight predators, thus contributing to their demise considering that certain species of birds are constantly migrating,[1220] renewable energy - fossil and nuclear (Chernobyl disaster),[1221] the intervention of south American natives in power stations sites, for example, are not uncommon (the Belo Monte Dam, planned to be fully operational by 2019, is constantly being targeted by such groups).[1222]

i. Price Elasticity[1223] risks

Price elasticity risks (PER) are intimately related to the consumer's ability in purchasing a product, or accepting the cost of a service (PPP or BOT).[1224] Changes on the price of a product will influence the gross profit and

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[1219] Transfer Pricing Guidelines (n 503) 61.

[1220] Between 1989 and 1990, 32 birds were killed by wind turbines. In 1993, the Spanish government authorities approved the construction of 269 wind turbines in areas where birds were constantly migrating through. By failing to foresee such impact, the turbines caused the death of hundreds of birds in that area. Ricardo Terciote. *A energia aeolica e o meio ambiente*. Thesis University of Campinas – Unicamp. http://www.proceedings.scielo.br/scielo.php?pid=MSC0000000022002000100002&script=sci_arttext. Accessed in 10 Jan 2018.

[1221] Nuclear disaster (April 1986) occurred in the Ukranian Soviet Socialist Republic during the simulation of a power-failure, when all safety systems were intentionally disabled causing the death of approximately 27000 people due to radiation exposure.

[1222] *Indios mantem funcionarios da usina de Belo Monte em aldeia no Para*. (2016). http://g1.globo.com/pa/para/noticia/2016/03/indios-impedem-funcionarios-de-belo-monte-de-sair-de-aldeia-no-para.html. Accessed in 10 Jan 2018.

[1223] The theory of consumer choice and demand, studies the relationship between the price of a good and consumer's tastes. ***Demand Price elasticity*** measures how consumer choice reacts to possible price variations ("the more substitutes for the good, the greater the elasticity on demand; the fewer the substitutes, the lower the elasticity"). Robert Cooter and Thomas Unlen (n 15) 26.

[1224] European International Contractors (n 1205) 20.

consequently the operation's risks. In 1999 the South African province of KwaZulu-Natal, signed a 30 year concession contract with Siza Water Company (Siza) to restructure sanitation services in that region. Although the services improved the standard of living (*Lebensstandard*) in the area (water treatment, sewer system), it had also increased the service's price, which was transferred to the final consumer, who were unable to pay the 119% increase.[1225]

j. Hazard risks

Hazard risks are mainly caused by external events that may result in potential (or actual) damages and losses (*force majoure* - natural disasters).[1226]

4. Contractual Risk Analysis (CRA) and Functional Risk Analysis (FRA)

Contractual analysis. Associated companies may assume risks by entering into *ex ante* agreements where each enterprises will, beforehand, delineate the amount of risk is prepared to undertake. Such agreement may (or not) specifically state each party's liability to the transaction. Although tax administrations will analyse such contracts when assessing transfer pricing transactions, authorities will not limit themselves to such contracts, for sometimes contractual pricing arrangements alone do not reflect the extent of the actual contribution of a particular party (*contractual risk assessment* must go hand-in-hand with *functional risk assessment*).[1227] A proper risk assessment should comprise both approaches, namely, the contractual as well as the conduct (generally associated with the management and control of the relevant risk, the ability to mitigate its occurrence and finally, having the financial capacity to assume such risk independently).

Functional analysis. When conducting a function analysis, tax authorities and companies assess the conduct of the relevant undertaking in relation to the risk, that is to say, how the associated company deal with such risk. At this phase of the assessment questions such as: *Does the associated company acts in such a way in which is able to* ***control risk***? *Does the associated company have* ***managing powers over the risk/operation***? *Which associated company is able to* ***mitigate such risk***? And most importantly, *which enterprise* ***has financial control*** *as well as* ***financial capacity*** *over that risk*? By answering these questions the *assessor* will be able to ascertain ***materially*** the party's contribution to the operation. The OECD and the World Bank Group recently presented a study addressing the difficulties in assessing comparables for transfer pricing purposes, thus providing a general (practical) guidance on how tax authorities (and parties) should approach the matter.[1228] Such study

[1225] Peter Farlam. *Assessing public-private partnerships in Afric*a. South African Institute of International Affairs, Nepal Policy Focus Report n 2, 2005. 21. https://www.oecd.org/investment/investmentfordevelopment/34867724.pdf. Accessed in 10 Jan 2018.

[1226] Transfer Pricing Guidelines (n 503) 61.

[1227] Ibid 64.

[1228] The Platform for Collaboration on Tax. Discussion Draft: A toolkit for Addressing Difficulties in Accessing Comparables Date for Transfer Pricing Analysis. Feedback period 24 January 2017 to 21. February (2017). http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf.

presented a non-exhaustive list of questions in order to better understand the relationship of the "*various functions, risks, and intangibles*" [1229] in TP instances.[1230]

5. CR and FR Cross-Examination

Cross-Examination. When cross-examining, companies and tax authorities will interpret (subsume) the contract's terms regarding risk allocation and the actual conduct of the companies towards the relevant risk. In other words, the full extent of the parties' relationship to the risk will be assessed. As previously studied, sometimes the contract itself is not sufficient for a full conclusion to be drawn. Moreover, associated companies may not even enter into written contracts, thus it is left to tax authorities to assess the actual contribution of each company to the risk, verifying whether the party assuming the risk, exercises control over such risk and if it has financial capacity to assume such risk.

[1229] The Platform for Collaboration on Tax (n 1228) 84.

[1230] The study separates the questions according to the undertaking's business functions in the following order: (***1***) ***Analysis of Functions***: ***I. Manufacturing*** (materials purchased, inventory, production equipment, production scheduling, manufacturing and process engineering, package and labelling, quality control, shipping of products – What materials or partly finished goods are purchased? Where the inventory is held? Who determines the purchasing budget? Who is responsible for production scheduling decisions? What products are produced? What package and labelling is done? Who performs the quality control and who bears the costs? Who pays freight shares for product in and out?); ***II. R&D*** (What research and development activites does the company carry out?); ***III. Marketing*** (strategic, advertising, trade shows – Does the company carry out its own marketing? What forms of marketing does the company utilize?); ***IV. Sales and Distribution*** (sales, quality control, freight, inventory, installation and after-sales services – How are sales made and who is involved? What forms does quality control take? Who is responsible for shipping deadlines? Where the stock is held? Does the company install its products?); ***V. Administration and other services*** (general administration, pricing policy, accounting, legal, computer processing, finance/loans/credit, personnel, use of property/leasing – Is there a complete administration function? Who determines the products pricing? What accounting functions are carried out? By whom? Who is responsible for legal matters? Is computer processing and programming done in the company's premises? If not, by whom and where*?* Are there any intercompany loans or long terms receivables and, if so, is interest charged? Are there any compensation to or from overseas affiliates? Is property owned or leased from affiliates?); **VI.** ***Executive*** (To whom does the general manager report to?). (***2***) ***Risks Analysis***: ***I. Market risks*** (What are the market risks?), ***II. Inventory risk*** (Does inventory become obsolete?*),* ***III. Credit and bad debt risk*** (What credit terms are given and received*?),* ***IV. Foreign exchange risk*** (Are the company exposed to foreign risk? If so, explain the risks). (***3***) ***Analysis of Intangibles***: ***I. Manufacturing*** (R&D, manufacturing processing/technological know-how, trademarks/patents etc, product quality, other – Has the company developed any of its own products? Are they unique? Does the company possess technological know-how? Does the company own any trademarks/patents? Within the company' industry, and competition wise, how would the company rate the quality of its product? Are there any other manufacturing intangibles?*);* ***II. Marketing*** (trademarks/trade names, corporate reputation, developed marketing organization, ability to provide service to customers – Does the company own its trademarks/trade names? Does the company considers having a corporate reputation? Does the company have a developed marketing organization? Within company's industry, and comparing to its competitors, how would the company rate the quality of the services it provides to customers?). The Platform for Collaboration on Tax (n 1228) 84.

6. Risk Distribution

If after cross-examining the transaction's CR and FR, there is still doubt as to what was agreed between the associated enterprises, one must then analyse all relevant economic evidences of the transaction, that is to say, when it is not possible to clearly ascertain which company controls the risks and has the necessary financial capacity in order to control the risk, further analysis will be conducted. In case multiple enterprises have control over the risk as well as financial capacity, tax authorities will assume that the company that has the most control over the transaction (management) will be entitled the main controller of that risk, whereas the other party with the least control over the relevant risk must be compensated appropriately. Alternatively, if the company's compensation with the least control is assumed to be disproportional, tax authorities certainly will adjust the transaction's price in such a way that the company which bares the most risk will eventually be entitled to larger share of income generated by the asset. [1231]

7. Price Adjustment

Adjusting the transaction's price is the last step of the process, for it is expected that tax authorities (and undertakings), have already: ***1.*** conducted a proper risk analysis of the relevant operation, ***2.*** scrutinized the contract's terms (if any) in order to ascertain that the parties who have assumed the risks have in fact acted as such and ***3.*** cross-analysed the contract and the function of the undertaking's involved in order to ascertain whether the contract's terms correspond to the actual conduct of the parties. If the contract's terms are in tune with their functions, the transaction's price will be considered at arm's length and no other test will conducted. Nevertheless, if after such analysis it is still not clear whether (***i***) the associated enterprises followed the contractual terms and whether (***ii***) the party assuming the risk exercises control over that risk, although it is not required the undertaking to perform a day-to-day mitigation of the risk ***in order to control the risk*** (the company must be able to constantly assess whether the objectives related to the risk are being adequately met) and whether the company has (***iii***) financial capacity over the risk, ***4.*** further analysis will be conducted in in order to verify each company's contribution to that particular risk, for the higher the risk, the higher the financial return in relation to that risk. The steps of a functional analysis are described bellow.

(1) Identify the operation's risks (*external risks* – political instability, judicial, regulatory, competition, economic environment, geological, environmental etc, or *internal risks* – operational, maintenance, cash flow, liquidity etc).
(2) Contract identification (CRA). Identify the contracted risks.
(3) Functional Risk Analysis. Identify the actual parties' conducts in relation to that risk.
(4) Cross-examination. Compare whether the contracted risk is in tune with the actual functon.

[1231] Transfer Pricing Guidelines (n 503) 70.

(5) Risk allocation assessed according to each party's contribution.
(6) Price adjustment.

For that matter, we will provide two examples. In the ***first*** example the associated enterprises' conduct will be in tune with the written contract. In second example, the contract's terms do not reflect both enterprises' functions in respect to the "*management of the specific, economically significant risks*".[1232]

a. Assessment 1

Company B (subsidiary) produces a certain good for Company A. The production's costs are all allocated to Company A. Nonetheless, Company B was hired by Company A to build a factory and buy all the necessary equipment in order to produce that good, in such a way that the product is manufactured according to the technical designs provided by Company A, the same Company entitled to control the good's quality and to run the control checks on the product's manufacturing process. Although Company B must comply carefully with its contractual obligations in maintaining the product's standard, Company A mitigates the risk by performing regularly quality checks on Company's B line of production, that is to say, it has total control over its Subsidiary, namely, Company B. Company A also provides for the exact number of units that need be produced according to its own market studies and business strategy. Company B has control over the risk and provide Company A market information that will eventually be used in future business strategies. Both Companies exercise control over the risk and have financial capacity.

Figure 14



1. *Risk identification.* According to the case stem, Company A has to provide for the financial risks of the operation (cash flow, liquidity risks and maintenance) as well as for business strategy (economic environment, competition). Company B, must manage maintenance risks as well as operational risks.
2. *Contract identification (CRA)*. According to the contract's terms, Company A will provide the necessary funds for the operation and conduct quality checks whereas Company B will manage the operation itself, that is, control risks related to its day-to-day operation.
3. *Functional Analysis.* When assessing the actual parties' conduct in respect to the risks taken, the relevant tax authority concludes that both companies control the risk and manage the operation on a regular basis, that is to say, the quality control is managed by both undertakings. Moreover, the relevant tax authority assume that both undertakings are

[1232] Transfer Pricing Guidelines (n 503) 64.

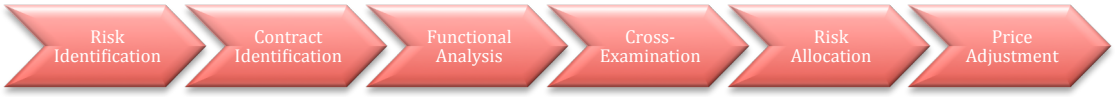
financially capable, although Company A mitigates the risk with periodical quality control checks.

4. *Cross-examination* (*CRA x FRA*). When cross-examining the parties' relationship to the transaction, it is concluded that the contractual risk assumed is consistent to that of the actual operation's risks. In other words, both parties have assumed contractual risks consistent to the perform function and also both companies exercises control over the risk and have the financial capacity to assume such risk.
5. *Conclusion.* Note that both companies have an equal amount of liability in relation to the risk, both are economically independent, although Company A mitigates the risks, thus it must be appropriately compensated.

b. Assessment 2

A MNE comprised by Company Y (located in high tax jurisdiction State A) and its fully owned Subsidiary X (located in a low tax jurisdiction State B), enters into an contract to develop a certain patent which is expected to generate future income to the Group. Under such contract Company Y will provide the funding and the know-how, whereas Subsidiary X will provide labour and fully manage the patent's development. According to the contract R&D contract, Subsidiary X is obliged to present a semestral report to Company Y, in order to demonstrate the exact costs realized and alternatively, that the time schedule regarding the patent's development is properly followed. Sub. X fails to properly provide the report to Company Y according to the contract's terms and do not control the patent's risk fully. Company X expects to complete the deliverable within a 5 year period, at an expected cost of 100 million euros per year (funded by Company Y). When finalized, the patent will be fully owned by Company Y, which will licence the patent to Subsidiary X that will schedule a payment plan for the right to use the patent (royalty). The patent has a potential to generate a 500 million euros profit per year for 10 years after the deliverable's completion. Subsidiary X anticipated return on the license amounts to 400 million euros per year till the end of the patent's useful life.

Figure 15



a *Risk identification.* The operation's risks are identify (external risks – political instability, judicial, regulatory, competition, economic environment, geological, environmental etc, or internal risks – operational, maintenance, cash flow, liquidity etc). We are not adding any other substantial risks to the operation for the sake of simplicity, nevertheless, if Subsidiary X (the patent's developer) is located in a politically instable country, or in a country prone to environmental risks that could compromise its ability to fully

develop the patent, such uncertainties will certainly be considered and properly priced by tax authorities.

b *Contract identification (CRA).* When examining the contract, the relevant tax authority assessed that Company Y would provide the necessary funding to the operation and the "*know-how*" to fully develop the patent. Although the relevant tax authority assessed that the cost driver [1233] (product costs and manufacturing costs)[1234] is allocated with Company Y, Subsidiary X must provide for its own fixed costs (rent), and all other costs related to the operation in that country not directly involved with the patent's development (assuming that Subsidiary X is not a pre-operational undertaking, therefore, it has other sources of income).

c *Functional Analysis (FRA).* When conducting a function analysis, tax authorities (or undertakings), assess the parties' conducts in relation to the relevant risk, for instance, which enterprise has financial control or/and managerial powers over the risk and if the companies are financially independent. The case stem provides that Company Y has financial control in relation to the patent that is being developed, for it receives semestral reports from its Subsidiary regarding the intangible's development, such as time schedule, costs etc, thus Company Y is able to control and mitigate the risks during the intangible's development phase. Subsidiary X is neither capable to assess the market risks during the development phase of the intangible (liquidity of Company Y), nor after the development phase (competition risks, operational risks etc). Nevertheless, Subsidiary X manages the patent's development and it is financially independent from Company Y. Subsidiary X's fixed costs (rent and other costs not related to the patent) are not be paid by Company Y.

d *Cross-examination* (*CRA x FRA*). Company Y has financial control over the patent's development as well as financial capacity whereas Subsidiary X do not have such financial control over the risk (although it is not required to undertakings to perform a day-to-day risk mitigation in order to control risk, the company must be able to constantly assess that the objectives related to that risk are being adequately met).[1235] Nevertheless, Sub. X has other sources of income, thus Sub. X has ***limited*** financial capacity. Subsidiary X is also able to manage the patent's development.

[1233] *Cost driver* or *activity base* is what gives *birth* to the costs, in this case, the patent's development.

[1234] *Product costs* or *manufacturing costs* are all costs related to the production of the good, divided according to the following criteria: *Direct materials*: materials that eventually become part of the finished product and can be easily traced to the finish product. *Direct labour*: labour costs that can be easily traced to the finish product. *Manufacturing overhead* (taxes, depreciation, utilities, insurance etc): all manufacturing costs related to keeping the production facilities and production process operating (*except* direct materials and direct labour). Examples of manufacturing overhead are: *indirect materials* and *indirect labour* (materials and labour that is not easily traced back to the final product – wages of a night security guard of a factory, the supervisor's wage of a factory's production line).

[1235] Transfer Pricing Guidelines (n 503) 56.

According to the contract's terms, Sub. X must provide a semestral report regarding the patent's development and costs, and eventually, failed to provide such report. Note that the companies' conducts are distinct from those properly specified in the written contract, therefore the contractual risks assumed by the associated enterprises are distinct from their actions. Had Subsidiary X:

(i) *followed the exact contractual terms*: presented the report on a six month basis;
(ii) *no control over the risk whatsoever*: presumably, Sub. X has some control over the risk for it did not provide its cost report to Company Y; and
(iii) *no financial capacity*: the fact that Sub. X has other sources of income, compromises the idea of Sub. X being fully dependent of Parent Company;

no further analysis would be conducted. In other words, where the parties' conduct conforms to the assumption of risk contained in the written contracts, the transaction would considered under arm's length. Nevertheless, since Subsidiary X ***do have*** financial capacity, and ***apparently*** has some control over the risk (patent), further analysis need be conducted. The fact is that, "where there is doubt as to what transaction was agreed between the associated enterprises, it is necessary to take into account all relevant evidence from the economically relevant characteristics of the transaction."[1236]

(iv) *Risk Allocation.* Although Subsidiary X exercises some control over the risk, and has also financial capacity, the risk should be allocated to Company Y that has full control ***over the relevant risk*** as well as financial capacity. Given the fact that Company Y has financial control and capacity over that risk, the relevant tax administration determines that the operation should be risk adjusted.
(v) *Price Adjustment.* During those 10 years of usable life of the intangible, assume that the risk should be adjusted according to the Subsidiary's contribution to the project (risk management). In this case, Subsidiary X would be entitled to, say 20% regarding administrative costs (100 million euros per year). According to the case stem, the anticipated result of the intangible amounts to 500 million euros per year. Company Y's anticipated return should amount to 400 million euros instead of 100 million euros (500-100), whereas Subsidiary X's anticipated return should amount to 100 million euros per year instead of 400 millions as previously anticipated.

[1236] Ibid 49.

(vi) *Conclusion*. Note that the price was adjusted according to the each company's contribution to the product's chain of creation. At the beginning of the case, we have mentioned that Company Y was located in a high tax jurisdiction, whereas Subsidiary X is located in a low tax jurisdiction. By adjusting the transaction's price, the respective tax authority where Company Y resides (State A – high tax jurisdiction) increased its taxable base, thus its revenue (considering that both jurisdictions agreed to the price adjustment). In sum, a detailed cross-examination between the transaction's CRA and the FRA redefined the operation's pricing.

Commercial opportunities and risk "affects the profit potential of that opportunity in the open market, and the allocation of risks assumed between the parties to the arrangement affects how profits or losses resulting from the transaction are allocated at arm's length through the pricing of the transaction. Therefore, in making comparisons between ***controlled*** and ***uncontrolled transactions*** and between ***controlled*** and ***uncontrolled parties*** it is necessary to analyse want risks have been assumed, what functions are performed that related to or affect the assumption or impact of these risks and which party or parties to the transaction assume these risks."[1237]

8. What was the transferred property? Tangible, Services or Intangibles?

It is fair to say that the product's characteristics and its functionality will determine its market value, moreover, such characteristics are fundamental in transfer pricing instances for they provide a basis for valuating the transaction, which ultimately will dictate the costs incurred by each associated enterprise in relation to the assumed risk. The quality and quantity of the product must also be assessed for they have direct influence on its final price (***tangibles***: physical features, availability, volume; ***services***: nature of the services; ***intangibles***: form of licencing, type of property, duration and degree of protection – patent, trademark etc).[1238] In sum, by properly assessing the product's price, one will be able to find a more reliable comparable price in the open market. This is particularly important when comparing the uncontrolled transaction's price to that of controlled transaction.[1239] As will be properly studied in other parts of this investigation, there are a number of approaches one could use when assessing controlled transactions, for instance, depending on the TP method, the product's characteristics will a higher influence on the transaction's price (under CUP,[1240] substantial differences in products' characteristics are more likely to affect its price, whereas under *resale price method* or *cost-plus method*, the

[1237] Transfer Pricing Guidelines (n 503) 53.
[1238] Transfer Pricing Guidelines (n 503) 73.
[1239] Ibid 73.
[1240] Comparable Uncontrolled Price Method (CUP).

product's features will have a much lower influence on its price).[1241] According to the OECD TP Guidelines "(…) it has been observed that comparability analysis for methods based on ***gross*** or ***net profits indicators*** often put more emphasis on ***functional analysis than on product similarities***."[1242]

9. What were the economic circumstances of the parties related to the transaction?

Economic risks may compromise the enterprises's ability to product goods or provide services, therefore when assessing comparable transactions tax authorities must consider the economic environment where the relevant undertaking operates. Economic circumstances may present ***internal risks*** (group synergies)[1243] as well as ***external risk factors*** (geographic location,[1244] special market features,[1245] political instability, competition, substitutive goods and services etc).[1246] After considering such uncertainties, tax authorities will, if necessary, adjust the transaction's risk, consequently, price.

[1241] The product's characteristics (services or tangibles) are less prone to price adjustments in respect to traditional transaction methods. Transfer Pricing Guidelines (n 503) 74.

[1242] Ibid 74.

[1243] ***Group synergies*** may influence the transaction's price, therefore comparability issues may arise, for instace, MNEs may combine purchasing power (bundled purchases), benefit from lower interest rates either due to intra-group loan or securities provided by other group members thus enhancing the borrower's credit score. Synergies may also lead to negative effect on prices ("size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of the group wide standars established by the MNE group"). Transfer Pricing Guidelines (n 503) 90.

[1244] Geographic location can in some cases lead to costs savings. MNEs many decide to relocate its operations (business strategy, group restructurings etc) to a place where costs such as labour, real estate etc, are lower. Tax authorities are likely to evaluate the treatment of such ***location savings*** in the context of a business restructuring as well as in any other relevant comparable context, especially if the cost savings are not passed on to the final consumer. Here, a functional analysis will certainly provide an answer to whether "location savings should be allocated amongst two or more associated enterprises". Nonetheless, ***when assessing location savings*** due to merger, group restructurings etc, tax authorities are likely to analyse the following criteria: (***i***) whether there are any costs savings; (***ii***) the total amount of such savings; (***iii***) if such savings are retained by the group or passed on to consumers (more competitive prices or higher prices) and; (***iv***) if not passed on to the consumers, how would an independent undertaking operate under similar circumstances (new investments on technology, enhancing output, pay higher dividends etc). State aid should also be included in the assessment pool conducted by the relevant tax authority, for it also influences the final product's price. Transfer Pricing Guidelines (n 503) 85.

[1245] Special ***market features*** are likely to influence the final price of a product, and consequently, the arm's length price. Examples of such transactions are: purchasing power of consumers, product preference, competition, the country's infrastructure (production, logistics), ***assembled workforce*** (being able to identify the benefits that a particular group of employees contribute to the operation *per se,* will also influence differences in price – *known-how*, *secret formula* and other *intangibles* -, it is assumed that comparability adjustments "may be made to reflect the impact of the assembled work force on arm's length prices for goods or services") or even if the relevant country requires a special regulatory license to operate (or a renew of such license) Such features will also affect the product's price. When analysing market characteristics, tax authorities will assess such activity in the same manner (criteria) as in ***locations savings*** (see previous citation). Transfer Pricing Guidelines (n 503) 85.

[1246] "The ***geographical market*** is another economic circumstance that should be identified. The identification of the relevant market is a factual question. For a number of industries, large

10. What is the business strategy of the companies involved?

The business plan will also be examined by tax authorities when assessing the transaction's comparability. Within this category, one should consider the product itself, product diversification, innovation, market penetration[1247] etc. Nonetheless, tax authorities tend to conduct a more thorough investigation when the relevant undertaking temporarily reduces prices in order to maximize profits in a long-run. Consider the following, a parent company located in a MS manufactures and sells a certain product at lower price to an exclusive distributer located in another MS. The distributer will be able to charge a lower price to the final consumer due to its cost savings. Nevertheless, the purpose of the relationship between the parties to the controlled transaction should be consistent with the taxpayer bearing the strategy's costs (producer), that is to say, had the product's distributor no part whatsoever in the group's long-term business plan (a sales agent for example), tax administrations generally would not consider the distributer capable of carrying such costs, and eventually, some adjustment would be necessary.[1248] Again, tax authorities will conduct a functional analysis in order to ascertain the exact role the associate enterprise played within the group's business strategy. To conclude, losses are a common enough factor of business life, companies may realize losses upon penetrating a new market (start-up losses), or even realize losses due to a failed business strategy, nevertheless, when a company continuously realize losses in a MS to a figure that surpasses what an independent enterprise would endure, then the "arm's length nature of the business strategy may be doubtful and may warrant a transfer pricing adjustment".[1249] A rather doubtful business strategy has been recently questioned in the *Public Accounts Select Committee Proceedings* regarding *Startbucks*' operation in the UK. The purpose of the proceedings was to understand why the company maintained its operations in the UK since it realized losses for the 10th year in a roll. Such a conduct may be characterized as abusive (TP exploitation).[1250] The Committee ***did not question the legality of***

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regional markets encompassing more than one country may prove to be reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) are very significant." Transfer Pricing Guidelines (n 503) 75.

[1247] Market penetration must be carefully assessed due to the fact that initially, under such schemes, undertakings may temporarily lower their prices on comparable (competitive products) in order to increase its market share. Generally, upon penetrating a new market, it is expected that companies to cope with higher costs than its competitors (star-up costs). Nevertheless, some MSs provide tax incentives in relation to start-up undertakings.

[1248] Transfer Pricing Guidelines (n 503) 76.

[1249] According the TP Guidelines "In determining what period of time an independent enterprise would accept, tax administrations may wish to consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued. (…) the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within a foreseeable future (recognizing that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions." Transfer Pricing Guidelines (n 503) 76.

[1250] The TP Guidelines sheds some light on the matter by stating that "(…) an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole". One must also consider that some MNEs produce a variety of products in various jurisdictions, and economic efficiency may eventually demand the Group to maintain a

the scheme (losses), but its morality, due to the fact that the company benefited from millions of euros in deductions.

11. Transaction Recognition and Irrational Transactions

As previously mentioned, when controlled and uncontroled comparable transactions between controlled and uncontrolled parties in comparable circumstances are recognizable, tax authorities should recognize the transaction under arm's length. Nevertheless, the fact that the relevant tax authority could not find a comparable transaction, do not necessarily mean that the transaction is non-recognizable. One has to assume that associated enterprises are considerably more flexible than independent enterprises when dealing with each other. Moreover, the transaction's complexity does not necessarily suggest that the transaction is not under arm's length.[1251] It is important to consider that a non-recognized TP transaction is likely to produce negative effects to the companies involved, such as risk of high adjustments, potential double taxation, penalties and interest, impact on the Group's financial report, deleterious impacts to the Group's reputation as well as to its shareholders, thus every possible effort should be made to ascertain the actual transaction's nature and apply the ALP as accurately as possible. Needless to say, the best possible outcome to a TP transaction is (***i***) no or minimal adjustments, (***ii***) no double taxation, (***iii***) no interest and (***iv***) no penalties. The most important point when finding comparables is ascertaining the transaction's ***commercial rationallity*** to the extent it is assumed that the transaction would be agreed upon between unrelated enterprises under comparable economic circumstances, and not necessarily finding ***an equal*** transaction.[1252]

The transaction's financial and commercial rationality dictates whether the transaction will be deemed as (un)recognized. Consider the following, Company A initiates a research process in order to create an intangible which will potentially generate income. Company A contractually agrees to transfer the intangible to its Subsidiary which will have full rights over the property for an unlimited period of time which it will pay ***x***. Note, due to lack of data on the intangible's future benefits, the agreement is commercially irrational, for neither Company A, nor its Sub. know the exact commercial potential of such intangible. Therefore, this transaction will be deemed as irrational, unrecognizable and eventually subjected to adjustments.[1253]

"Tax administrations should not accept especially low prices (e.g. pricing at marginal cost in a situation of underemployed production capacities) as arm's length prices unless independent enterprises could be expected to have determined prices in a comparable manner."[1254]

deficitary operation (a member of the group might realize losses for it produces all loss-making products, whilst other members produce profit-making products). Transfer Pricing Guidelines (n 503) 81.

[1251] Ibid 78.

[1252] Ibid 79.

[1253] Transfer Pricing Guidelines (n 503) 80.

[1254] Ibid 81.

12. Safe harbours

Applying safe harbours to a pre-defined category of taxpayers or transactions provides relief and reduce administrative burdens on both sides of the fence to a system which bears the characteristic of being complex, at best. By applying safe harbours, tax authorities can concentrated their efforts and resources to more complex transactions and small and medium size companies would spend less time when complying with TP rules. Moreover, SH rules provides certainty to eligible taxpayers that "the price charged or paid on qualifying controlled transactions will be accepted by the tax administrations that have adopted the safe harbour with a limited audit or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with, the safe harbour provisions".[1255] However, SH rules may also create concerns and produce ***negative impacts*** and adverse consequences, for instance, SHs may ***(1)*** increase the risk of DT and non-DT when applied unilaterally, or ***(2)*** create incentives to aggressive tax planning, ***(3)*** lead to taxable income being reported that is not in accordance with the ALP and ***(4)*** **"**raise issues of equity and uniformity".[1256]

(1) *Increase the risk of DT and non-DT when applied unilaterally.* By setting TP prices at certain levels (either above or bellow AL prices), tax authorities may "induce taxpayers to modify the prices that they would otherwise have charged or paid to controlled parties, in order to avoid transfer pricing scrutiny in the safe harbour country". On the one hand, if taxpayers report prices above AL in order to fall under the SH's threshold, tax authorities would benefit from a broader base, on the other hand, if understated, considering that the established prices are bellow general AL's thresholds, the tax authority would loose revenue. The TP gruidelines suggests the implementation of a *Memoranda of Understanding* (MOU) to be exchanged between tax authorities,[1257] which should contain: ***a.*** description and criteria of qualifying enterprises; ***b.***

[1255] Ibid 206.
[1256] Ibid 208.
[1257] The benefits of a bilateral approach are: ***(i)*** "A bilateral approach executed through competent authority MOUs could increase the likelihood that safe harbour provisions do not result in double taxation or double non-taxation. Bilateral safe harbours could be tailored to the economics of a particular market and circumstances, and thus be compatible with the arm's length principle. ***(ii)*** Bilateral safe harbours could be entered into on a selective basis with countries having similar tax rates, thus minimising the possibility that the safe harbour provision itself would create opportunities for transfer pricing manipulation and providing a means for limiting the application of the safe harbour to situations where transfer pricing risk is quite low. ***(iii)*** If the relevant countries desire, bilateral safe harbours could initially be limited to small taxpayers and/or small transactions in order to limit exposures to government tax revenue that might otherwise be created by the safe harbour. ***(iv)*** Safe harbours adopted by means of a competent authority MOU could be reviewed and modified from time to time by competent authority agreement, thus assuring that the provisions stay up to date and reflect developments in the broader economy. ***(v)*** For developing countries with serious resource constraints, bilateral MOUs entered into with a number of treaty partners could provide a means of protecting the local tax base in common transfer pricing fact patterns without an inordinate enforcement effort." Transfer Pricing Guidelines (n 503) 450.

description of qualifying transactions; [1258] ***c.*** AL range of the tested party; ***d.*** years of coverage; ***e.*** binding provision; ***f.*** monitoring and reporting provions; ***g.*** participating enterprises' documentation and information and ***h.*** dispute solving mechanism. [1259]

(2) *Create incentives to aggressive tax planning.* MNEs may be tempted to conducted some sort of aggressive tax planning, for instance, by ***breaking*** or ***simplifying*** transactions in order to fall under the SH's threshold, by reducing mark-up prices, considering that the SH is based on an "industry average" (a company may earn a 15% mark-up on controlled sales, but if "a country adopts a safe habour requiring a 10% mark-up, the company might have an incentive to comply with the safe harbour and shift the remaining 5% to a lower tas jurisdiction".[1260] Moreover, if tax authorities exchange a great number of MOUs, companies would be also tempted to shop for the most beneficial SH (SH shopping) as in DTCs. The best approach here would be a multilateral MOU. [1261]

(3) *Taxable income is not in accordance with the ALP.* In order to fall under the relevant SH, taxpayers may be obliged to use a certain method whereas other method would better fit the actual transaction's circumstances, thefore divorcing the controlled transaction from ALP, "wich requires the use of the most appropriate method".[1262] The best course of action would certainly be an ***optional regime*** where enterprises would opt to the relevant SF's rules when in full conformity.[1263]

(4) *Equity and uniformity issues* could arise for lack of a clear and defined set of SH rules (which size/type companies and transactions are eligible to SH rules?). It is important to stress the fact that when creating SH rules, two sets of different TP criteria are applicable, therefore pricise SH regulation is mandatory in order to avoid possible abuses.

Managing and complying with TP rules can be a burden to companies that eventually have to deal its perverse effects (compliance costs, adjustments, DT, interest, penalties etc), therefore properly designed SH rules are likely to "relieve some of these burdens" ultimately providing taxpayers more certainty.[1264]

13. Cost Contribution Arrangements (CCAs)

Cost Contribution Agreements are basically contracts entered into by associated undertakings in order to develop a certain activity. CCAs are agreements to undertake a certain commercial activity, that is to say, no separate

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[1258] Examples of qualifying transactions are: ***(A)*** low risk manufacturing services; ***(B)*** low risk distribution services and ***(C)*** low risk contract R&D development services. Transfer Pricing Guidelines (n 503) 452.

[1259] Transfer Pricing Guidelines (n 503) 451.

[1260] By reducing mark-up earnings the taxable income is shifted to another State, and on a large scale, "this could mean significant revenue loss for the country offering the safe harbour". Transfer Pricing Guidelines (n 503) 212.

[1261] Ibid 212.

[1262] Ibid 208.

[1263] Ibid 209.

[1264] Transfer Pricing Guidelines (n 503) 213.

company is created to develop the contracted activity. The contractual terms of the transaction are particularly important to CCAs (joint development of tangibles, intangibles or services intended to create a future source of income). It is important to point out that associated undertakings do not necessarily combine their operations in full in order to exploit the benefits of a CCA, that is to say, companies party to an agreement will realized the asset's gains individually.

CCAs must also be scrutinized under ALP, in other words, both a contractual analysis, as well as a function analysis will be performed in order to ascertain whether the contractual terms of the relevant transaction are in tune with parties' functions, and the price under AL. Moreover, the benefits of such arrangement must also be proportionate to each company's contribution when developing or producing the tangible or intangible asset. For instance, after developing a certain product, each undertaking participant to the process will benefit from the product's future income. Considering that associated undertakings had entered in a CCA, each company will benefit according to its actual contribution when the product starts generates income, that is, instead of licensing the product to the associated undertaking (which would create royalty payments, for example), the profits would have been previously allocated thefore eliminating future royalty or any type of license payments due to the right to use the property, that is, by contractually sharing R&D, production, marketing, distribution etc, of the relevant, tangible, intangible or service, groups will be able to remove obstacles created by "complex-cross licensing arrangements and associated allocation of risk, and replace them with a more streamlined sharing of contributions and risks, with ownership interests of the resulting intangible(s) shared in accordance with the terms of the CCA."[1265] In other words, CCAs provides the possibility of properly dividing the ownership of a good prior to its existence so that the participants to the CCA are able, for example, to exploit the property perpetually and royalty-free. [1266] Nonetheless, if under a functional analysis, the participant's contribution is not consistent with the CCA, some adjustment will probably be imposed. In other words, the participant's contribution in developing the good must be consistent with what independent companies would have agreed under comparable circumstances (ALP).[1267] Basically, there are two categories of CCAs, namely, (***i***) ***development CCAs*** and (***ii***) ***service CCAs***. The former (generally more costly), is related to the production and development of tangibles and intangibles, whereas the latter (generally less risky and with more immediate returns) stands of course, for services.[1268]

[1265] Ibid 347.

[1266] The TP Guidelines provides an interesting example of CCA as opposed to cross-licensing arrangements: "(…) an MNE group which manufactures products through three enterprises which operate a production site and have their own R&D teams engaged in various projects to improve production process. Those three enterprises enter into a CCA aimed at generating production process improvements, and as a result pool their expertise and share the risks. Since the CCA grants each participant rights to the outcomes of the projects, the CCA replaces the cross-licensing arrangements that may have resulted in the absence of a CCA and if the enterprises had individually developed certain intangibles and granted rights to one another. " Transfer Pricing Guidelines (n 503) 347.

[1267] Transfer Pricing Guidelines (n 503) 347.

[1268] Ibid 349.

In order to apply the ALP to CCAs, one must firstly (***i***) determine each party's benefit expectations,[1269] then analyze each party's (***ii***) contribution to the transaction and finally assess whether the actual parties' contractual contribution is (***iii***) consistent with the expected gains, that is, if the actual contribution to the transaction (R&D or financing) do not represent (at least reasonably) what the relevant party should/would benefit under comparable economic cicumstances, some adjustment will probably be deemed as necessary.[1270] Here, the rule of control, has an important role in assessing such contribution. As previously studied, when analyzing the transaction's economic conditions (comparability analysis), tax administrations will assess the contractual terms of the transaction[1271] then proceed to evaluate what was the exact contribution of each undertaking in respect to the assets and risks assumed in the transaction. The evaluation of such contribution (functional analysis) will determine which company has control over the transaction's risk, that is, which enterprise is able to decide how to respond to that risk (mitigating or laying off). Consider the following, two associate enterprises enter into a CCA, where Enterprise A, which has no expertise whatsoever to assess the product's development, will finance the operation, whereas Enterprise B will developed

[1269] Determining the parties involved to a CCA predates the benefit analysis, that is, if the party is not a participant to the CCA, it will not be able to enjoy the future benefits of the asset under the CCA. It is fundamental that the associated undertaking is assigned to receive future gains derived from the product by owning rights to such property due to its contribution during the product's development phase, therefore, it is fair to assume that a company that had *neither* control over the risk during the property's development, *nor* the financial capacity to assume such risk, will not be entitled to a share of the CCA's output. Transfer Pricing Guidelines (n 503) 351.

[1270] Companies may enter into CCAs to avoid tax. Consider the following, Company B, resident of a *low tax State*, provides finance (80 million euros) whereas Company A, resident of a *high tax State*, performs the bulk of the operation (risk control, management – risk mitigation - know-how etc) as well as contributing with a smaller share of capital (20 million). According to the CCA's terms, Company B is entitled to explore the good in its country as well as in the rest of the world. Company A will only be able to explore the good in its country. Now consider that the expected benefit ratio contained in the CCA is 80:20 in favour of Company B (both companies are financially capable with outstanding credit worthiness). Note, that the expected benefit of Company B is not consistent with the product's value of creation. Consequently, the relevant tax administration *raised a red flag* to the CCA's terms and demanded the transaction be adjusted. Had the tax administration not acted to impose adjustments to the CCA's terms, the associated companies would be benefiting from a lower tax rate where company B resides. The fact that company B provided the funds to the operation, does not necessarily entitles Company B to a *bigger piece of the pie*. In order to bring the transaction under AL, tax authorities are likely to impose a ratio reconfiguration (establishing a 80:20 in favour of Company A), **OR** demand a ***balancing payment*** in order to "*top up the value of the contributions*". If Company A contributed 20 million euros whereas Company B contributed 80 million, Company B would be required to pay another 60 million euros to Company B in order to increase Company's B contribution if the 80:20 ratio in favour of Company B is to be maintained. "*Any balancing payment should be treated as an addition to the contribution of the payor and as a reduction in the contribution of the recipient*." Transfer Pricing Guidelines (n 503) 360.

[1271] The TP Guidelines provides an non-exaustive list covering what should a CCA contract contain: (***i***) list of participants; (***ii***) list of associated enterprises which will eventually be involved in the operation, (***iii***) the activities performed by the undertakings involved, (***iv***) the CCA's duration, (***v***) the expected benefits' ratio, (***vi***) how the future benefits of the produced good will be explore, (***vii***) provisions of possible balancing payments for the purposes of contract adjustment. Transfer Pricing Guidelines (n 503) 363.

the product (R&D).[1272] Note that the contribution of each participant to the transaction is different in nature (finance and R&D), nonetheless Enterprise B is closer to the operation's risks, even though is not financially independent. In this case, a larger amount of the anticipated returns should be allocated to Enterprise B, which manages and control the risk.[1273]

Should the funder be entitled to a higher anticipated return?

Associated enterprises participants in the development of an intangible must be adequately compensated for their contribution to the product's chain of creation. Such contribution may be know-how (intangible), raw material (tangible) or in the form of capital. An associated enterprise will not necessarily receive a higher anticipated return on account of financing in full the good's development. Generally, the company that had the most controll over the operation's risks, will be entitled to greater returns. Therefore, before attributing to the funder a higher control, one must first assess the details of the transaction's finance (creditworthiness of the funded party, securities etc). Nevertheless, finance and risk are intimately related, for the higher the risk in developing a product, added to the fact that the product's development is highly dependent of such capital, the more control the funder needs in order to reduce and control such risks, that is, the funder will inevitably and actively participate on the product's development, regularly assessing its potential in generating future income (risk management).

In order to enhance productivity, companies party to a CCA may outsource certain activities under the condition that the associated company (***i***) has control over such risk as well as (***ii***) financial capacity. In such a case, the ALP would probably demand (if necessary) appropriate compensation in respect to the services provided to participants to the CCA.[1274]

a. Expected benefits and Adjustments

As previously mentioned, determining each company's expected benefits is central when measuring each party's contribution to the CCA. One way of measuring benefit expectation is assessing each company's proportionate shares with allocation keys such as sales, profits, units used, units produced or sold, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by "a certain group of employees if there is a strong correlation between the time spent and the creation of the combined

[1272] Does the associated company have *control* over such risk? Financing the risk does not necessarily mean that the company controls the risk, thus the answer is ***NO***. Does the associated Company have managing powers over the risk? ***NO.*** Which associated Company is able to mitigate such risk? According to the example Enterprise A has ***no expertise to assess*** the product's development process. Which enterprise has financial control as well as financial capacity over that risk? Well, as in most transfer pricing cases there is it not a simple and straight answer as to whether the financer should be deemed as the risk's main controller if the company is the only financially capable in relation to the transaction. The TP Guidelines suggests that the entity assessing the transaction should perform a functional analysis, in order to identify and measure the actual operation's contribution. Ibid 269.

[1273] Ibid 349.

[1274] Ibid 352.

profits, number of servers, data storage, floor area of retail points etc [1275] (mainly used for services CCAs).[1276] Nonetheless, in R&D CCAs, benefits are "expected to be realised in the future and not solely in the year the costs are incurred". [1277] It is also possible that the company's projected results not be entirely materialized, that is, the expected result may have been under or over-assessed (a patent may have generated a higher income over the years, for example). In such cases, where distortions between the projected and the actual result occurs, tax authorities are likely to examine whether the "projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using ***hindsight***."[1278](emphasis added) Nonetheless, contributions to CCAs should be periodically reassessed an properly documented, for the occurrence of unforeseeable circumstances during the time of the product's development, may influence each party's risk to the transaction eventually leading to some sort of adjustment (balancing payments). But one questions pertains: *How should tax authorities (and companies) measure contribution?* The most intuitive answer to that question is: ***incurred costs***. Each party's contribution should be assessed according to the undertaking's incurred costs employed in the transaction (allocation keys based on costs, such as relative spending and/or investment in key areas such as R&D, engineering, marketing).[1279] Nevertheless, sometimes determining costs may not be that simple. Measuring a company's contribution where only tangible goods are employed is considerably simpler had the company contributed only with certain intangibles. Nonetheless, for the sake of practicality, where the difference between the contribution's value and the incurred costs are minimal, the contribution should be measured at cost.[1280] According to the TP Guidelines, if an associated undertaking claims that a certain independent undertaking's contribution to an uncontrolled transaction ***at costs***, is comparable to that of the controlled transaction between controlled parties, tax authorities are likely to analyse whether: the independent undertaking provided any (***i***) compensation to the particular contribution or if the independent undertaking proceeded with a (***ii***) schedule payment or any reimbursement that could have affected its price. Moreover, tax administrations will also assess "all economically relevant characteristics of the transaction in the broader context of the arrangement, including the impact of any broader arrangement of economically related transactions which may exist between the parties to the uncontrolled

[1275] Transfer Pricing Guidelines (n 503) 141.
[1276] Ibid 353.
[1277] Ibid 353.
[1278] *Hindsight* is a transfer price based on ex post data when assessing ALP. BEPS action 8 proposed, as an exception, to allow the use of such method to HTVI when, (i) "no sufficiently reliable comparable exits and (ii) there is a lack of reliable projections of future cashflows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain. Jens Brodbeck. *BEPS action 8: OECD proposes introducing hindsight into the transfer pricing of hard-to-value-intangibles.* (2015) https://www.ensafrica.com/news/BEPS-action-8-OECD-proposes-introducing-hindsight-into-the-transfer-pricing-of?Id=1873&STitle=tax%20ENSight. Accessed in 10 Jan 2018.
[1279] Transfer Pricing Guidelines (n 503) 114.
[1280] According to the TP Guidelines "(…) where the cost is found to be an appropriate basis for measuring current contributions, it is likely to be sufficient to use actual costs as the basis for so doing." Transfer Pricing Guidelines (n 503) 357.

transaction (…)".[1281]

b. CCA early termination, entry or withdrawal

CCAs requires constant review, thus, if by some reason the controlling party concludes that the CCA's costs will certainly surpass its future results, the company may decide to terminate or even withdrawal its participation from the transaction. Early withdrawal (buy-out) or termination of the CCA will result in a necessary reassessment of the parties' contribution to the operation which could eventually lead to some sort of adjustment in the future, therefore, in such a case parties should be attentive so that its contribution to the transaction are well documented. New participants to an already active CCA may "*buy-in*" in relevant CCA in order to become a part and benefit from future income. Needless to say, such payment must be proportionate to the benefits it expects to gain in the future. Moreover, ***balancing payments*** made out to new entrants "*could be netted against any buy-in payment*" and must be properly documented for taxation purposes.[1282]

14. What is property? (legal, economic and philosophical concepts)

Property law, in general, provides a legal framework for resource allocation and wealth distribution.[1283] However, the way and manner in which property was distributed throughout history varied considerably.[1284] Now, *long story short*, from a ***legal perspective*** property is a "bundle of rights" owned by a proprietor who can "possess, use, develop, improve, transform, consume deplete, destroy, sell, donate, bequeath, transfer, motgage, lease, loan, or exclude other from their property".[1285] The first important thing about property from a legal viewpoint is that these rights are "impersonal in the sense that they attach to property, not persons" that is to say, any person who owns the rights to that property are entitled to do with that property what it pleases, and if third-parties prevents the property's owner from exercising his right, the court will "enjoin them to stop - the court will issue an order that they must stop interfering on pain of punishment for contempt of court",[1286]or in the words of *Delbert Grady*, the owner may request the court to "*correct them*".[1287] Contrary to property rights, contractual rights are attached to the person (personal rights).

[1281] Transfer Pricing Guidelines (n 503) 356.
[1282] Ibid 361.
[1283] Robert Cooter and Thomas Unlen (n 15) 70.
[1284] "Blackstone viewed property as providing its owner with complete control over resources, and he regarded this freedom to control material things as 'guardian of every other right.' Gluckman found that property in an African tribe called the Barotse conveyed to its owner reponsability, not freedom. For example, the Brotse hold rich persons responsible for contributing to the properity of their kin (family). Finally, Marx and Engels regarded property as the institution by which the few enslave the many". Robert Cooter and Thomas Unlen (n 15) 70.
[1285] Robert Cooter and Thomas Unlen (n 15) 73.
[1286] Ibid 73.
[1287] "My girls, sir, they didn't care much for the Overlook at first. One of them actually stole a pack of matches and tried to burn it down. But I 'corrected' them sir. And when my wife tried to prevent me from doing my duty, I 'corrected' her". *The Shining.* Stanley Kubrick. Perf. Jack Nicholson, Shelly Duval, Philip Stone. Warner Bros (1980). Film.

The concept of property from an ***economic perspective***, is intimately connected to the economic concept of bargaining games (or theory), that is to say, the benefit or the surplus created from that bargaining game, we explain. When bargaining, players generally come to terms after interacting and cooperating, however, sometimes the terms for interacting and cooperating are imposed from outside parties (external influences, if you will), such as the law,[1288] nonetheless, if the bargaining prospers, no law is necessary, on the contrary, the law will plays its part.[1289] *Cooperation…*is at the heart of bargaining games and constitute the very foundation of an "economic theory of property".[1290] A cooperative game[1291] creates efficiency by maximizing output,

[1288] Robert Cooter and Thomas Unlen (n 15) 81.

[1289] Ibid 81.

[1290] Ibid 74.

[1291] Professor Ronald H. Coase, with his Coase theorem, won the Noben Prize in economics, which fits perfectly to explain property under an economic perspective. The theorien has help founding the economic analysis of the law. Consider the following example. A cattle rancher and a farmer live beside each other. "The farmer grows corn on some of his land and leaves some of it uncultivated. The rancher runs cattle over all of her land. The boundary between the anch and the farm is clear, but there is no fence. Thus, from time to time the cattle wander onto the farmer's property and damage the corn. The damage could be reduced by building a fence, continually supervising the cattle, keeping fewer cattle, or growing less cor-each of which is costly. The rancher and the farmer could bargain with each other to decide who should bear the cost of the damage. Alternatively, the law could intervene and assigned liability for the damages. There are two specific rules the law could adopt: 1. The aftmer is reponsable for keeping the cattle off his property, and he must pay for the damages when they get in (a regime we call "ranchers' rights "or "open range"), or 2. The rancher is reponsable for keeping the cattle on her property, and she must pay for the damage when they get out ("farmers'rights" or "closed range"). Under thi first rule, the farmer would have no legal recourse against damage done by his neighbour's cattle. To reduce the damage, the farmer would have to grow less corn or fence his cornfields. Under the second rule, the rancher must builda fence to keep the cattle on her property. If the cattle scapes, the law could ascertain the facts, determine the monetary value of the damage, and make the rancher pay the farmer. Which law is better? Perhaps you think the fairness requires injuries to pay for the damage they cause. If so, you will approach the question as traditional lawyers do, by farmer's crops do not harm the rancher's cows. The cause of the harm runs from rancher to farmer, and many people believe that fairness requires the party who causes harm to pay for it. Professor Coase, however, answered in terms of *efficiency* . All other things equal, we would like the legal rule to encourage efficiency in both ranching and farming. This approach yielded a counterintuitive conclusion, which can be explained using some numbers. Supposed that, without any fence, the invasion the cattle costs the farmer $100 per year in lost profits from growing corn. The cost of installing and maintaining a fence around the farmer's cornfileds is $50 per year, and the cost os installing a fence around the ranch is $75 per year. Thus, we are assuming that damage of $100 can be avoided at an annual cost of $50 by the farmer or $75 by the rancher. Obvioulsy, efficiency requires the farmer to build a fence around his cornfileds, rather than the rancher to build a fence around her ranch. Now, consider what will happen under either legal rule. Under the first legal rule (rancher's rights), the farmer will bear damage of $100 each year from wandering cattle. He can eliminate this damage at cost of $50 per year, for a net saving of $50 per year. Therefore, the first rule will cause the farmer to build a fence around his cornfileds. Under the second rule(farmer's rights), the rancher can escape liability for $100 at a cost of $75. Consequently, the second rule will cause the rancher to build a fence around her ranch thus saving $25. Apparently, the fisrt rule, which saves $50, is more efficient than the second rule, which saves $25. But this efficiency is only apparent; it is not real. We begin our understanding of this apparent puzzle by first imagining how the rancher and the farmer could have resolved their problem by cooperative bargaining and then comparing that outcome with the apperant outcomes under the different legal rules. Supposed that the farmer and the rancher had fallen in love, married, and combined their susiness interests. They would then maximize the combined profits from farming and rancheing, and these jointm profits will be

equalizing interaction parterns (equilibrium) [1292] while reaching full efficiency,[1293] however bargaining games may also fail due to high ***transaction costs***. The term (transaction costs) encompasses "all impediments to bargaining", [1294] and consists of three main elements: ***(1)*** *search costs*, ***(2)*** *bargaining costs* and ***(3)*** *enforcement cost*. The table bellow depicts more clearly factors that ultimately can affect transaction's price/cost. [1295]

Low Transaction Costs	*High Transaction Costs*
1. Standardized good or service	1. Unique good or service
2. Clear, simple rights	2. Uncertain, complex rights
3. Few parties	3. Many parties
4. Friendly parties	4. Hostile parties
5. Family parties	5. Unfamiliar parties
6. Reasonable behaviour	6. Unreasonable behaviour
7.Instantaneous exchange	7. Delayed exchange
8. Non contingencies	8. Numerous contingencies
9. Low costs of monitoring	9. High costs of monitoring
10. Cheap punishments	10. Costly punishments

highest when they build a fence around the corfields, not around the ranch. Consequently, the married couple will build a fence around the cornfieldsm, regardless of whether the law is the first rule of the second rule. In other words, thye will cooperate to maximize their joint profits, regardless of the rule of law. We have seen that the first rule is more efficient than the secont in the farmer and the rancher follwe the law without cooperation but that the law makes no difference to efficiency when to cooperate. The farmer and the rancher do not need to get married in order to cooperate. Rational businesspeople can ofte bargain together and agree on the term of cooperation. By bargaining to an agreement, rather than following the law noncooperatively, the rancher and the farmer can save $25. Tht is, if the parties can bargain successfully with each other, the efficient outcome will be achieved, regardless of the rule of law. Recall the most efficient outcome is for the farmer to build a fence around his cornfilelds, and that when parties simply follow the law without cooperating, the second rule (farmer's rights) leads to the apparent inefficiency of the *rancher's* building a fence around her ranch. But consider how bargaining might proceed uner the second rule: ***Rancher:*** '*The law makes me responsible for any damages that my cattle do to your crops. There would be no damages if there was a fence. I can fence my ranch for $75 per year, whereas you can fence your conrfields for $50 per year. Let's make a deal. I'll pay you $50 per year to fence your cornfield*'. ***Farmer:*** '*If I agree, and you pay me $50 per year to fence my cornfields, I woun't be any better off than if I did nothing and you had to fence you ranch. However, you'll save $25. You shouldn't receive all of the gains from cooperation. You should give me a share of the gains by paying me more than $50 per year for fencing my cornfields'*. ***Rancher:*** '*OK. Let's split the savings from cooperation. I'll pay you $62,50 per year, and you build the fence. That way we'll each receive half of the $25 gained by cooperating'*. ***Farmer:*** '*Agreed*'. Note the important implication: Cooperation leads to the fence's being buit around the *farmer's* conrfields, depite the fact that the second legal rule (farmer'rights) was controlling. The greater efficiency of the legal rule is apparent, not real. (…) The bargaining situation is quite different if the law adopts the first rule (ranchers'rights), rather than the second rule (farmers' rights). Under the first rule, the farmer is responsible for building a fence to keep the cattle out of his cornfields. In these circumstances, cooperation between the farmer and the rancher does not save costs relative to following he lawnoncooperatively. Consequently,m under the firs rule, the farmer will go ahead and build the fence, without any bargaining." Ibid 82.

[1292] Ibid 13.

[1293] The production of a certain good is fully efficient if one of the two conditions is met: "1. It is not possible to produce the same amount o foutput using a lower-cost combination ofof inputs, or 2. Is is not possible to produce more output using the same combination of inputs". There is also *allocative efficiency* (*Pareto Efficiency*) where a "particular situation is (…) Pareto or allocative efficient it is impossible to change it so as to make at least one person better off (…) without making another person worse off". Ibid 14.

[1294] Ibid 85.

[1295] Robert Cooter and Thomas Unlen (n 15) 91.

If "transaction costs are zero, an efficient use of resources results from private bargaining, ***regardless of the legal assignment of property rights***". [1296] In sum, property rights from an economic perspective is the process of wealth maximization which "achieves *economic efficiency* by moving goods from people who value them less to people who value them more".[1297]

Philosophers throughout human history, tried to explain the meaning of property "on its ability to advance values such as *utility*, *justice*, *liberty* and *self-expression* and *social evolution*". [1298] Utilitarians understand that the true measure of a good's value is the net pleasure or satisfaction it generates, thus the purpose of property is to enhance the "total pleasure or satisfaction obtained from material and other resources". Under ***Utilitarianism***, the fact a son had thrown out his parents out of his house because he thinks "their loss of utility from being dispossessed is less than his gain in utility from having them out of the hause", could be relied upon when litigating (utilitarian defense) if a *Utilitarian* concept of property prevailed in society.[1299] Property may also be used as a mean to achieve ***distributive justice*** where "valuable assets of society are periodically redistributed so as to achieve a roughly equal distribution of property". [1300] Property carries also the idea of ***liberty***, being independent from dictatorial authoritarial governments, the very soul of capitalism, concept created probably to "thwart absolutism by depriving the king of absolute power".[1301] Note that private property is a precondition for a descentralized resource allocation mechanism, in fact, it is *must* for any market. [1302] Property is also the result of the owner's ***self-expression***. A sculpter turns a rock into something else, an expression of its own being, his personality, his nature, a painter rearranges colors and turn materials into art, not necessarily imitating life, but to confront its spectators with a "transcendental principle which arts puts us into communication with once again".[1303] Contrary to all philosophical ideas regarding property previously discussed which are based on "serving ultimate values"[1304] (utility, justice, liberty and self-expression), conservative philosophers "idelize forms of social order that, like the common law of property, evolve over time in much the same manner as the myriad species of life. Like organisms, social forms are, in this view, subject to the rules of natural selection. The conservative philosophers condemn institutions imposed on us by planners, engineers, politicians, and other societal decision makers for much the same reasons that environmentalists condemn actions that interfere with an area's environment"[1305] as a way to ***social evolution***.

[1296] Ibid 85.
[1297] Robert Cooter and Thomas Unlen (n 15) 108.
[1298] Ibid 109.
[1299] Ibid 109.
[1300] Ibid 110.
[1301] Ibid 111.
[1302] Ibid 111.
[1303] "l'Art n'est pas l'imitation de la vie, / mais la vie est l'imitation d'un principe transcendant avec lequel l'art nous remet en communication" Antonin Artaud.
[1304] Robert Cooter and Thomas Unlen (n 15) 111.
[1305] Ibid 111.

15. Tangible Assets

Generally, both the classification and valuation of tangible assets presents no difficulty whatsoever (inventory, equipment etc), therefore we understand that there is no need to extend the discussion besides limiting this topic to a simple and straightforward definition of tangible assets provided by the OECD glossary of terms: "property with a physical form, e.g. personal property, real property as distinguished from intangible property."[1306]

16. Intangible Assets

In the words of Bill Gates, "Never before in history has innovation offered promise of so much to so many, in so short a time (…)". The fact is that, there is a great shift of economic paradigm is still occurring due to a number of factors leading to an inevitable "eclipse of capitalism"[1307] since the father of modern capitalism wrote the Wealth of Nations.

When a company innovates with a new technology, it acquires competitive advantage and immediately generates extraordinary profits, which are the innovetor's reward for devoting "resources and effort" in developing a righ risk activity. However, with time innovation tends to diffuse itself by competitive market forces, ultimately bringing the competitive advantage back to the previous "ordinary level",[1308] that is, back to an equilibrium, and as long as the innovation persists existing with its competitive advantage, so will the macro-economic *disequilibrium* caused by innovation.

Question: ***Does individual ambition still serves the common good?*** *Jeremy Rifkin* in his book "The Zero Marginal Cost Society", argues that the old era of capitalism is already losing its place to a new form of commercial interaction of extreme productivity at almost zero marginal cost of production, where the maximal level of efficiency is reached.[1309] According to the author, the connectivity of things (*The Internet of Things - IoT*)[1310] is the main reason why

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[1306] *OECD Glossary of Tax Terms*. http://www.oecd.org/ctp/glossaryoftaxterms.htm#T. Accessed in 10 Jan 2018.

[1307] Jeremy Rifkin (n 258) 2.

[1308] Robert Cooter and Thomas Unlen (n 15) 115.

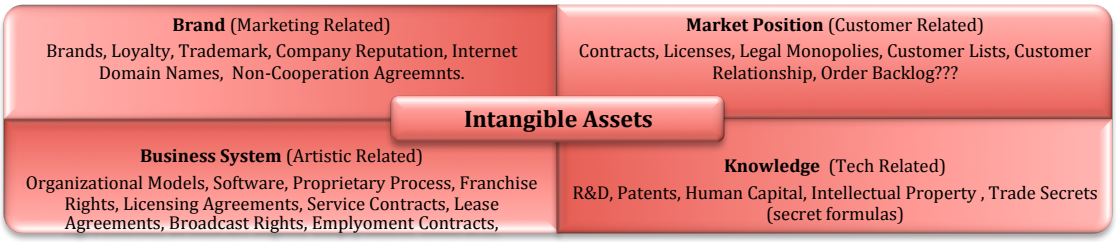
[1309] Productivity is a "*measure of productive efficiency calculated as the ratio of what is produced to what s required to produced it*". https://www.merriam-webster.com/dictionary/productivity. Accessed in 02 June 2018.

[1310] The Internet of Things is a complete independent smart infra-structure that connects every machine, resident, business in an "(…) intelligent network comprise of a Communications Internet, Energy internet, and Logistics Internet, all embedded in a single operation system. In the United States alone, 37 million digital smart meters are now providing real-time information on electricity use. Within ten years, every building in America and Europe, as well as other countries around the world, will be equipped with smart meters. And every device-thermostats, assembly lines, warehouse equipment, TVs, washing machines and computers-will have sensors connected to the smart meter and the Internet of Things platform. In 2007, there were 10 million sensors connecting every type of human contrivance to the Internet of Things. In 2013, that number was set to exceed 3.5 billion, and even more impressive, by 2030, it is projected that 100 trillion sensors will connect to the IoT. Other sensing devices, including aerial sensory technologies, software logs, radio frequency identification readers, and wireless sensor networks, will assist in collecting Big Data on a wide range of subjects from changing price of electricity on the grid, to logistics traffic across supply chains, production flows on the assembly line, services in the back and front office, as well as up-to-the-moment tracking of consumer

this hyper productivity (at zero cost production) is possible. The same author stresses the fact that such change in economic paradigms will possibly be understood as the third industrial revolution. In sum, what we are experiencing today is the complete shift of paradigms where the value of immaterial property overcomes the value of material property. In 2010 the book value of Coca-Cola Company (see section xx) was U$ 40 billion dollars. Nevertheless, the market capitalization was U$ 150 billion dollars. Question: what does the 110 billion dollars gap stands for? In sum, the difference between the book value of a company and the market ruling capitalization are intangibles. The book value of a company represents a (1) Historical cost convention which could have come 20 years back; (2) can be internally manage

One of the major difficulties within the transfer pricing taxation institute, relates to the proper ***definition*** and ***evaluation*** on intangibles. Action 8 of BEPS seeks to provide a clear and broad definition of such assets in order to ensure that profits related to such assets are allocated according its creation value.[1311] A proper and full study on intangibles will certainly fall outside the scope of out work, nevertheless, a simple definition for intangible is an asset which is not physical in its substance. We propose to divide this property category in four main groups, namely, Brands; Market Position; Business System and Knowledge.[1312]

Figure 16



Pursuing our discussion on intangibles, as we have previously discussed, tax liability is assessed over a cost x profit base. Valuating intangibles assets can be a real challenge for MNE as well as for tax administrations worldwide. We have to agree that valuing a company's contribution to a certain operation based only on the cost of services and tangibles, is much easier than valuating

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activities. (…) the intelligent infrastructure, in turn, will feed a continuous stream of Big Data to every business connected to the network, which they can then process with advanced analytics to create predictive algorithms and automated systems to improve their ***thermodynamic efficiency, dramatically increase their productivity, and reduce their marginal costs across the value chain to near zero***. (emphasis added) Cisco Systems forecasts that by 2022, the Internet of Everything will generate $14.4 trillion in cost savings and revenue." Apparently, James Cameron's *Skynet* is not science fiction anymore. Jeremy Rifkin (n 258) 73.

[1311] *Discussion draft on Arm's length pricing of intangibles when valuation is highly uncertain at the time of the transaction and special considerations for hard-to-evaluate intangibles*. OECD. BEPS Action 8:Hard-to-value intangibles. (2015). http://www.oecd.org/tax/transfer-pricing/discussion-draft-beps-action-8-hard-to-value-intangibles.pdf.

[1312] Trade secrets such as formulas and recepies fall within this intangible category. An interesting case between taxation and trade secrets relates to Eighteen-Century (1783) Stamp Duty case, imposed by the British government on ***quack medicines***. (Reich Stamp Duty Act – *Stempelgesetz*). Andrea Amatucci (n 2) 80.

intangible costs. Conducting a proper study on the valuation of intangibles, will fall outside the scope of this investigation, for we would have to enter other fields of study (accounting and finance). Nonetheless, we will present the basics of intangible valuation, for it will enhance the *intuitive understanding of a functional relationship* between the value of creation in relation to intangibles and transfer pricing.[1313]

a. Intangibles and Latent Intangibles. "Iceberg Principle"[1314]

Companies value tangibles and intangibles for a number reasons, for instance, for the purposes of (***1***) business strategy, mergers, acquisitions, selling, purchasing, licensing IP assets (patents, copyrights, brands, transferrable knowledge etc).[1315] (***2***) Undertakings may need to value their intangibles for infringement calculation purposes (litigation). (***3***) Joint Ventures (corporate alliances) demand a proper intangible evaluation, as well as other forms of business affiliations (management services contracts, franchising, co-marketing etc) in order to assess the contribution of each party.[1316] (***4***) Listed companies must issue Financial Reporting according to the relevant regulation. The regulation must specify the "*valuation, amortization and reporting of goodwill*"[1317] as well as other intangible assets. (***5***) Bankruptcy. Generally, the most valuable asset of a bankrupt company are intangibles. (***6***) Financing and Securitization, for example, loans guaranteed against license stream (factoring) or securitization of intellectual property.[1318] And lastly (***7***) for tax liability purposes. EU Regulations on the valuation of intangibles for tax planning and compliance (charitable donations of intellectual property, cross-border sale or license of IP (transfer-pricing),[1319] assessment of tax liability in respect of corporate reorganizations, goodwill allocation etc. [1320]

The acquiring company must ascertain the value of tangible and intangibles both from a positive and more importantly, from a *negative economic perspective.* Examples of an ***above the see level*** negative ***tangible*** assets valuation are: support costs, deliverables rejected, key requirements missed, works cancelled, complaints and rework. A ***bellow the sea level*** negative ***intangible*** assets

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[1313] "The BEPS work on transfer pricing addressed BEPS issues that commonly arise among companies active in the digital economy as well as other taxpayer (…) the overall objective of the transafer ricing actions is to bring the allocation ot income within a multinational group of companies more directly in line with the location of the economic activity that gives rise to that income (…). This objective is pursued by focusing on key transfer pricing issues including issues related to (i) the transfer and use of intangibles including hard-to-value intangibles, and cost contribution arrangemens, (ii) delineating the actual transaction and business risks, and (iii) global valu chains and transaction profit split methods" Addressing the Tax Challenges of the Digital Economy (n 257) 90.

[1314] Naresh Phanfat. *Valuation of Intangible Assets*. (2012). https://www.youtube.com/watch?v=Zys3B2azq04&t=6038s.

[1315] Farok J. Contractor. *Intangible assets and principles for their valuation*. Rutgers University. (2000) 3.

[1316] idem Pag.3.

[1317] Paul Flignor, Danid Orozco. *Intangible Asset & Intellectual Property Valuation: A Multidisciplinary Perspective*. Ipthought.com (2006). 2.

[1318] Idem Pag. 2.

[1319] Idem. Pag.3.

[1320] Idem Pag 3.

valuation are: reputational damage, loss of future business, lack of trust, loss of future clients/customers, onerous contract conditions, deliverables not used, high costs of implementing, organizational change, high cost of using a deliverable, lost opportunities, benefit not realized, low moral and productivity.

Each class of *tangible* asset has latently its *intangible* counterpart, which consequently, possess a value. For example, the intangible counterpart of *cash* (tangible) is liquidity (intangible), for the value of money changes over time (100 euros today, has a different value tomorrow). Understanding such differences are extremely important when assessing tax liability, for instance, the Brazilian Supreme Court acknowledged that inflation may be offset against profits. On the other hand, the ECJ denied deduction in respect of to a currency loss realization due to a more favourable exchange rate. Note that in whichever case (inflation or currency loss over exchange rates), the *cash's* liquidity (intangible) influenced the tax liability of both undertakings. The table bellow depicts some tangible categories with their counterparts respectively.[1321]

Tangible	**Implicit Tangible**
Cash	Liquidity
Convertible Bonds	Convertibility
Sales	Brand Name
Employee Benefits	Human Resources (HR)
Datas	Customer Relationship
Bank Deposits	Call Deposits
Advertising	Brand Name
R&D	Patent

Recognizing an intangible is not always easy. The *recognition* of an item as an intangible asset requires an entity to demonstrate that the asset meets the following requirements: ***(i)*** the asset must meet the definition of an intangible assets and ***(ii)*** the asset must meet the recognition criteria.

(i) The asset must meet the definition of an intangible;

(ii) The asset must meet the recognition criteria;

a. An intangible asset shall be recognized if, and only if, it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity (IAS 38). [1322]

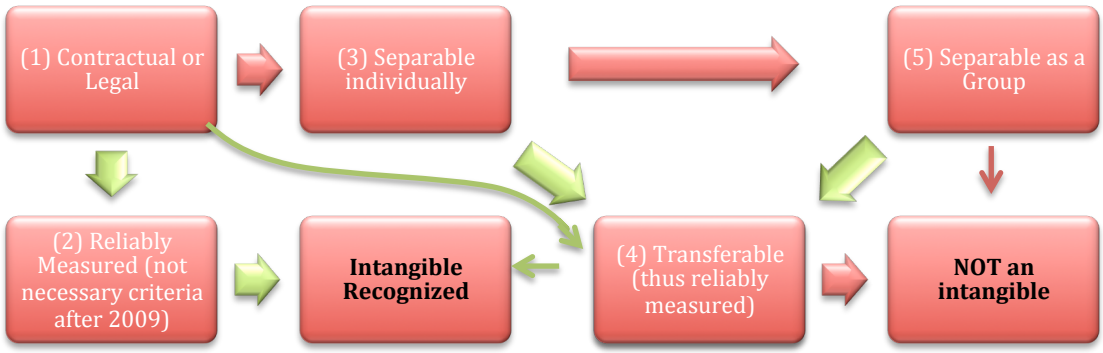
[1321] Naresh Phanfat (n 1314).

[1322] "IAS 38 sets out the criteria for recognising and measuring intangible assets and requires disclosures about them. An intangible asset is an identifiable non-monetary asset without physical substance. Such an asset is identifiable when it is separable, or when it arises from contractual or other legal rights. Separable assets can be sold, transferred, licensed, etc. Examples of intangible assets include computer software, licences, trademarks, patents, films, copyrights and import quotas. Goodwill acquired in a business combination is accounted for in accordance with IFRS 3 and is outside the scope of IAS 38. Internally generated goodwill is within the scope of IAS 38 but is not recognised as an asset because it is not an identifiable resource." *IAS 38 Intangible Assets* (n 821).

b. The cost of the asset must be reliable measured (after 2009 the IFRS revised its statute and the reliability test was taken off from the list) (IAS 38).[1323]

According to IFRS, if an asset is contractually or legally (***1***) and reliably measured (***2***), the asset may be recognized as an intangible. Nevertheless, if the relevant asset is NEITHER contractual nor legal (***1***), then one must ascertain whether the asset is separable individually (***3***), and if not individually, as a Group (***5***). If the asset is separable individually (***3***) or as a Group (***5***), then the asset is transferable (***4***) thus can be reliably measured (***2***) and consequently be recognized as an intangible. The graph bellow will help us identifying intangible.

Figure 17



On the other hand, if the asset is NEITHER contractual nor legal (***1***), NEITHER separable Individually (***3***) nor as a Group (***5***), the asset is NOT an intangible. Finally, if the intangible is contractual or legal (***1***) but not transferable (***4***), them the asset is NOT an intangible. Intangible recognition leads to intangible enforceability. ***The enforceability of an intangible is the exact factor which promotes/increase the status the property to an Intellectual Property Right***.

b. The basics of Intangible Valuation. "Pyramidal" Approach

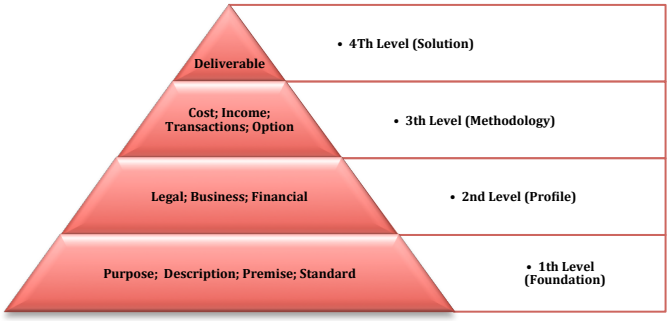
Assets are income generating resources (a patent generates royalties, a loan generates interest, a property may generate capital gains when sold as well as shares of listed companies when sold etc). Valuation is the process of defining the current value of a good or service. The current worth is extremely important, for the valuation is only relevant on the valuation date. In other words, valuation is the quantification of business strategy and strategic planning.[1324] Question: "How much would you be prepared to pay today for an asset that generates a given future flow of net receipts in the future?"[1325] The ***present discounting value*** (PDV) of future receipts is calculated according to the following formula: [1326]

[1323] See citation above.
[1324] Paul Flignor, Danid Orozco (n 1317) 5.
[1325] Robert Cooter and Thomas Unlen (n 15) 37.
[1326] Formula extracted from Robert Cooter and Thomas Unlen (n 15) 37.

$$PDV = \frac{F1}{(1+r)} + \frac{F_2}{(1+r)^2} + \frac{F_3}{(1+r)^3} + \frac{F_4}{(1+r)^4} + \cdots + \frac{F_n}{(1+r)^n}$$

The asset generates in the first year F_1, in the second F_2, in the third F_3, in the fourth F_4 and F_n in the last year. The annual interest rate is at r, thus the *PDV* equals ***x***.[1327] Now, moving on to the process of valuating intangibles. The process of valuating an intangible must follow a pyramidal methodology, that is to say, beginning from the base of the pyramid (Foundation) to the top (Solution).[1328]

Figure 18



At the base of the pyramid lies the ***foundation*** of the intangible valuation analysis, which is associated with four main blocks, namely, *purpose*, *description*, *premise* and *standard*. The next level is the ***profile*** (*legal*, *business* and *financial*), then the valuation's ***methodology*** (*cost*, *income*, *transactions* and *options*) and lastly the ***solution*** (*deliverable*).

aa. 1th Level (**Foundation**)

Purpose. Valuation demands time, money effort etc, therefore, companies will not valuate assets on a *whim* basis. In other words, asset valuation must have a purpose. *Why are we actually valuating this asset?* [1329] As previously discussed, a company valuates its assets due to a number of reasons (business strategy, financial reporting, litigation, financing and securitization, bankruptcy and for tax purposes). ***Description***. The description delineates the asset which is being subjected to valuation. *What is the asset?* It is here where the intangible will be *recognized*. ***Premise***. Under the *premise* category, the valued asset will be conceptually analyzed according to its future use. *How will the asset be used*? Premise is particularly important in liquidation (bankruptcy) procedures, where the "distinction between an orderly disposition and a distressed disposition can have a significant impact on valuation."[1330] ***Standard***. The valuation standard is the price range which the willing seller and the willing buyer would agree upon. *Who is the buyer of the asset?*. This category is often referred to as the "*fair*

[1327] The formula has also practical applications within the law, for example "suppose that a court is seeking to compensate someone whose property was destroyed. One method of valuating the loss is to compute the present value of the future flow of the net receipts to which the owner was entitled." Ibid 37.
[1328] Ibid 1.
[1329] Paul Flignor, Danid Orozco (n 1317) 2.
[1330] Idem. Pag.4.

market value", which is also used by courts of law when assessing compensation amount due to involuntary use of an asset.[1331]

ab. 2nd Level (**Profile**)

The second step of the valuation process is assessing the opportunities and limitations of the asset according to its *legal*, *business* and *financial* characteristics. This level will assess the ability of the asset to generate income and value in the future.[1332] ***Legal***. The fact that intangibles can be replicated at almost zero marginal cost (*Jeremy Rifkin*), imposes upon such assets the necessity of a proper legal protection (enforceability). All assets (tangible or intangible -customer list, customer relationship etc- or IP-related) will have attached to them some sort of ownership contract. Nevertheless, the immaterial characteristic of an intangible asset imposes upon such property the necessity of a proper (legal) protection, which has direct influence over its value. Nonetheless, the unique features of such immaterial goods (trade secret, utility patent, copyright, trademarks etc), must be assessed according to its own particular characteristics.[1333] ***Business***. The value of any asset is captured by its economic exploitation, ultimately determined by the business strategy of the company and market forces (competition, lifecycle of the offering, [1334] government regulation, new technologies etc). Intellectual property, in most cases, is never analysed individually, that is, the value of a patent used by a tech company, for example, will often be bundled with a trademark or a trade secret, which will exert influence over the final value of the intangible. Other aspects such as useful life of the asset, economic characterization (ability of the asset to

[1331] Idem. Pag.4.

[1332] Idem. Pag.4.

[1333] Each intangible must be assessed according to its limitations and opportunities based on its unique characteristics, for example, ***trade secrets*** lasts as long as it remains a secret, thus its value will invariably change over time (e.i. Coca-cola formula) and are protected within a confidential information scope. Nevertheless, the complexity of the secret is likely to limit possible derivation instances, which consequently will influence its value. ***Utility Patents*** are granted on a limited time basis (20 years), given by the Government and infringed if produced, used or sold without consent. Here, again, the complexity of the patent (number of claim elements, for example) will influence the value of the intangible, for the higher the number of elements of the patent, the higher the possibility of "designing around" the patent (patentable elements: structural product components, process steps etc). ***Copyrights***, on the other hand, have a longer life (70 to 100 years). Nevertheless, their value may significantly change over time (e.i. Disney animation) and the impossibility of creating derivatives, enhances the value of the property. Infringement may be constituted by copying, performing or distributing the intangible without consent. ***Trademarks***, on the other hand, have unlimited life as long as such property is used. This means that the value of the trademark will change over time. The fact the owner of the trademark may control its derivatives, will certainly optimize the value over such property. Trademarks may also be used as a vehicle for goodwill and its value is often leverage in order to reach new markets or attract business partners. The confusion, mistake or deception may result in infringement. Intangible Asset & Intellectual Property Valuation: A Multidisciplinary Perspective. Paul Flignor, Danid Orozco (n 1317) 7.

[1334] When a new product is introduced in the market, consumers choose the product over its features (patents) and after and later, there is a shift of consumer preference from feature to brand, in such a way that the value of the trademark increases significantly. Paul Flignor, Danid Orozco (n 1317) 5.

generate residual income[1335] of the value chain), are also important valuation factors.[1336] ***Financial***.

ac. 3rd Level (**Methodology**)

After answering the 1th level fundamental questions, and understanding the asset's profile (2nd level), it is time to attribute the most adequate valuation methodology, which consists on the following four methods: ***(1)*** Transaction, ***(2)*** Cost, ***(3)*** Income and ***(4)*** Binomial/Option.

(1) *Transaction method.* [1337] A transaction method is assessed according to the actual "price paid for a similar intangible under similar circmstances".[1338]

[1335] "***Residual income*** is defined as the amount of income (or loss) remaining after all subcontractors and routine providers have been paid. It is aligned closely with entrepreneurial activities." Paul Flignor, Danid Orozco (n 1317) 5.

[1336] "***Value chains*** are composed of functions and assets which can be characterized as either routine or entrepreneurial. A routine function or asset, in principle, can be obtained from an alternative provider in an arm's length transaction. Therefore, any excess profit (above and beyond a 'routine' amount) can be retained by the contracting party and does not accrue to the owner or performer of the asset or function. In contrast, an entrepreneurial function or asset is one which is critical to the value chain and is unavailable from alternative suppliers. Therefore, entrepreneurial functions and assets are in a much stronger bargaining position than other members of the value chain and claim a larger share of the total profits." Paul Flignor, Danid Orozco (n 1317) 5.

[1337] "***Transactional case study***: *Trademark*. ***Foundation***: This is a fair market valuation to properly assess royalty rates of trademarks between a U.S. cosmetic company and several overseas affiliates for tax purposes. ***Profile***: At issue are the value of a series of trademarks for mid-range women's cosmetics sold through department stores, drug stores and other retail outlets. The trademarks will be licensed for three years to a series of companies in Latin America for exclusive use in their territories. The company will also provide marketing services to the licensees on an as-needed basis. Some of the licensees will manufacture the cosmetic directly while others will outsource to third party manufacturers. The company has undisputed ownership of the relevant trademarks and manages them actively in all relevant countries. In this industry, the trademarks are characterized as 'entrepreneurial' in that they are a critical element of the success of the revenue stream and have no close substitutes in the market. The financial projections of the product lines are stable, with moderate growth and constant margins. ***Transaction Method Application***: A baseline transaction is identified: an exclusive license of the same trademarks/tradenames with no upfront fee and a running royalty rate of 7% of net sales to a Western European company. The license agreement is for 5 years. Adjustments were made for the following elements: - *Location*: Trademark valuation can differ significantly by geography, depending on the demographics and competitive factors of the territories. It this instance it was concluded that the underlying value of trademarks in the cosmetic industries in Europe and Latin American were comparable, and no explicit adjustment for geography is required. - *Advertising support*: To help launch the brands in the new territories, the licensor has agreed to provide market development support of up to $1 million in the first year. The royalty rate was adjusted upward to compensate the licensor for this added expense. The adjustment was computed by reimbursing the licensor for the $1m plus a one-year cost of capital to compensate for the time value of money. When capitalized over the projected sales of the three year license agreement, the net effect was to increase the royalty rate by 0.2%. - IP Strength: Trademark protection and ability to manage the use of the marks is determined to be lower in Latin America than in Europe. The subjective estimate was a decrease in the royalty rate of 0.5% of net sales. - *Length*: The length of the license agreement is an important factor in determining value. Longer licensing agreements tend to have lower royalty rates. However, in this instance the expectation is that the agreement would likely be renewed at the end of the three year period, so no adjustment was performed." Paul Flignor, Danid Orozco (n 1317) 10.

[1338] Paul Flignor, Danid Orozco (n 1317) 9.

Transaction methds can be subdivided into two main steps, namely, screening and adjustments. The former refers to "the selection process of identifying candidate third party transactions with sufficient pricing, scope and term and conditions to be demmed comparable to the intangible on question". The latterrefers to "an explicit quantifiable change in the valuation due a specific rationale."[1339]

(2) *Cost method.*[1340] When applying the "replacement cost method", the asset's valuation will be assessed by replacing the asset's cost to a similar IP outside the legal proteciont's scope. Generally, a "common usage of the replacement cost method is the cost to design around a patent or set of patents. This method is based on the principle of substitution - an investor would not pay more for an asset than the cost to obtain similar benefits from another asset. This method is particularly useful when the legal protection is weak or the technology is relatively well-known, and the IP does not produce income currently. The replacement cost method is a forwardlooking perspective on how to create an asset with similar functionality to the asset in question – it should not be confused with historical cost or accounting cost."[1341]

(3) *Income method.* [1342] The income method is the most basic valuation methods. Such method is based on "the ability of the asset to somehow generate

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[1339] According to Flignor and Orozco "[A]djustments are typically grounded in a baseline transaction (or transactions) that are sufficiently close to the subject intangible asset, and for which sufficient information is available to analyse the technical, legal, business and financial terms. Adjustments are then based on either 'hard,' quantifiable data where there is an explicit difference between the subject intangible asset and the outside evidence or subjective estimates by the analyst. Adjustments must be used with care, as too many may limit the comparability of the outsideevidence and can compromise the credibility of the transactional method. (…) Entrepreneurial IP, by nature of their uniqueness, will have a great deal of difficulty in identifying similar transactions for use in this method. This is analogous to valuing a Van Gogh masterpiece based on the price of a Rembrandt. Both are fine art, but likely have very different market values." Paul Flignor, Danid Orozco (n 1317) 9.

[1340] "Replacement Cost Method Case Study: Auto Dealer Network Foundation: This is a fair market valuation of the dealer network of an automotive distribution company for negotiation purposes. Profile: The intangible asset in question is the network of relationships between the auto distributor and the independent franchise dealerships. Importantly, the analysis does not value the dealership directly but rather the distribution channel relationship that the automotive company has established with the independent dealers. The automotive company incurs cost to establish, monitor, and train the dealers. These costs form the basis of the replacement cost analysis. Here, the replacement cost is the only viable method to value the network, as there is no income stream directly associated with the intangible and this type of intangible is rarely sold in third party transactions for use under the transaction method. Replacement Cost Methodology: The dealer network valuation method is based on establishment and support costs. The establishment costs include the effort analysis to identify site, dealer-owner, environmental impact assessment, etc. This represents the cost to create a new dealer network. This 'new network' must be lowered to reflect the changing demographics and desirability of the locations due to time, or the obsolescence of the network. These costs are supplemented by the ongoing support costs in training, monitoring, etc. This sum is the total Dealer Network Investment. To harmonize the time value of money across the different points in time used to derive the cost estimate, a return on capital is applied to the investment total to derive the dealer network value." Paul Flignor, Danid Orozco (n 1317) 13.

[1341] Paul Flignor, Danid Orozco (n 1317) 12.

[1342] "Income Method Case Study: Gasoline Trademark Valuation Foundation: This is a fair market valuation of the value of the trademark of a retail gasoline brand name for tax planning purposes. Profile: The subject IP was the retail gasoline trademark of a major oil company. Gasoline price is determined primarily by the underlying price of crude oil, refining, and local regulatory factors,

future income. This underlying characteristic is often referred to as the 'intrinsic'value of the asset, and is captured by the ability to directly or indirectly generate a positive cash flow. This cash flow, when appropriately discounted, is the underlying premise of the income method".[1343]

(4) *Binomial/Option method.*[1344] The binomial and other non-traditional methods (option methods) is basically valuation methods based on future contingent events.[1345]

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and secondarily by location and brand. To account for the primary factors, an industry database providing price by region and brand was employed. This data enabled the determination of a price premium for the trademark in question vs. the price of a similar grade unbranded gasoline.17 This price premium is then adjusted downwards for the incremental costs in supporting the brand, including advertising, costs associated with the credit card program, and certain identifiable selling and admin costs estimated to be above those required for an unbranded product. The price premium is multiplied by the annual expected sales of branded gasoline. As trademarks have infinite life employed, and as the economic life of the trademark is also infinite if the brand is maintained properly, an infinite life was used, and no terminal value is required. A discount rate of 20% was employed, based on typical rates of return on brandrelated assets." Paul Flignor, Danid Orozco (n 1317) 11.

[1343] Paul Flignor, Danid Orozco (n 1317) 11.

[1344] "Binomial Method Case Study: Noncommercialized Agricultural Patent Foundation: This is a fair market valuation of a noncommercialized patent for purposes of negotiated sale. The European corn borer caterpillar ("ECB") is a ravenous pest, destroying millions of dollars of U.S. corn each year. For years a bacterium, Bacillus thuringiensis ("Bt"), has proved an effective insecticide for the ECB. A transgenic corn was developed that maps the effective genes from the Bt bacteria into the seed corn, creating what is referred to as 'Bt corn.' One of the primary environmental and farm policy concerns raised by use of any transgenic seed such as Bt corn is the development of resistance by the target pest. Here, the concern is that extensive use of Bt corn will lead to the development of a resistant strain of ECB to the Bt bacterium, making both the modified corn as well as conventional insecticides ineffective. To combat this potential, the Environmental Protection Agency ("EPA") has mandated use of a 'refuge' planting policy. A refuge policy mandates that a certain percentage of the acreage be planted with conventional hybrid corn that excludes the Bt genetic enhancement. Planting 20-40% of the acreage with hybrid corn creates a refuge where non-resistant strains of ECB can develop and mate with the resistant strain, creating offspring that will most likely not carry the resistant gene to the Bt bacterium. A main obstacle in implementing the high-dose refuge strategy is the dependence on the voluntary compliance of the individual farmer. Compliance efforts have been hampered by the difficulty in monitoring seed and crop management practices, especially among smaller farmers. If compliance does not increase, the EPA may pull the approval for Bt corn, and prohibit the sale of a profitable line for several seed companies. To help ensure compliance with the refuge policy, a business method patent was obtained to bundle an insurance policy with Bt bacteria in the transgenic seed. The patent has 6 years of remaining life. A binomial model is appropriate here because the patent is of no value unless the resistant gene within the ECB mutates and spreads. Here a decision tree is employed to derive all the conceivable scenarios, with the associated probabilities. The value of the patent is then the probability of resistance developing and the patent becoming valuable times the payoff (license value) of the payoff if the favorable scenario develops. With an expected licensing fee or $1.5M per year if the above scenario comes true, the expected income is still quite small due to the low probability. The cumulative value, expressed as a net present value using the income method, is just under $25,000." Paul Flignor, Danid Orozco (n 1317) 14.

[1345] "This family of methods includes real options, binomial models, and Monte Carlo simulations. They are all based on decision tree models where the conditional events required for the IP to generate value is modeled explicitly. At the core of each of these methods is a two step process: first, compute the probability of the favorable event occurring that will make the IP valuable (or 'in the money'), and second, compute the payoff if the favorable event occurs (usually using one of the traditional three methods described above). The real option method is based on the successful Fischer-Black valuation model for pricing options (calls and puts) of financial stocks.

ad. 4th Level (**Solution**)

Under the pyramidal approach the solution lies on its top, that is to say, it is the actual result of the valuation's process, the final step that expresses the "analysis in a way that meaningfully helps resolvea business issue". [1346] The solution for a certain deliverable are divided in three categories, namely, ***(i)*** planning recommendation, ***(ii)*** compliance or ***(iii)*** dispute resolution.

Planning recommendation. Generally, it gravitates around the matter of "whether to enter into a IP sale or license transaction". The deliverable will be a management report "on the feasibility of the proposed transactions and the likely financial costs and benefits". [1347]

Compliance will in most cases provide a financial report in respesct the relevant IP or IA (intangible asset) "to comply with a regulatory requirement. The most common compliance issue today concerns the business combination reporting requirement of FASB, but significant reporting requirement exist in the tax code as well. In addition, compliance reporting may also be required for non-governmental purposes including fairness and sovelcy opinions of business enterprises or financing and lending." [1348]

Dispute resolution concerns to settlement of "infringement claims of IP or contractual violations for IA. The deliverable here is often expert testimony to compliment the expert's report. The specific standars are determined by the relevant court jurisdiction". [1349]

17. TP Methods

Basically, there are two main groups of transfer pricing methods, namely, (1) *Traditional Methods* and (2) *Transaction Profit Method*. Traditional methods are the most efficient method to establish whether the transaction between two

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The basic premise behind the real option method is that an investment with an asymmetric payoff (i.e., a potentially large payoff and only limited losses) will have an increased value as the level of uncertainty, known as volatility, increases. Consequently, real option methods have been most useful where large capital investments are required with a highly uncertain and far away payoff, such as the pharmaceutical and oil exploration industries. Monte Carlo simulations, named for the gambling games popularized at the Mediterranean resort models a low probability payoff over multiple iterations. Monte Carlo simulations are used to estimate the spread of diseases, engineering tolerances and even the probability of the Chicago Cubs winning the World Series! The binomial expansion method, or decision tree, is the most intuitive of these methods. In the binomial expansion the required events and decisions are modeled explicitly, each with their own probabilities. An important aspect of building a binomial expansion is to ensure all potential alternatives and scenarios. Each of these alternative methods should be used with care. The intuition behind each of these is often difficult for the reader of the valuation analysis to follow, and clarity in the purpose and approach of the valuation is always a prime objective of any analysis. Indeed, the intuition behind these methods can be so confusing that often the analyst can become absorbed with the model parameters and lose sight of the original valuation purpose. Despite (or because) or the technical complexity of these methods, they require extreme care in building models that are a highly sensitive to changes in underlying assumptions and parameters." Paul Flignor, Danid Orozco (n 1317) 14.

[1346] Paul Flignor, Danid Orozco (n 1317) 16.

[1347] Ibid 16.

[1348] Ibid 16.

[1349] Ibid 16.

or more associated enterprises is at arm's length, due to the fact that any price variation of an controllable transaction compared to a uncontrolled transaction can be easily "traced to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in a comparable uncontrolled transaction to the price of a controlled transaction."[1350] On the other hand, transaction profit methods are preferred over traditional methods. This is because in cases where it is difficult to properly assess each exact undertaking's contribution to the operation, a *division approach* (unique contribution to the controlled transaction) may be more appropriate than a *one-sided approach*. [1351] Nonetheless, methods that are profit based, must only be applied when compatible with arm's length, that is, when the transaction's price margin of profits from a particular controlled transaction, is comparable against the transaction's price margin of profits conducted between independent enterprises.[1352]

a. Traditional Transactional Methods

aa. Comparable Uncontrolled Price Method (CUP) (CUP-Shopping)[1353]

In sum, the CUP method compares the price of a controlled transaction of goods and services (associated enterprises), against the price of *similar* goods and services of an uncontrolled transaction (independent enterprises), in such a way that, tax authorities will demand a price adjustment if the conditions of the "commercial and financial relations of the associated enterprises are not at arm's length, and the price in the controlled transaction may need to be substituted for the price in the controlled transaction*."[1354]* Pursuing our discussion on CUP, a controllable deal is comparable to an uncontrollable deal if **one** of the following criteria is met: (i) the transaction's appointed differences may eventually influence the property's price; or (ii) specific adjustments to the transaction are able remove such distortions. It is important to note that, the comparable uncontrolled price method is the most straightforward and reliable arm's length approach.[1355] Nevertheless, some specific transactions attract to themselves the most appropriate TP method, for instance, commodities transfer, which will be properly discussed as an independent topic bellow.

CUP on Commodities. Such goods (commodities) are relatively easier to price when compared to other goods (services, patents etc), for commodity prices are constantly (daily-basis) evaluated, either in the domestic or international market. For that matter, commodities *quoted price[1356]* is generally used by

[1350] Transfer Pricing Guidelines (n 503) 98.
[1351] Ibid 98.
[1352] Ibid 98.
[1353] John Vella, Elly Van de Velde, Raymond Luja. *International Taxation and Tax Rulings: Policy Issues at Challenging Times*. European Parliament Directorate-General for Internal Policies (2016). 46.
[1354] Transfer Pricing Guidelines (n 503) 101.
[1355] Ibid 101.
[1356] Quoted price: Prices obtained from a recognized and transparent entity private or governmental agency (indexes).

independent undertakings when pricing uncontrolled transactions.[1357] Nevertheless, the arm's length price may be related to a comparable uncontrolled transaction, or to an uncontrolled arrangement traded according to special circumstances at a certain date, for instance, future commodities contract, where the terms of a certain purchase are arranged at a previous date and the terms of delivery, insurance, transportation etc, considering that such commodity is being physically traded. Needless to say, the arrangement in which such contract was fixed will influence the price of the good, in other words, if the price of the commodity of a comparable uncontrolled transaction differs of that of the comparable controlled transaction, tax authorities are likely to impose the transaction be adjusted "*to ensue that the economically relevant characteristics of the transaction are comparable*."[1358] The *TP Guidelines* provides valuable information on how parties should proceed in order to avoid being audit it due to lack of information in respect to the transaction, for as previously mentioned, TP adjustments will certainly negatively affect the company's operation somewhat (penalties, interest, double taxation etc), therefore it is extremely important that companies maintain the documentation that justifies the transaction's price complete as possible (pricing formulas, third party end-customer agreements, discounts, pricing date[1359] etc) so that the comparable controlled transaction is properly assessed by the relevant tax authorities, consequently, reducing as much as possible extra efforts (time, money).[1360]

CUP on Similar Products. Comparable uncontrolled price method is also a possible approach when an independent undertaking sells the same product sold by the associated undertakings. For instance, an independent enterprise sells Feeder Cattle at a certain quantity, age and weight as other two or more associated undertakings approximately at the same date. Now consider that there is only one possible comparable uncontrolled transaction that could be use as a paradigm in relation to the controlled transaction, where the uncontrolled transaction differs not on the traded quantity of cattle, but on the animal's age

[1357] Transfer Pricing Guidelines (n 503) 102.
[1358] Ibid 103.
[1359] Pricing dates are particularly important not only to traditional methods, but to all TP methods. Consider the following, a parent company of a MS enters into a contract with its subsidiary located in another MS for the purchase of a certain commodity. Some years after the transaction, tax authorities conclude the price of that commodity is inconsistent to its market value of a comparable uncontrolled transaction, which consequently will lead to a price adjustment of that transaction. Therefore, if the party provides reliable evidence as to the reason why certain price was contracted, such as detailed information about the transaction (proposals, contracts – registered or not), ultimately proving that the transaction was under arm's length (insofar the undertakings' conducts are consistent to the presented facts), tax administrations are likely to accept the price agreed by the associated companies. However, if the conduct of the parties is not consistent to the contract's price at that specific date, tax authorities will impose upon the associated enterprises that the price be adjusted to that of comparable uncontrolled transactions ("When the taxpayer does not provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled transaction and the tax administration cannot otherwise determine a different pricing date under the Guidance in section D of chapter I, tax administrations may deem the pricing dade for the commodity transaction on the basis of the evidence available to the tax daministation; this may be the date of the shipment as evidence by the bill of lading or equivalent document depending on the transport") Transfer Pricing Guidelines (n 503) 104.
[1360] Transfer Pricing Guidelines (n 503) 103.

(not a two year old feeder, but a less than one year feeder). Question: Does the age difference affect the price of the transaction? The answer to this question would need be obtained from the open market (commodities exchange), or from other undertakings. If after such assessment, tax authorities conclude that the age of the animal influenced on its price, the price of the transaction would need be adjusted. ***Specific characteristics*** of the transaction such as delivery (transport rules), [1361] may also disfigure the comparable controlled and uncontrolled transactions.

ab. Resale Price Method

As the method's name denote, the resale price method is the difference between the purchase price paid by the associated undertaking and the price which that same undertaking charges upon selling the product to an independent company or to the final consumer.[1362]Therefore, this topic's key entity will be the ***Distributer***. In order to calculate the actual purchase price, one must subtract from the actual purchased price the resale gross margin price[1363] (which should not be bellow the company's budgetary plan).[1364] The result will

[1361] The delivery's risk of a ***CFR*** (Cost of Freight- The seller pays for the carriage of the goods up to the named port of destination. Risk transfers to buyer when the goods have been loaded on board the ship in the country of Export. The Shipper is responsible for origin costs including export clearance and freight costs for carriage to named port. The shipper is not responsible for delivery to the final destination from the port (generally the buyer's facilities), or for buying insurance), and a ***FOB*** (Free on Board- Under FOB terms the seller bears all costs and risks up to the point the goods are loaded on board the vessel. The seller's responsibility does not end at that point unless the goods are "appropriated to the contract" that is, they are "clearly set aside or otherwise identified as the contract goods."[18] Therefore, FOB contract requires a seller to deliver goods on board a vessel that is to be designated by the buyer in a manner customary at the particular port. In this case, the seller must also arrange for export clearance. On the other hand, the buyer pays cost of marine freight transportation, bill of lading fees, insurance, unloading and transportation cost from the arrival port to destination), will affect the product's price.

[1362] Transfer Pricing Guidelines (n 503) 105.

[1363] ***Gross margin*** depicts the efficiency of the company's production, by dividing the ***Gross Profit*** ($Revenue - COGS = GP$) by the total ***revenue***, therefore, if a certain company's ***GP*** *equals 50* (150 – 100 = 50), its ***GM*** would be 33% ($^{50}/_{150} = 0{,}33$).

[1364] It is by budgeting that companies are able to determine their goals, future activity plans (new investment) and most importantly, control their current activity so that their goals are met. Nevertheless, a MNE's budget is not necessarily static (change of business strategy). However, the moment for defining a business strategy is generally when companies budget, that questions such as: what will the competitive pressures in that market be? What products will the company sell in that specific market? What region is expected to generate futures sales? Should the company outsource its production, management etc? How will the company finance its operation? Equity or debt? Nonetheless, the ***resale price margin*** or the ***gross price margin*** is the product of the budgeting process which should follow the subsequent order: (***i***) ***Strategic Plan*** (what is the company's plan for the next two, five or ten years?); (***ii***) ***Master Budget***, that is, a plan for how much sales revenue must earn, how much raw material will need to purchase, how much manufacturing costs will the MNE incur, wages of employees and payment of suppliers, administrative expenses, quantity of finished goods and inventory, how much cash will be collected from customers, how much money will the MNE borrow etc; (***iii***) ***Sales Budget***, that describes how many units must the company sell on a monthly or quarterly basis (marketing departments generally obtain a sales forecast according to the company's *master budget* and apply it according to costumer's needs, past trends, plan for new products/marketing studies, advertising and marketing plans etc), after assessing how much must the company sell in order

be the "*arm's length price for the original transfer of property between the associated enterprises*." [1365] Product's differences do not have the same importance in *resale price methods* when compared to a CUP method, this is because the price difference is not (in most cases) attributed to the product itself, but to the risk and assets used by the company to produce or distribute the good, therefore when the "*uncontrolled and controlled transactions are comparable in all characteristics other then the product itself, the resale price method might produce a more reliable measure of arm's length than the CUP method*."[1366] Such analysis is particular to ***distributer undertakings***, which deal a variety of products of similar price but with distinct characteristics (toasters and blenders). Nevertheless, comparing the same category products, will provide a more conclusive result on the assessment. The TP Guidelines provides two main criteria (at least one must be met) in order to assess the comparability of a controlled transaction against an uncontrolled transaction for the purposes of resale price margin: (***i***) the transaction's differences between independent undertakings and associated undertakings must not affect the resale gross margin in the open market and (***ii***) adjustments to the transaction are able to eliminated such price differences.[1367] It is important to keep in mind that the shorter the time period the between the comparable controlled and uncontrolled transaction, the more reliable the comparison will be (here, large time lapses will certainly influence the product's price).[1368]

When there is not a substantial value to the good added, that is to say, a small contribution (if any) to the product's value, the resale price method becomes relatively easy to be assessed when compared to a uncontrollable transaction. For example, if the associated company, distributer of a certain goods contributes by adding extra value to the product (marketing activities), the product's price will be affected, thus, when using such comparable transactions, tax authorities should be attentive of such fact. Now, consider another situation where an associated company's product is further processed. Reaching an arm's length price might be more difficult. One has to consider that, when a good is processed, the initial product will inevitably lose its identity, and although that is easier to evaluate the contribution of each joint good to the final product in respect to tangibles (paint, screws, nails used in making a car - *indirect materials*;[1369] salaries of night security guards for the factory or supervisors over

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to maintain its economic viability, undertakings plan their (***iv***) ***Production Budget***, having in mind that a low inventory with a higher demand will cause the company to lose sales, and a high inventory may present others risks, such as product's obsolescence, damage etc, (***v***) ***Selling Expense Budget***, that is to say, what will be the costs of departments other than production/manufacturing, (***vi***) ***Cash Budget***, which generally is last prepared for it depends on the sales budget, budget expenditures (materials, labour, selling and general expenses etc). Cash budget is also fundamental to the company's strategic plan for a proper cash budgeting will be assessed by financial institutions during a credit analysis, that is to say, the company's ability to repay the loan, and finally, companies prepare their (***vi***) ***Budgeted Financial Statements***, with all information related to previous budgets (*Master Budget* to *Cash Budget*), in order to provide an overall projection for the subsequent year.

[1365] Transfer Pricing Guidelines (n 503) 106.

[1366] Ibid 107.

[1367] Transfer Pricing Guidelines (n 503) 106.

[1368] Ibid 108.

[1369] ***Indirect materials*** are products used in a line of production which the effort to trace the cost to the particular finish good is considerably complex (***manufacturing overhead***).

multiple cat lines in a factory – *indirect labor*),[1370] evaluating the distributer's contribution to the product, will not be smoothly evaluated.[1371] It is important to point that, any contribution to a certain good, whether by actively participating in the good's production process, or in marketing or distributing such product, any price variation what independent enterprises would agreed, will have to be properly documented, that is, reasonably justified, [1372] otherwise such unjustifiable comparable controlled price variations will certainly be adjusted by the relevant tax authority. Distributer's transactions that have any king of monopoly arrangement, must also be carefully analyzed, for it may "*influence the margin*."[1373]

IMPORTANT: "Where accounting practices differ from the controlled transaction to the uncontrolled transaction, appropriate adjustments should be made to the data used in calculating the resale price margin in order to ensure that the same types of costs are used in each case to arrive at the gross margin.[1374] For example, costs of R&D may be reflected in operating expenses or in costs of sales. The respective gross margins would not be comparable without appropriate adjustments." [1375]

Before concluding this topic, we will two present a short examples where adjustments need be made before the controlled and uncontrolled transaction can be considered as comparable transaction for the purposes of the resale price method.

Example 1. Two companies sell electronic devices, on the same market and of the same brand. Distributer X does not offer any type of warranty for that particular product, whereas, Distributer Y gives 1 year warranty over its products though it does not compute the warranty price its product. Nevertheless, Distributer Y charges a higher price for the product when compared to Distributer X. Note that the warranty provides enough evidence that, due to the warranty, Distributer Y incurs in higher costs when selling the product, therefore the transactions are not comparable for the purposes of the resale price method. Now, consider that both distributers, under the same circumstances, sells the same products, at the same price, with the warranty guarantee which is compensated by the supplier which sells its product at a lower price. Nonetheless, Distributer X does not perform the warranty by providing the consumer with a new unit, instead, Distributer X ships the product back to the supplier. However, Distributer's X price discount on its product, is lower than that Distributer Y receives from its supplier. Distributer Y places the warranty costs as goods sold[1376] in its financial statement, whereas Distributer X places the warranty expenses (sending the product back to the supplier) under

[1370] ***Indirect labor*** is work performed in the production line of a certain good, which is not directly traced to the good's cost, therefore assessing its contributions to the good's cost is considerably complex.
[1371] Transfer Pricing Guidelines (n 503) 108.
[1372] Ibid 108.
[1373] Ibid 109.
[1374] The Platform for Collaboration on Tax (n 1228) 84.
[1375] Transfer Pricing Guidelines (n 503) 110.
[1376] ***Cost of Goods Sold*** (COGS).

operating expenses. [1377] Until the margin distortion is corrected, both transactions are not comparable for the purposes of the resale price method.[1378]

Example 2. Two undertakings (Company X and Company Y) pays its executives annually a certain amount of shares according to their individual performance (employee stock-based compensation). When comparing the gross margin of Company X uncontrolled transaction against Company Y controlled transaction, it is assessed that Company Y did not book the stock remuneration transaction (6 million euros) as an expense in its annual report as did Company X. By not including such expense, the, Company Y was able to increase its gross margin substantially when compared to Company's Y margin.

Annual Report	*Company Y (Before)*	*Company Y (After)*
Income	150	150
COGS	(100)	(100)
GP	50	50
Administrative/Operating Expenses (overhead)	(23)	(29)[1379]
Depreciation	(4)	(4)
Gross Profit	26	17
Corporate Tax 30%	7,8	5,1
Profit After Tax	18,2	11,9

According to the example above, is the corporation tax is say 30% in the country where Company Y operates, the undertaking will suffer a substantial impact on its net gross income, considering that Company Y had to adjust its book according to the uncontrolled transaction. [1380]

ac. Cost-Plus Method

The cost-plus method, consist on the assessment of the additional cost *mark-up*[1381] over the property's/service's price upon its transfer. This method is recommended when assessing the price transfer of *semi-finished goods* traded between associate companies, where "associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services".[1382] Note that ***commodities*** (similar goods) are generally more appropriately analyzed under a ***CUP method***, alternatively, ***finished goods*** (distributer) typically are assessed under a ***resale price method***, and finally ***semi-finished goods*** (the assembling line of a certain product, for instance) under ***cost-plus method***.

According to the TP Guidelines, the cost plus mark-up of a supplier in a controlled transaction should be compared to the cost plus mark-up that the

[1377] ***Operating Expenses*** (OE).
[1378] Example adapted from as from TP Guidelines. Transfer Pricing Guidelines (n 503) 110.
[1379] 23 (AE) + 6 (Stock compensation).
[1380] Example adapted from Appendix 11. The Platform for Collaboration on Tax (n 1228).
[1381] ***Cost mark-up*** may be defined as the difference between the lowest possible price of a certain good (break-even price) to the final price charged to the consumer of the good (marked-up spread).
[1382] Transfer Pricing Guidelines (n 503) 111.

same supplier has on an uncontrolled transaction (***internal comparable***),[1383] and in the absence (*or in addition)* of an internal comparable price, to the cost mark-up that the undetaking would have earned in a comparable transaction conducted by an independed undertaking (external comparable). As in resale price method, the conditions to ***establish comparability*** between controlled and uncontrolled transactions are: (***i***) none of the differences between both transactions (controlled and uncontrolled) affects the cost mark-up in the open market and (***ii***) the transaction's price can be reasonably adjusted so that any price difference is eliminated.[1384]

An undertaking that produces furniture with its ***own*** equipment/machinery (cutting wood, painting etc), has a lower cost than its competitor, that produces its furniture with leased machinery, ultimately influencing the its final costs, therefore influencing the company's cost mark-up ("differences between the controlled and uncontrolled transactions that have an effect on the size of the mark-up must be analysed to determine what adjustments should be made to the uncontrolled transaction's respective mark up").[1385] Consequently, the OECD guideline on TP, stresses the importance of scrutinizing: the ***types of expenses*** (operating expenses, non-operating expenses – leases), the ***functions perfomed*** as well as the ***risks taken*** when assessing comparability.[1386] The *guidelines* suggests that when assessing comparability, adjustments should be considered on the following instances:

(i) Expenses that reflect a functional difference of used assets and risk, which were not accounted when applying the cost-plus method, may require some sort of adjustment;

(ii) Expenses related to other functions than analized under cost-plus method may require adjustment, for "separate compensation for those functions may need to be determined"[1387]

The OECD guindance suggests that if differences in expenses are proven to be the result of a more efficient enterprise, which was able to reduce its costs, no adjustment may be required. To conclude, it is important to point out the relation between accounting consistency when analysing comparability, that is to say, when analyzing both controlled and uncontrolled transactions it is important to assess whether the accounting practices in respect to both transactions are similar in order to ensure that the same type of costs used in each case are comparable.[1388] As previously mentioned the ***cost driver*** or ***activity based*** of an enterprise will determine the manufacturing costs in producing a certain good or providing a certain service. Such costs (job-production costing/job-order costing) are divided in *direct costs*, which are easily traced to the finish product or service, *direct labour costs*, which also can be easily traced to the finish product or service and *manufacturing overhead,* which relates to all manufacturing costs in keeping the production facilities and

[1383] Ibid 111.
[1384] Ibid 111.
[1385] Ibid 113.
[1386] Ibid 113.
[1387] Transfer Pricing Guidelines (n 503) 113.
[1388] Ibid 113.

production process operating (*except* direct materials and direct labour). Examples of manufacturing overhead are: *indirect materials* and *indirect labour* (materials and labour that is not easily traced back to the final product). Pursuing our discussion on the comparability of accounting methods, differences on how enterprises treat certain costs may also influence the reliability of comparable transactions, for instance, generally the cost plus method is applied over ***gross profit*** mark-up. Gross profit is calculated according to the formula bellow:

$$Revenue^{1389} - COGS^{1390} = GP$$

Note that operating expenses (OE)[1391] were not concluded on the formula, therefore, if tax authorities were to assess the costs of a product or service under a ***net-profit*** mark-up, the cost of such transaction would be considerably *higher*:

$$Revenue - COGS - OE - interest - taxes = NP$$

Nonetheless, as previously mentioned, cost-plus method is applied under a gross profit mark-up, however if the both the controlled and the uncontrolled transaction are not based on the same accounting standards, the reliability of the comparability assessment would be compromised due to the fact that companies may treat certain costs differently ultimately affecting the final cost of the product or service. In sum, the "basis for applying the cost plus method will be formed by all the costs connected to the assembling activities". [1392]Consider the example bellow. Subsidiary A1, resident of State B and fully owned by Parent Company A, resident of State C, produces computers. Subsidiary A's activity restricts to the assemble of such computers, at the at the full expense of its Parent Company resident of another State. The decision of incorporating a subsidiary in another State was based mainly on the reduced costs that such company would have in assembeling its computers (lower wages, taxes etc). After the goods are assembled, Co.A1 proceeds with a quality control of such computers that are ultimately distributed to various distributions centres in a number of different States. Contractually, Sub A1's activity is described being purely of a manufacturing nature.

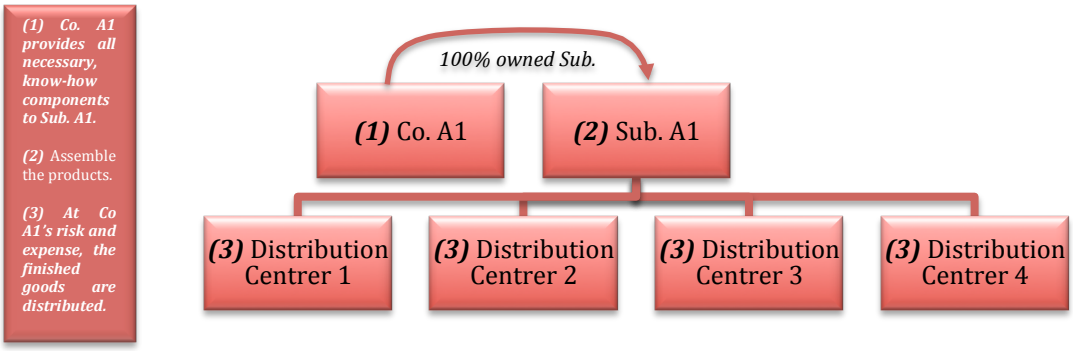
[1389] ***Revenue***, sometimes referred to as ***sales*** or ***turnover***.

[1390] ***Costs of goods sold*** (COGS) may be defined as the actual cost in producing a certain product or providing a certain service, in other words: Would this cost (expense) exist if no sales were made? (*a.* raw materials, *b.* wage of a salesman, *c.* indirect materials: materials which the effort to trace the cost to the finished good are too complex – *a*. direct costs, *b*. direct labour and *c*. manufacturing overhead).

[1391] Contrary to COGS, ***operation expenses*** (OE) have a linear behavior through time regardless the company's level of activity (cost driver/activity based). For instance, the rent for the factory where the company produces its goods, the wage of certain employees (accountant, secretary, security guard etc). The company will have to provide for such costs regardless the company's production.

[1392] Transfer Pricing Guidelines (n 503) 116.

Figure 19



As previously mentioned cost-plus method is generally the most appropriate method in order to assess the transfer price of a *semi-finished good.* The price contracted between associated enterprises (controlled transaction), must gravitate around the price contracted between unrelated enterprises (uncontrolled transaction), otherwise, tax authorities may required some sort of adjustment. However, sometimes the Parent Company may be tempted to attract some of its associated company's overhead (located in a low tax jurisdiction) to its books for its own benefit (cost of reparing the product, for instance), ultimately shifting the cost to the parent company, thefore manipulating the transfered price. Nevertheless, under a cost-plus method, the only risks that the assembler could attract to its operation relate to the quantity or quality of the assembled product, therefore, the "basis for applying the cost plus-method will be formed by all the costs connected to the assembling activities".[1393] In sum, cost allocation should be based on a function analysis.[1394]

b. Transaction Method

Only profit methods that "satisfy the arm's length principle are those that are consistent with Article 9 of the OECD Model Tax Convention and follow the requirement for a comparability analysis as described" in the OECD guidelines.[1395] All TP methods are only acceptable to the extent they are consistent with the guideline's provisions. Transaction profit methods are divided into two major goups, namely, transaction net margin method and the transaction profit-split method.[1396] Transaction methods are preferred on the following circumstances, when a party to the transaction, make an unique contribution to the controlled transaction, or when the parties' contribution to the transaction are highly integrated, in such a way that a profit split would provide greater reliability on the transaction's comparability analysis when compared to an "one-sided method".[1397]

[1393] Transfer Pricing Guidelines (n 503) 116.
[1394] Ibid 115.
[1395] Ibid 117.
[1396] Ibid 117.
[1397] Ibid 98.

aa. Transaction Net Margin Method (TNMM)

Transaction Net Margin Method is assessed under a base (cost x profit) that the relevant enterprise realizes when conducting the controlled transaction, that is, the TNMM should be applied in the same manner as the traditional resale and cost-plus methods previously discussed, as as in both methods, the TNMM consists on the comparison between controlled and uncontrolled transaction, in other words "the net profit indicator of the taxpayer from the controlled transaction (...) should ideally be established by reference to the net profit indicator that the same taxpayer earns in a comparable uncontrolled transaction",[1398] and in not possible either ***internal comparables*** or ***external comparables*** may serve a porssible guides, added to a functional analysis.[1399] As we shall see in more detail, the TNMM may be the more appropriate method when the contribution made by the associated enterprise to the transaction are not unique, for instance, is an associated company contributes to the operation itself with an unique intangible, the TNMM will not be the more appropriate method, but the profit-split method, however, if the company's comtribution to the operation is not unique, for example, the company may contribute with a non-unique intangible (business process, market knowledge, brand name, patent), the TNMM or a traditional method (CUP, cost-plus or resale) may be deemed as more appropriate.[1400] According to the OECD TP guidelines, the TNMM can be less sensitive to differences in product characteristics when compared to other "one-sided methods" such as cost-plus or resale price methods (traditional methods), and the reason for that is that under TNMM a "greater emphasis is generally placed on the ***functional comparability*** than on the characteristics of products".[1401] The table bellow depicts numerically the difference in price paid by a ***distributer company*** (in the case of a distributer, one must use ***purchased price*** instead of ***COGS***) which performs a ***limited marketing function*** and another distributer which performs a more ***broad marketing function*** when selling the same product.

	Co. 1 (Limited function)	Co. 2 (Broad Function)
Total of Sales	5000	5000
Purchased price	3000	2400
GP	2000	2600
GM	40%[1402]	52%[1403]
Marketing expenses	250	750
Overhead	1500	1500
NP margin	250 (5%)	350 (7%)

One can immediately identify that Co. 2, which operated with a more broad marketing function paid less for the product (3000 - 2400 = 600), due to the fact that it had to perform marketing functions (additional expense of ***450***

[1398] Ibid 118.
[1399] Ibid 118.
[1400] Ibid 118.
[1401] Transfer Pricing Guidelines (n 503) 425.
[1402] 2000/5000 = 0,4.
[1403] 2600/5000 = 0,52.

and remuneration of ***150*** for the marketing functions performed by the distributor, totaling ***600***). Now, were the relevant tax authority (or taxpayer) to apply other method than the TNMM (resale price method or cost-plus method) it would ultimately work with ***GP*** instead of ***NP***, therefore the "effect of the functional differences on the cost structure" would be greater, that is ***12%*** of 5000 = ***600***, instead of only ***3%*** of 5000 = ***150***. Note that the "net profit margin can be less sensitive than gross margins to differences in the extent and complexity of functions".[1404]

Pursuing out discussion on TNMM, it is important to include (***determination of net profit***) only items that are "directly or indirectly related to the controlled transaction (…)" ***and*** that are of an operating nature to the controlled transaction,[1405]for instance, non-operating items such as expenses, interest income and taxes shoud be excluded (except when the circumstances of the case, risks and functions are carried out in such a manner the the inclusion of such costs are necessary in order to enhance the reliability of the comparability analysis.[1406] The OECD TP guidelines stresses the point that credit terms and sales prices differences could ultimately affect the transaction's comparability, for instance, large retail companies which have long term credit lines with its suppliers and at the same time offer its customes only short term credit lines, are able to "derive excess cash", allowing the company to reduce the final price of its products to the final consumer. Foreign exchange gains or losses should be included to the extent that such operation is "of a trading nature (e.g. exchange gain or loss on a trade receivable or payable)" and if the tested party ultimately conducted such operation. Hedged transactions must also be computed as costs to the extent thet the operation was "borne by the tested party".[1407]

Bellow we listed some of the advantages and drawbacks to TNMM.

Drawbacks	**Advantages**
- Lack of availability of information regarding uncontrolled transactions at the time of the controlled transaction is concluded; - Difficulty on ascertaining revenue and OE in respect to controlled transactions in order to establish the "net profit indicator used as a profit method";[1408] - Difficulties in determining the appropriate adjustment when applying the TNMM in instances where the associated enterprise	- Net profit indicators (return on assets operating income to sales and other indicators certain operations in particular,[1410] are less affected, and more tolerant to transaction differences and functionalities when compared to GP;[1411] - Being a "one-sided method" (thus less complex), it simplifies the method's analysis, by approaching the financial indicators of only one party to the transaction, that is, it is not necessary to "state the books

[1404] Transfer Pricing Guidelines (n 503) 426.
[1405] Ibid 123.
[1406] Ibid 124.
[1407] Transfer Pricing Guidelines (n 503) 125.
[1408] Ibid 120.

is at both sides of the transaction (selling and buying)[1409]	and records of all participants in the business activity on a common basis or to allocatate costs for other participants"[1412] as in profit split;

"In no case should transactional profit methods be used so as to result in over-taxing enterprises mainly because they take profits lower than average, or in under-taking enterprises that make higher than average profits. There is no justification under the arm's length principle for imposing additional tax enterprises that are less successful than average or, conversely, for under-taxing enterprises that are more successful then average, when the reason for their success or lack thereof is attributable to commercial factors".[1413]Moreover, one should not apply a profit method simply due to difficulty in obtaining comparable data.[1414]

18. Documentation[1415]

The Ernst & Young Transfer Pricing Surveys demonstrates that "***transfer pricing*** has increased compliance burdens over the last years, due to two main factors: (i) ***more demanding documentation*** requirements from tax authorities accompanied by tax authority reviews; (ii) adjustments and changes of the type and scope of business operations around the world. Particularly, the increased documentation demands owing to transfer pricing appear to be stretching tax department resources. In the 2007 Survey, 65% of respondents saw an increased need for transfer pricing resources over the former three years, with 72% meeting the need through increased reliance on external advisors and 34% by hiring in-house resources. Already in the 2005 Survey, many companies seemed to have expanded their internal resources dedicated to transfer pricing and task risk management, increasing their average headcount by 1 full-time equivalent to 2.5."[1416] Documentation in transfer pricing is extremely important, for they provide necessary formality to the transaction. When the operation occurs within the single market, tax authorities have the prerogative of requiring the necessary documents in order to ascertain the veracity of the operation. If the

[1410] Ibid 130.
[1411] According to the OECD TP guidelines "Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, this may lead to a wide range of gross proft margins but still broadly similar levels of net operating profit indicators". Transfer Pricing Guidelines (n 503) 119.
[1409] Ibid 120.
[1412] Ibid 119.
[1413] Ibid 98.
[1414] Ibid 98.
[1415] The principle of proportionality has an intimate relation with the following discrimination justifications: *difficulties in obtaining information* and the *effectiveness of fiscal supervision*. *Section (I.B.1.d*). If a MS is not able to collect the necessary documentation for the correct tax assessment itself, and after requesting the tax payer, for any reason, he/she/it fails to produce such documents (proving thus that the conditions for the benefit are met), the relevant Member States' tax authority is not obliged to grant the benefit. Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 89.
[1416] COM (2011) 121/4 final. 11.

operation has a third-country part, a MS may not demand that a third-Country or the tax-payer himself, to provide the necessary documentation. Legal instruments (DTCs or TIEAs) regulate the situation, and in the event of a dispute, it is left to the courts to decide upon the matter.[1417] Sometimes MSs may create difficulties upon undertakings to gather TP information, and afterwards, justify the discriminatory measure under these grounds. Such rules were incorporated in the Mutual Assistance Directive.[1418] PricewaterhouseCoopers LLP (PWC) carriied out since 2005 "an annual Total Tax Contribution survey of the Hundred Group of Finance Directors (ie an association of the 100 largest listed UK companies, which contribute nearly a quarter of the total corporation tax take in the UK) asking them to provide information on the time spent on compliance activities relating to their taxes borne and collected, as well as to provide data on their tax payments. The results of the 2007 survey showed an average cost of tax compliance for corporate income taxation of 2.2% of taxes paid. On top of that, around ***15% of the time spent on compliance activities relate to the international aspects of corporate taxation*** (of which, ***transfer pricing represented 36%***, Controlled Foreign Corporations 23%, double tax relief 19%, withholding tax 6%, treasury consents 4%, and other 12%). Furthermore, the results of the 2008 Survey show that 43% of the total compliance time and 54% of the total compliance costs relate to corporation tax."[1419] Therefore, it is fair to say that TP constitute to undertakings one of the main compliance villains.

G. M&A Taxation (International)

"So what do you do?' [...] 'I',m into, oh,
murders and executions mostly' [...] Do you
like it? most guys I know who work in mergers
and acquisitions don't really like it'"[1420]

Patrick Bateman

Merger mania is prevalent during periods of high economic activity and generate enourmouns fees to those who participate providing legal and financial assistance. From the 1950s on, the international community experienced a number of international waves of "expansion and consolidation through mergers" in the audit business.[1421] Throughout the second half of the 1980s and during the 1990s, a frenetic period of mergers occurred. Between 1998 and 2001 another wave or mergers continued following a period of economic decline till 2005. Numerous mergers have taken place between MNEs that have "sought to restructure and consolidate their place in an increasingly global market".[1422] Mergers in the pharmaceutical industry, motor industry, oil industry, entertainment industry, audit industry etc (Pfizer and Warner-Lambert merged

[1417] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 89.
[1418] The exchange of information regarding the filed of direct taxation falls within the scope of the principle of Enhanced Cooperation. Directive 2011/16/EU.
[1419] COM (2011) 121/4 final. 11.
[1420] Bret Easton Ellis. *American Psycho*.
[1421] Peter Walton (n 786) 4.
[1422] Richard Whish & David Bailey (n 734) 855.

only to become the largest in the world (2000 - *case M 1878*),[1423] Daimler-Benz and Chrysler (1998 – *case M 1204*),[1424] Ford and Volvo (1999 – *case M 1452*),[1425] Renault and Nissan (1999 – *case M 1519*),[1426] GM and Saab (2000 – *case M 1847*),[1427] Fiat and Chrysler (2009 – *case M 5518*),[1428] Exxon and Mobil (1999 –

[1423] Pfizer exchanged 2,75 shares of Pfizer common stock for each outstanding share of Warner-Lambert stock ***in a tax-free transaction*** valued at $98,31 per Warner-Lambert share, or $90 billion, based on Pfizer's February 4 closing price of $35,75. This represents a 34% premium over the average closing prices of Warner-Lambert during October 1999. The combined company is called Pfizer Inc. had an annual revenue of approximately $28 billion (2000), including $21 billion in prescription pharmaceutical sales, and a estimate market capitalization of approximately $ 230 billion. *Pfizer, Warner-Lambert Agree to $90 Billion Merger (2000)*. https://www.drugdiscoveryonline.com/doc/pfizer-warner-lambert-agree-to-90-billion-mer-0001. Accessed in 10 Jan 2018.

[1424] The merger was accomplished through exchange offer and merger transactions in which stockholders of both companies became stockholders of a NewCo. Daimler-Benz acquired one share of DaimlerChrysler for each Daimler-Benz Share they owned. Chrysler stockholders received 0,547 of DaimerChrysler for each share they owned. The ratio was adjusted to reflect the special pay-out and capital increase Daimler-Benz's transaction. The transaction was ***concluded tax free*** for both companies and their shareholders. Chrysler shareholders acquired approximately 43 of NewCo., and Daimler-Benz shareholder 57%. The merger was highly controvertial due to *cultural differences,* (corporate structure, culture, customer relation, value chain, leadership etc) leading Chrysler to loose approximately 1 billion euros in 2003. *Daimler-Benz and Chrysler sign merger agreement* (1998) https://www.dieselnet.com/news/1998/05daimler.php. Accessed in 10 Feb 2018.

[1425] In 1999 Ford took-over Volvo for approximately $6.45 billion kronas with the hopes of benefiting from economies of scale and intensifying its presence in the luxury market. Howeveer, the plan did not turn out as it was expected, for in 2010 Ford sold Volvo to a Chinese company (Zhejiang Geely Holding Group) for a fraction of the price paid in 1999 ($1.8 billion dollars), realizing a 72% loss. *Ford selss Volvo to Geely. Devolving Volvo.* The Economist (2010) https://www.economist.com/node/15804598. Accessed in 10 Feb 2018.

[1426] With a rising debt load and declining sales, the Japanese Company Nissan and Renault announced a $5.4 billion dollar alliance, where Renault became a minority 36.8 % shareholder of Nissan Motor, 22.5% of Nissan Diesel Motor Co. and the European finance subsidiaries in return for cash infusion. Nissan market value in 2018 is at $43.3 billion with a revenue of $108.8 billion dollars in 2017. Phil Serafino, Ania Nussbaum. *What You need to Know About a Renault-Nissan Merger* (2018) https://www.bloomberg.com/news/articles/2018-03-29/renault-nissan-deal-would-untangle-20-year-pact-for-shift-to-ev. Accessed in 10 Feb 2018.

[1427] GM bought Saab for $600 million dollars for 50% ownership of Saab, with an option on the other 50% (in 1990 Saab realized a $848 million dollar loss, almos $9,200 dollars loss per unit). In 1999, GM exercised its option for the other half of the company. In December 19, 2011 Saab Auto was declared bankrupt. Matthias Holweg, Nick Oliver. *Who Killed Saab Automobile*. University of Cambridge. (2011) https://www.business-school.ed.ac.uk/__data/assets/pdf_file/0010/43768/Who-killed-Saab-Automobile-Final-Report-December-19-2011.pdf.

[1428] "On 30 April 2009 Chrysler filed for protection from its creditors under Chapter 11 of the US Bankruptcy Code and announced plans for a global strategic alliance with Fiat. On 10 June 2009, after a judicial procedure, the company formerly known as Chrysler LLC sold substantially all of its assets, without certain debts and liabilities, to a new company that will operate as Chrysler Group LLC. Fiat has acquired an initial 20% equity interest in Chrysler and entered into a number of agreements with the company to provide it with access to certain Fiat technology, platforms and power trains. Despite Fiat's stake of only 20% in Chrysler, which it may increase in future, Fiat holds rights in the decision-making process of Chrysler that will enable it to exercise sole control over Chrysler." *Mergers: Commission approves acquisition of Chrysler by Fiat*. (2009). http://europa.eu/rapid/press-release_IP-09-1189_en.htm. Accessed in 10 Feb 2018.

case M 1383),[1429] BP and Arco (1999 – *case M 1532*),[1430] America Online and Time-Warner (2000 – *case M 1845*)).[1431]

In sum, firms merge to: ***1.*** achieve economies of scale and scope; ***2.*** to operate more efficiently; ***3.*** to become national champion (see conclusion); ***4.*** to take control on the management of its competitor (dissatisfied shareholders may sell their shares to another firm that will better manage the company's operation); ***5.*** to exit a certain industry; ***6.*** to increase market power, or due to ***7.*** *sex, drugs and rock and roll* ("many mergers cannot be explained in the rational economic terms (…) but (…) they are fulled by the speculative greed of individuals or companies or the personal vanity of a particular swashbuckling senior executive; it will not take a great deal of imagination to think of certain high-profile entrepreneurs that might answer this description").[1432]

A *true* merger constitutes basically of two separate companies merging into a new company.[1433] Mergers may create anti-competitive effects as well as positive effects in the relevant market. Negative effects are generated by the removal of "important competitive constraints on one or more sellers, who consequently have increased market power".[1434] Mergers may present horizontal, vertical and conglomerate effects. ***Horizontal effects*** are created when actual or potential same products, geographical and same level competitors merge, needless to say, horizontal effects on competition are much greater than those of vertical effects, or conglomerate effects, for that matter. Horizontal mergers may give rise to non-coordinated as well as to coordinated effects[1435] that are likely to impede "effective competition by creating or strengthening the dominant position of a single firm".[1436] ***Vertical effects*** occur "between firms that operate at different, but complementary, levels of the

[1429] Exxon and Mobil merged in 1999 on a $250 billion dollar deal. The merger was expected to generate a 2.8 billion dollar savings after two years. At the time the both companies merged, brent crude was at $10.43 a barrel (oil prices were substantially low, thus energy companies were taking a hit). In sum, Mobil shareholders would receive a 30 per cent of the merged group and were offered 1.32 Exxon shares for each Mobil share they owned. *Exxon-Mobil merger done* (1999). http://money.cnn.com/1999/11/30/deals/exxonmobil/. Accessed in 10 Feb 2018.

[1430] The deal consisted on the following, Arco shareholders received 0,82 of BP depositary shares, or a value of about $78,57 a share for each of the 327 million shares remaining. After BP anounced its purchase, stockes plummeted almost 6% in 1999. At the time the deal was concluded both BP and Arco expected to save 1$ billion dollars in costs by 2001, added to $500 million dollars at Arco's side, which would come from combining exploration activities which overlapped in Alaska and the North Sea. Gains on retail were also expected and the rest from cutting jobs (approximately 2.000). Christopher Cooper, Brushan Bahree, Steve Liesman. *Why Arco Agreed to Merger With the Giant, BP Amoco*. (1999) https://www.wsj.com/articles/SB923011068313487 90. Accessed in 10 Feb 2018.

[1431] America Online bought Time-Warner for $162 billion dollars in 2000. AOL shareholder would own 55 % of the company and Time-Warner the difference (AOL brands: AOL, CompuServe, CNN, Time, Netscape, TBS, TNT, Cartoon Network, HBO, Warner Music Group, Fortune, Sports Illustrated, Entertainment Weekly and Looney Tunes). Seth Sutel. *AOL Buys Time Warner for $162 billion*. (2000) http://abcnews.go.com/Business/Decade/aol-buys-time-warner-162-billion/story?id=9279138. Accessed in 10 Feb 2018.

[1432] Richard Whish & David Bailey (n 734) 857.

[1433] Ibid 853.

[1434] Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings OJ C 31, 5.2.2004, p. 5–18. Para. 24.

[1435] Richard Whish & David Bailey (n 734) 915.

[1436] Ibid 854.

market for the same final product".[1437] Lastly, ***conglomerate effects***, when different entities, operating neither horizontaly, nor vertically merge thus creating another entity capable of using its "power in two different but related, or even unrelated, markets to foreclose competitors". [1438]

When one thinks about competition, the first thing that comes to mind is ***market power*** (of course protecting the competitive process, maintaining low prices, enhancing quality, widening product substitutability, improving technology and improving efficiency are the main goals of competition law and competition policy overall).[1439] *Question*: has the relevant party the ability to influence the competitive process in such a way as to reduce demand substitutability, supply substitutability and constraint the competitive process? To answer that question authorities have to measure the entity's market concentration, and one way of doing that is using the so-called *Herfindahl-Hirschman Index* (HHI).[1440] If the *index* is bellow 1.000, the market concentration is *low*; between 1.000 and 1.800 *moderate* and finally, if over 1.800, *highly concentrated*. For instance, a certain group wishes to buy a certain competitor, and files an application with the relevant competition authority. When analysing the company's market concentration, the competition authority concluded that there are total of 20 competitors in the relevant market: 15 of them have market share of 5% and the other 5 have a market share of 5%

$$\text{HHI} = 15 \times 5^2 + 5 \times 5^2 = 375 + 125 = 500$$

The market concentration is bellow 1.000, thus ***low***. Considering hypothetically that the merger's approval depended only on the HHI, the merger would have been approved. In another case, a certain group filed for authorization to acquire one of its competitors. Authorities found that there are 10 competitors in the relevant market: 5 of them have market share of 15% and the other 5 have a market share of 5%

$$\text{HHI} = 5 \times 15^2 + 5 \times 5^2 = 1.125 + 125 = 1.250$$

The market concentration is between 1.000 and 1.800, thus ***moderate***, thus further analysis would have been conducted. In another case, a certain group filed for authorization to acquire one of its competitors. Authorities found that there are 4 competitors in the relevant market: 2 of them have market share of 30% and the other 2 have a market share of 20%

$$\text{HHI} = 2 \times 30^2 + 2 \times 20^2 = 1.800 + 800 = 2.600$$

The market concentration is above 1.800, thus ***high.*** Considering hypothetically that the merger's approval depended only on the HHI, the merger would have been denied.

Nonetheless, in real cases, competition authorities do not rely on the HHI alone when deciding whether to prohibit a merger, that is, a "much more

[1437] Ibid 854.
[1438] Ibid 855.
[1439] Ibid 28.
[1440] Ibid 45.

sophisticated analysis would be undertaken",[1441] for instance, the HHI do not account for dynamism and innovation for it has a very "static view of markets based on market figures",[1442] thus it is substantially limited.[1443]

1. Competitive harm theories

Non-coordinated or unilateral detrimental effects on competition in respect to ***horizontal mergers*** are created when ***(1)*** merging firms have large market share, ***(2)*** when they are close competitiors, ***(3)*** when customers of the merging companies see their switching possibilities to other suppliers reduce, ***(4)*** when competitors are unlikely to increase supply if price increases, ***(5)*** when the merging firms are able to hinder expansion by competitiors, ***(6)*** when the merger removes other important competitive forces etc.[1444] On the other hand, ***coordinated*** negative effects to horizontal mergers are explained by the fact that in "some markets the structure may be such that firms will consider it possible, economically rational, and hence preferable, to adopt on a sustainable basis a course of action aimed at increased prices".[1445] Coordinated anti-competitive effects may take many forms, for example, when competitors ***(1)*** arrive at a "common perception as to how the coordination should work"[1446] (reaching terms of coordination), ***(2)*** by monitoring deviation (monitoring one another in order to ascertain that no one is cheating),[1447] ***(3)*** by implementing deterring mechanisms ("coordination is not sustainable unless the consequences of deviation are sufficiently severe to convince coordinating firms that is is in their best interest to adhere to the terms of coordination"), [1448] ***(4)*** by constraining outsiders' reactions (coordination is only possible with no outside competitive forces) etc. Nonetheless, mergers may create market efficiencies, that is, it is possible that "efficiencies brought about by a merger counteract the effects on competition and in particular the potential harm to consumers that it might otherwise have".[1449]

Vertical effects are less likely to occur, however vertical mergers have the potential to harm competition, for instance, vertical mergers may foreclose other firms in the industry from entering the market or provide greater integration between firms possibly facilitating coordination effects/actions.[1450]

Conglomerate effects are also unlikely to give rise to adverse effects on competition, for there is no "removal of actual or potential; competitors from the market as in the case of horizontal mergers; nor do they bring together firms that have a vertical relationship in relation to the same product, where there may be incentives to foreclose competitors from the upstream or downstream

[1441] Richard Whish & David Bailey (n 734) 46.
[1442] Ibid 46.
[1443] "In Spar *Österreichische Warenhandels v Commission* (*Case M 5047*) the General Court rejected an argument that the European Commission had unlawfully failed to use the HHI when assessing the effects of a merger". Ibid 46.
[1444] Ibid 916.
[1445] Ibid 917.
[1446] Horizontal Merger Guidelines (n 1434) Para 44.
[1447] Richard Whish & David Bailey (n 734) 918.
[1448] Horizontal Merger Guidelines (n 1434) Para. 52.
[1449] Ibid Para. 76.
[1450] Richard Whish & David Bailey (n 734) 863.

market". Competition literature understands harm effects on conglomerate mergers to be "particularly speculative".[1451]

Due to the subject's vastness (Competition law), we have no other alternative but to conduct only a perfunctory analysis.[1452]

2. Tax concerns

Now, back to tax law. The main purpose of the Mergers and Acquisitions Directive is to maintain the tax neutrality on the restructuring of undertakings. Although considered an enormous advance in regulating tax matters in relation to cross-border operation restructurings,[1453] Directive 90/434/EEC, did not improve certain forms of mergers and acquisitions, such as transactions without share exchange, the creation of a PE in the MS of the transferor etc. Eventually the text was amended by Directive 2005/19/EC, including thus the referred situations in its wording. A number of other difficulties[1454] were presented at the time the report, namely, *Corporate Taxation in the Internal Market* was written such as the absence of a Community legislation on company law,[1455] the absence of some company forms on the merger directive that eventually prevented MSs from applying the tax neutrality benefits to such companies,[1456] the lack of the directive's coverage on the transfer of assets from natural person's operating firms to companies[1457] etc. Another questionable situation that persists on the text of the amended version of Directive 90/434/EEC, is taxation in relation to division or exchange of shares, which allows MSs to tax the exchange/division before their disposal,[1458] that is to say, before the realization of the shares.

3. Immediate Tax Problems

Immediate issues with mergers may occur when the acquiring company must pay the difference between market value and the "tax accounts value of the

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[1451] Ibid 864.

[1452] For a deeper analysis on Mergers see Richard Whish & David Bailey (n 734) 853 – 1002.

[1453] COM (2001) 582 final 223.

[1454] The incompatibility between the National legislations and the Directive were also studied. Examples of such contrasts would be the differences of opinions on how anti-abuse-clauses should be applied, such as the disposal of shares after an exchange of assets (for each State provides a different period of time in which companies are allowed to dispose shares after receiving them in exchange (the early share disposal does not necessarily results in an abusive conduct [Case C-28/95 / *Leur Bloem* (1997]), or taxation on capital gains on shares before their disposal. Such examples demonstrate some of the Directive's flaws. COM (2001) 582 final 237.

[1455] COM (2001) 582 final 234.

[1456] The French SAS (Simplified Joint Stock Company), as well as Belgium *Cooperative Societis*, are two examples of company forms excluded by the directive. COM (2001) 582 final 235.

[1457] COM (2001) 582 final 235.

[1458] By force of article 8(2) Directive 90/434/EEC, "Member States shall make the application of paragraph 1" which prevents MS from taxing the division or exchange of shares between cross-border operating Undertakings, "conditional upon the shareholder's not attributing to the securities received a value for tax purposes higher than the securities exchanged had immediately before the merger, division or exchange." Article 8(4) of the amended vension reads: "Paragraphs 1 and 3 shall apply only if the shareholder does not attribute to the securities received a value for tax purposes higher than the securities exchanged had immediately before the merger, division or exchange."

transferred property",[1459] for instance. The point is that the acquiring company may not have enough cash to pay capital gains tax, since it received only assets in return from the acquired company. Therefore, the acquiring company may have to "wind up any tax-exempt reserves it carried in respect of the transferred assets". In such a case, the company will be obliged to pay CIT on the value of such reserves, [1460] and since losses are generally ring-fenced, the acquiring company will not be able carry over to the acquired company.

4. Deferral of Capital Gains Tax and Carry-over of tax Values

Tax deferral is granted to those companies that merge, divide or partially divide their operations. As previously metioned, the Directive's benefits are only granted to companies that fulfil the general conditions imposed by the Directive, namely, be listed in the annex, be a resident for tax purposes within the EU and be subjected to a certain tax listed in the Direcive. Nonetheless, the Directive do not grant deferral regardless. Article 4(4) condition tax deferral upon the receiving company computing "any new depreciation and any gains or losses in respect of the assets and liabilities transferred according to the rules that would have applied to the transferring company or companies if the merger, division or partial division had not taken place". This process is known as ***roll-over***, that is, assets and liabilities of the company that is being transferred have to be "taken over by the receiving company in the Member State of the transferring company".[1461] The Directive also withdrawns its benefits in instances where "the receiving company is entitled to have any new depreciation or any gains or losses in respect of the assets and liabilities transferred"[1462] (***step-up***).[1463] It is important to understand that the relief is only granted if the receiving company continues with its old "tax basis and the old depreciation method",[1464] that is to say, in case the receiving company opts for a "step-up tax base (real value)," [1465] the deferral will not be granted to those assets and liabilities for it would open the path for avoidance.

The benefit of tax deferral cannot compromise the State's ability to recover the deferred tax in the future. Article 4(2)(b) Merger Directive makes the benefit conditional upon the transferred assets and liabilities remaining "effectively connected with the permanent establishment of the receiving company in the Member State of the transferring company and play a part in generating the profits or losses taken into account for tax purposes". By including such provision the European legislator saved MSs future tax claims, thus "ensuring that the future realization of the deferred capital gains (…) be part of the tax base allocated to the state of the transferring company; thus, to the state under whose tax jurisdiction they were generated".[1466] It is important to remember that profits generated by foreign PEs are liable in that State precisely

[1459] Ben Terra and Peter Wattel (n 60) 374.
[1460] Ben Terra and Peter Wattel (n 60) 375.
[1461] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 164.
[1462] Merger Directive Article 4 (5).
[1463] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 164.
[1464] Ben Terra and Peter Wattel (n 60) 384.
[1465] Ibid 384.
[1466] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 165.

due to its connection to that State (Article 7 (1) OCD Model). Nonetheless, there are some cases where the PE rule fails, for instance, in respect to profits generated from the operation of ships, air transports and waterway transports, which shall be taxed only "in the Contracting States in which the effective place of management of the enterprise is situated" (Article 8 OECD Model), that is to say, the place where the PE operates has no taxing rights whatsoever (in order to solve the matter, the Council and the Commission agreed that "Art. 4 of the Directive should not prevent the Member State of a transferring company from taxing at the time of the reorganization gains that would otherwise, by virtue of a tax treaty provisions, escape in that state altogether".[1467]The fact of the matter is assets and liabilities must remain in the MS, otherwise MS are allowed to deny the Directive's benefits, for example, MSs may deny deferral benefits on capital gains on a transferred asset if that asset "leaves the tax jurisdiction of that State (…) to become a part of a sub-branch (a branch of the branch) in a third State".[1468] The pertaining question here is, is taxing hidden reserves[1469] in tune with the Treaty's freedoms? Well, levying taxes on unrealized capital gains due to migration to another State when no taxation would have been imposed on similar cases domestically, has been found to be against the Treaty's spirit (freedom of establishment).[1470] However, if the relevant MS is preventend, at a later date, of exercising its tax rights it would be unreasonable not allowing MSs from exercising its rights somehow. Immediate taxation of uncrystilized gains, according to the ECJ, infringes the proportionality principle for there are less restrictive measures MSs could impose in order to safeguard future claims, however, preventing MSs from recovering such tax, also seems disproportionate. To solve this conundrum the ECJ suggests an "optional system, offering taxpayers the choice between immediate payment of the tax or deferred payment, possibly together with interest in accordance with the applicable national legislation. (…) Furthermore, the Member States may also take into account the risk of non-recovery of the tax in the case of deferral by measures such as the provision of a bank guarantee (…) to supply collateral is imposed on the basis of the actual risk of non-recovery of the tax".[1471]

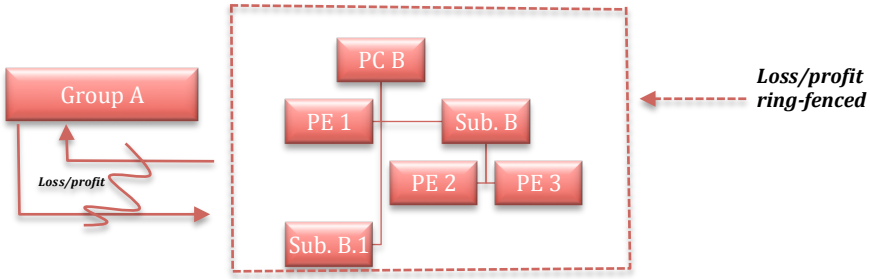
5. Transferring losses in company reorganizations (pre-existing Losses)

Although article 6 of the Merger Directive determines MSs to allow the "receiving company to takeover losses of the transferring company which had not been exhausted for tax purposes", such treatment is only addressed to mergers where the "PEs of the receiving company or emigrating SE/SCE are located but not by the state of residence of the receiving company or emigrating company".[1472] Consider the following example. Group A, resident of MS A, buy Group's B deficitary operation in MS B, thus becoming Group AB. According to Article 6 Merger Directive, the receiving group (Group A) will be allowed to takeover the losses of the transferring company not yet exhausted for tax

[1467] Ibid 165.
[1468] Ben Terra and Peter Wattel (n 60) 386.
[1469] Hidden reserves (unrealized capital gains).
[1470] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 165.
[1471] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 167.
[1472] Ibid 169.

purposes (non-discrimination rule).[1473] After a successful business strategy in that State, Group AB offsets its losses against Group's AB profits in ***State B*** in the years following the merger.

Figure 20



Note that Group AB was not able to offset Group AB's losses realized in MS B against profits of Group AB's operation in MS A, for MS A legislation do not allow cross-border loss compensation, moreover, the Merger Directive do not provide for such situation. After the merger occurred, Group B's PEs became Group AB's PEs, and as previously studied in other parts of this investigation, PEs are not "independend" undertakings, that is to say, they are heavily dependent on the PC to operate and its profit/loss account is assessed on a consolidation basis with its PC, and under NTP[1474] losses incurred by PEs are taken into account when assessing the PC's liability ("tax treatment of losses incurred through foreign permanent establishments (…) is generally linked to the method through which double taxation is relieved. Countries which relieve double taxation through the ordinary foreign tax credit method generally take into account profits and losses derived through a foregin PE in the determination of the taxable income of resident companies").[1475] In respect to losses of a foreign subsidiary, as a general rule, are not taken into account in the PC's State.

Most countries do not allow transferring losses from acquired to acquiring company.[1476] The reason for this is to prevent abusive practices such as the acquisitions of companies only for the purpose of tax optimization (acquisitions may occur before the year's end, that is to say, before the loss has properly been materialized in an attempt to reduce tax liability in the future).[1477] Despite the *ratio* of such measure being the prevention of abusive behaviours, it is clearly an impediment to corporate restructurings, contributing negatively to the better functioning of the Internal Market.[1478] However, States that neither impose any restrictions on the use of carry-forward, nor restrict the use of built-in (uncrystallized) losses in M&A or group taxation regimes, "are more exposed to aggressive tax planning".[1479]

Rules concerning pre-existing losses are particularly important to mergers and may be a deal breaker. Most countries maintain that losses must remain

[1473] Ibid 169.
[1474] Normal temperature and pressure conditions (NTP).
[1475] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 38.
[1476] COM (2001) 582 final 238.
[1477] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 49.
[1478] COM (2001) 582 final 238.
[1479] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 30.

with the joined company, that is to say, the loss is *ring-fenced.*[1480] This measure prevents abusive behaviours such as loss-trafficking.[1481] Nonetheless, countries such as Austria, New Zealand, Norway, Italy, Spain, France and Sweden allow pre-consolidated losses be used to offset the group's earnings in merger operations.[1482] Austria and Norway allow the offsetting of such losses after a careful and full analysis of the relevant merger, that is to say, if the tax administration of those countries concluded that the main purpose of the merger was to "exploit the tax position (pre-merger losses)" the relevant tax administration is likely to deny deduction (if the purchased company do not hold assets or any liabilities related to such losses, for example).[1483] New Zealand allows the use of pre-existent losses to be offset against profits in corporate reorganizations, it requires the original shareholder(s) to maintain a minimum of 49% of voting rights. If this condition is not satisfied the company will not be able to apply for such deduction.[1484] France likewise allows such deduction, but also conducts a thorough assessment in order to ascertain whether the operation is economically justified, that is, that the sole purpose of the merger was not to avoid taxation. Moreover, it also requires the company to maintain the same activity for a minimum period of three years (contrary to Austria, Norway, New Zealand and Sweden, *France do not require* the acquired/merged company to maintain a certain control threshold to allow losses of the acquired company be offset against the profits of the purchaser). ***Italy***, for example, allow pre-existing losses be transferred after passing the following two test proof, namely, ***(1) net equity test***: carry-forward is "allowed within the limit of the amount of the net equity resulting from the balance sheet for the financial year preceeding the shareholder resolution approving the merger" and ***(2) vitality test***: the entity's profit and loss account "whose losses are to be carried forward shows for the financial year prior to the resolution of merger revenues and labour costs higher than 40% of the average of the two prior financial years".[1485] ***Spain,*** allow pre-existing losses be carried forward, unless such losses "have already resulted, at the level of the acquiring company, in tax deductible impairement losses on equity instruments issued by the transferring company".[1486] In ***France***, pre-existing losses may be offset agains the receiving company's profits "only if there is a preliminary ministerial approval", which in most cases are subjected to two tests, namely, ***(1)*** the operation being economically justifiable, without a possible taxation *bias*, and ***(2)*** the activity which create the losses must be maintained for a minimum period of three years by the receiving company. As for the receiving company, pre-existing losses may be used against profits made after the merger "***provided there is no change of business purpose or activity***".[1487]

[1480] Ring-fencing: arrangement in which an entity's assets are separated from the parent company.
[1481] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 33.
[1482] Ibid 37.
[1483] Ibid 37.
[1484] Ibid 37.
[1485] Ibid 38.
[1486] Ibid 38.
[1487] Ibid 38.

6. Share Deal[1488]

Double taxation on share exchange or transfer of assets may also raise uncertainty over the tax liability of such operations. Although capital gains on such transactions are tax neutral before the disposal of the shares, according to the Directive,[1489] States may tax them on their disposal "in the same way as the gain arising out of the transfer of shares existing before the acquisition".[1490] Nevertheless a number of MSs tax such capital gains before the disposal of the shares. The taxation of capital gains before the relevant shares are sold, is not in any way authorized in the Directive's wording and are more a matter of administrative convenience of tax authorities. The study on company taxation in the internal market raises the flag on the possible indirect costs that corporate restructuring within the Union may generate (MS may levy indirect duties in case the property of certain assets are transferred).[1491]

[1488] Capital gains derived out of share deals may be subjected to tax exemption under affiliation privileges. The rules regarding International Affiliation Privileges vary according to the relevant country. In Austria, for example, capital gains arising from the sale of a domestic subsidiary is subjected to 25% corporation tax, unless the shareholding surpass the 10% threshold and is maintained for a period of time longer than 12 months. Is this a case, the seller may be benefited with privileges such as dividend exemption as well as capital gain exemption. Nevertheless, if the seller is an Austrian resident, it will subjected to 25% corporate tax when disposing the shares. http://www.taxand.at/Uploads/Document/MA_Tax_Guide_2013(1).pdf. Accessed in 10 Feb 2018.

[1489] 90/434 EEC Article 4(1).

[1490] COM (2001) 582 final.

[1491] Directive 69/335/EEC grant MSs the possibility to levy taxes on land registration transfers, mortgage, apply fees to capital increase due to the immovable property added value (such understanding was confirmed in the SIF Case C-42/96), and the value of such costs may create impediments, or even prevent companies from reorganizing their activities throughout the single market. For a better understanding of the cost involved in such restructurings, we extracted an example of a large European multinational group restructuring initiative. A Dutch company "calculated the tax costs it would incur to restructure its European activities within one single company with permanent establishments in the Member States. The cost would be even higher if the Merger Directive had not been adopted. The starting point is a Dutch holding company with shares in five national sub-holding companies situated in different Member States which themselves have holdings in three operating companies in the same Member State. The objective is to create a structure under which the parent holding company of the group would remain unchanged but would hold shares in only one single "European" company with five permanent establishments. The five national sub-holding companies and 15 operating companies would cease to exist. The means of arriving at this reorganization would be as follows: 1. Create a new "European" company. 2. Transfer the assets from the 15 operating companies to the "European" company in exchange for the new company's shares to the 15 operating companies. 3. The 15 operating companies sell their shares to the "European" company to the group's parent holding company. (…) this operation would result in the following tax costs: Cost of transferring assets to the "European" company: Transfer taxes (on immovable property in particular), tax costs involved in terminating a group scheme: total transfers of shares of the "European" company to the group parent holding company: Total cost - If the operation is halted in the first stage (without transferring shares) avoided but there will be an annual cost of "European" company to the 15 former operating companies (the Parent-Subsidiary Directive does not apply as the 25% holding threshold is not reached). The restructuring operation will therefore cost." COM (2001) 582 final 240.

7. LBO (Leverage Buyouts)

A certain individual plans on getting married and starts looking for houses in order to move in with his future wife. However, he does not have enough money to purchase the house on a single payment, therefore, he goes to a bank which agrees to loan him the cash to buy the house. However the bank only finances 70% of the house's price, the difference has to be paid by the individual up front. In other words, the individual did not have enough capital to buy the house therefore he raises cash through debt (leverage). Now, although this example is farily simple to understand, it is not the best example to explain LBO. Now, consider that the same individual is alreadty married and wishes to purchase a house as an investment strategy. Nonetheless, he does not have the cash to back the operation up, thefore he contracts a loan for 70% of the house's value. The monthly instalments will be paid by the house's tenant and at a future date, with the house already paid, he will sell the house and realize capital gains due to the house's appreciated value. This is a LBO.

Companies may acquire the target company with debt, equity or retained earnings/profits. Acquiring through ***debt*** may be more beneficial, at least from a tax perspective, if the PC resides in an exemption country with a comparably ***lower tax burden*** (the interest payment made to the PC by the associated enterprise is a deductible expense at the source, consequently the jurisdiction where the PC resides will be entitled to tax such income (interest)). If however, the PC opts for financing its subsidiary through ***equity***, the return on capital is taxed in the country where the subsidiary resides. Now, if the PC resides in a credit State, repatriated dividends are subject to tax in the residence country of the parent company, while the foreign tax paid is credited. Thus, parent companies in tax credit countries will be indifferent to debt finance and equity finance (thin capitalization).

H. Double Taxation

As previously studied, direct taxes are a powerful tool in regulating the economy as well as conducting public policies, therefore it falls within the competence of each State to apply the more appropriate policy. The relationship between the State and its citizens in tax law is deliberately delineated, and it could not be any different (at least in democratic countries) for any "moral" tax order must consistently rely and respect fundamental rights, product of an evolution of constitutional traditions common to egalitarian countries. First, one must first ascertain whether the fact that triggered the levy is properly regulated by the relevant legal framework. For instance, a certain invidividual sold a certain good in which he derived income, therefore he is liable to tax in that State, for the relevant legal statute provides that income is liable to tax. Considering that such individual has a connection with the State where he derived such income (nationality), he will liable to tax in that State, that is, where the economic activity occurred. When the State imposes upon its citizens its autonomous taxing powers "which it holds by virtue of its existence",[1492] the relevant jurisdicion's legal framework will, at least at first sight, dictated the

[1492] Di Paolo, "La 'non giuridicità' della norma tributaria", *Trib,* (1939) *14.*

extent of the citizen's obligation to the State. However, if according to the relevant case it was established that other State other than that where the obligation was borne (source State) is also entitled to such rights due to a connecting factor (permanent home, center of vital interests, habitual abode, citizen's nationality or even place of management of an enterprise - all classifications will be properly be covered in the following topics), the other State (considering that both States have previously entered into a DTC) will also exercise its autonomous taxing rights. This part of the study will cover the functioning and the allocation imposed by the relevant DTC.

Double taxation will eventually arise when two or more States exercise their taxing rights on the same income, according to the principle adopted in that State (worldwide[1493] or territorial).[1494] Consider the following example, an individual resident in Austria, with economic interests in Germany, thus both countries have taxing rights on the income the individual generates (both Austria and Germany apply a worldwide system of taxation). Had Austria and Germany not entered into a DTC, such income would ultimately be taxed in both countries (once when when the individual receives its income in Germany, and when such income is transferred to his home country - Austria). Lack of DT relief leads to serious impediments to international trade.

It is also important to note, the fact that a DTC does not expressively list a specific tax, do not grant States the power to impose upon the relevant entity an obligation that would not exist domestically under similar circumstances (***comparability doctrine***). Consider the following case, two companies, namely *Underschaft* (No.1) a company incorporated in the UK and *Underschaft* (No. 2) incorporate in the Netherlands. Both companies dispose of shares of other two companies incorporated in Australia. Undershaft (No.1) realized $273.000,00 of gains. Back then the Commissioner argued that the DTC entered into by Australia DTA (1980),[1495] did not limited Auatralia's right to tax such capital gains "(…) *derived by entities that are residents of a pre-CGT* (Capital Gain Tax) *DTA treaty* (…)".[1496] The Federal Court of that country reached the conclusion that the Capital Gain Tax Act, "(…) was not a separate tax but merely a part of Australian income tax under the relevant Income Tax Assessment Act and ruled that CGT

[1493] Countries that adopt a worldwide system of taxation will tax income regardless where income was earned. For example, an individual is a resident of a jurisdiction that apply a ***WWTS*** (UK) and receives dividends from a French company. According to the DTC, such dividends will be taxed in the recipient State (UK) that has ***full taxation rights***. Nontheless France has also ***limited taxing rights*** in respect to such dividends. Therefore, such dividends will be taxed in France and in the UK.

[1494] Territoriality (limited tax liability).

[1495] Article (13) of the Australia-Switzerland DTC, "(…) *Gains of a capital nature from the alienation of any property other than that referred to in paragraph 1,2,3 and 4* (income, profits or gains from alienation of: (1) immovable property, (2) movable property part of a business property or PE, (3) ships or aircraft and (4) shares directly or indirectly related to immovable property) *shall be taxable only in the Contracting State of which the alienator is a resident.* Convention Between the Swiss Confederation and Australia for the Avoidance of Double Taxation with respect to Taxes on Income (2013).

[1496] Undershaft (No. 1) Ltd (formerly CGNU Holdings (Aust.) Ltd) and Undershaft (No. 2) BV (formerly Norwich Union Overseas Holdings BV) v. Commissioner of Taxation [2009] FCA 41.

was '***substantially similar, if not identical, to income tax***' (thus *comparable*) for the purposes of Article 2(2) (…)" (emphasis added). [1497]

1. Persons Covered (Article 1 OECD Model)

Article 1 OECD Model[1498] sets the DTC's personal scope rules, that is, to whom the regulation is applicable. In sum, the Model's provisions are applied to taxpayers of a certain State due to domicile, residence or place of management (allocation factors). It is mandatory that at least one of the two States to apply a worldwide tax system. Taxpayers subjected to ***worldwide tax liability*** may benefit from the relevant DTC's provisions. In other words, if the relevant taxpayer is only liable to tax in that State in respect of income from "sources in that state or capital situated therein", the taxpayer will not be considered a resident of that Contracting State.[1499] Again, one of the States entitled to taxation rights must (theoretically) detain full rights on the taxpayer's income, therefore, if both States are only entitled to limited taxing rights (for example, if both States operate under a ***territorial system***), taxpayers will not be able to benefit from the DTC's provisions. In this case, the relevant State is most likely to apply (of own accord) a ***unilateral measure*** in order to provide DT relief (according to *Michael Lang* the manner in which such unilateral measures are granted varies, that is, some States, such as Germany, have specific legislation on the matter, others (Austria) choose to grant the benefit under a discretionary approach, and others under a reciprocity approach (Brazil).[1500]

The concept of ***residence*** is particularly imporat to DTCs and to tax law in general, that is, it is specifically such *term* that will indicate (in most cases) which State will ultimately be entitled to the relevant taxing rights. Nonetheless, Article 1 OECD Model provides only a general definition as to which entities should be covered by the relevant DTC.[1501] In sum, DTCs may either contain provisions with the term *residents* or provide a wider scope of application, for instance, some jurisdictions make reference to *taxpayers*, therefore covering also non-residents. Nonetheless, countries tend to apply DTCs to residents (individuals or undertakings) of one or both Contracting States.[1502] Here, it is important that we briefly present some entities that may raise some questions as to whether such persons should be covered by DTCs, namely, *Partnerships*, *Collective Investment Vehicles* (CIV), *Sovereign States* (and subdivisions and wholly-owned entities), *conduit companies* and *entities that benefit from special tax regimes* (religious entities, for instance). Permanent establishments (PEs) are not regarded as persons.[1503]

In order to be considered a resident of a State for tax purposes, the entity *(whether an individual, enterprise, foundation, partnerships etc),* ***must be liable to tax in that State.***

[1497] Michael Lang (n 461) 88.
[1498] "This Conventions shall apply to persons who are residents on one or both of the Contracting State." OECD Model Article 1.
[1499] Michael Lang (n 461) 70.
[1500] Michael Lang (n 461) 30.
[1501] "This Convention shall apply to persons who are residents of one or both of the Contracting States." OECD Model Article 1.
[1502] Commentaries on the Articles of the Model Tax Convention 45.
[1503] Michael Lang (n 461) 70.

a. Partnerships

According to the OECD Commentaries, the term "*person*" must be read as broad as possible, that is, an *individual* a *company* or a *body of persons* (entities that although not incorporated may fall under the scope of the treaty, for instance, a foundation (*Stiftung*) or partnerships). However the latter may be considered as "***other** bodies of persons*" and consenquently fall outside the DTC's scope.[1504] Consider the following example, according to the legal framework of a certain State, partnerships are considered *transparent entities* for tax purposes, that is to say, the *entity will not itself be taxed* if eventually derives taxable income, only its partners are liable to taxation, therefore the income "*flows through*"[1505] the partnership to its partners who are liable to tax personally. [1506] In that case, the partnership will not be considered a resident of the relevant State and thus be excluded from the DTC's benefits. Such rule, however does not prevent its partners from benefiting from the DTC's reliefs. Consider the following example, a Dutch partnership has four partners with a seat of business in *Greece*. Each partner resides in different countries in Europe, one in Portugal, other in Austria, one in Luxembourg and another in Finland. Thus, since the law of such countries treat partnerships as transparent entities,[1507] the tax liability would fall under the partners, thus the Portuguese resident would fall under the auspices of the Portugal-Greece DTC, the Austrian under the Austrian-Greece DTC, the Germany resident under the Germany-Greece DTC and finaly the Finland partner would fall under Finish-Greece DTC.[1508] To conclude the topic we will present nine examples, three ***bilateral cases*** and six ***triangular cases.*** In the first three examples, all States treat the partnership as non-residents ***(Set 1)***, and in the following, at least one State treats partnerships as taxable entities ***(Set 2).***

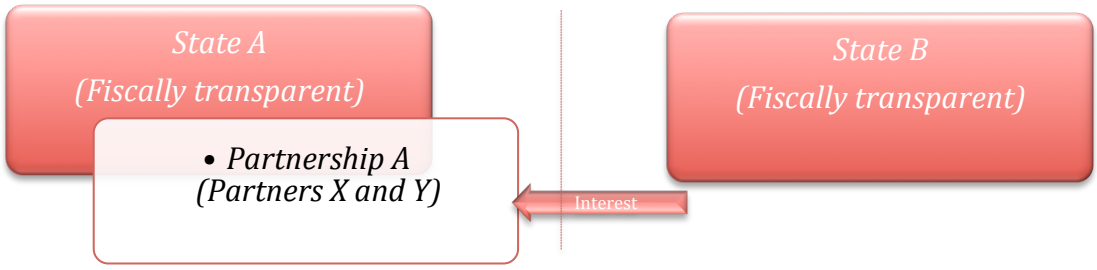
aa. Example 1 (Bilateral case) **(Set 1)[1509]**

A partnership properly established in State A, treats partnerships as transparent entities, thus the partners are liable to tax, not the partnership itself. Partnership A receives income (interest) from an entity resident of State B. The income derived from State B is not attributable to a PE, thus Article 11 (1) (4)

[1504] Commentaries on the Articles of the Model Tax Convention 78.
[1505] *The Application of the OECD Model Tax Convention to Partnerships*. OECD Publishing, Paris. (1999). 18.
[1506] Commentaries on the Articles of the Model Tax Convention 86.
[1507] The following States consider partnerships transparent entities: Australia, Austria, Canada, Czech Republic, Denmark, Finland, Germany, Louxembourg, the Netherlands, New Zealand, Norway, Poland, Slovak Republic, Sweden, Switzerland and the UK impose liability upon partners (***non-resident for the purposes of tax***). The following States consider partnerships liable to tax whereas in countries such as Belgium, France, Hungary, Mexico and Spain (***resident for the purposes of tax treaties – non-transparent***). *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 70 e seq..
[1508] Michael Lang (n 461) 80.
[1509] Non-resident partnerships.

OECD Model do not apply.[1510] State B also treats partnerships in State A as transparent.

Figure 21



In this case, State B's legislation dictates that Partners X and Y should be treated as taxpayers in State A, and not the partnership itself. Article 11 B-A DTC states "[I]nterest arising in a Contracting State and paid to a resident of the other State may be taxed in that other State", namely, State A. Under the law of State A, the income derived from State B ***flows through*** Partnership A established in State A to partners X and Y, who ultimately are liable to tax State A.[1511]

ab. Example 2 (Triangular case) **(Set 1)** [1512]

A partnership effectively managed[1513] in State "A" (transparent partnership State – ***recipient State***) receives income (interest) not attributable to a PE from an entity resident in State C. Partners of Partnership A are residents of State "B". States A, B and State C treat Partnership A as fiscally ***transparent***. Question: Will the income deriving from State "C" be covered by the relevant DTCs?

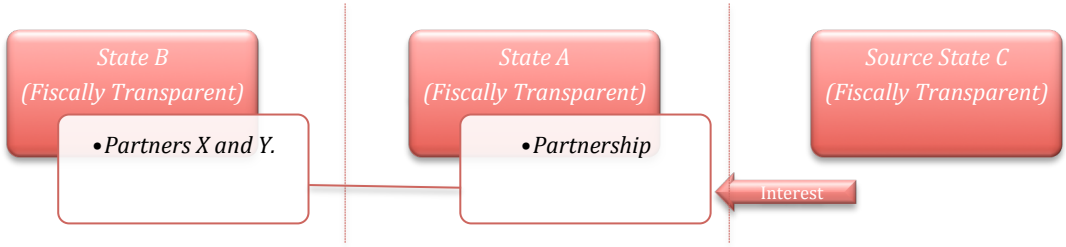
Figure 22

[1510] "1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. 4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply." OECD Model Article 11 (1) (4).

[1511] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 18.

[1512] Non-resident partnerships.

[1513] "For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated" OECD Model Article 4(3).

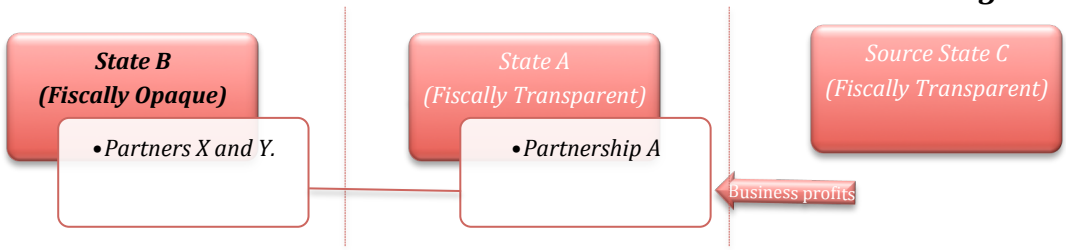


Considering that States B and C treat Partnership A as an ***transparent entity***, C-B DTC allocation rules dictates that partners X and Y are liable to tax, and Partnership A may not require the benefits of C-A DTC for partnership A is not a resident of State A. The OECD suggests States to deny DTC's benefits in "cases they cannot verify whether a person is truly entitled to these benefits."[1514]

ac. Example 3 (Triangular case) **(Set 1)** [1515]

A partnership effectively managed[1516] in State "A" (transparent partnership State – ***recipient State***) derives income (business profits) from a source other than a PE[1517] resident of State C (***source State***). Partners of Partnership A are residents of State "B". Both State A and State C treats Partnership A as fiscally ***transparent*** while State B treats Partnership A as fiscally ***opaque***. Question: Will the income deriving from State "C" be covered by the relevant DTCs?

Figure 23



Considering that State C treats Partnership A as a ***transparent entity*** and that State B's laws treats Partnership A as ***fiscally opaque***, State B will allocate Partnership A's income to Partnership A, and not to its partners X and Y.

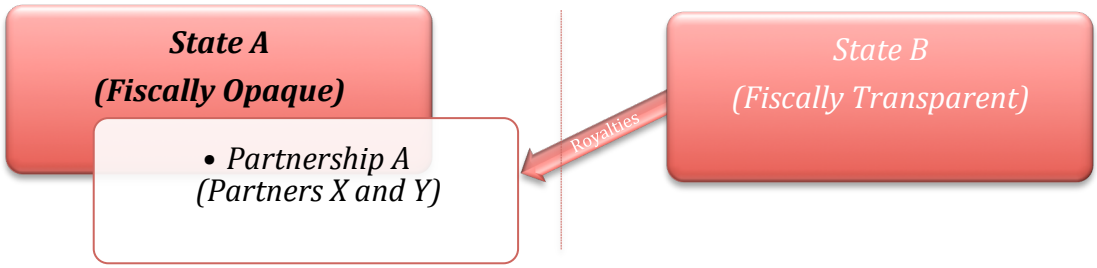
[1514] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 19.
[1515] Non-resident partnerships.
[1516] "For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated" OECD Model Article 4(3).
[1517] "1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State." OECD Model Article 7(1).

Therefore, since State C treats Partnership A resident of State A as fiscally transparent, State C will not be required to extent the DTC benefits since State B allocates the income to Partnership A. consequently, C-B DTC is not applicable. The treatment of Partnership A in State A is irrelevant for the purposes of C-B DTC, although it important when applying the C-A DTC. [1518]

ad. Example 4 (Bilateral case) **(Set 2)**[1519]

A partnership properly established in State B, treats partnerships as transparent entities, thus the partners are liable to tax, not the partnership itself. Partnership A receives from Partnership B resident in State B income (royalties), that is, the income derived in State B is not attributable to a PE, thus Article 12 (1) (3) OECD Model do not apply.[1520]

Figure 24



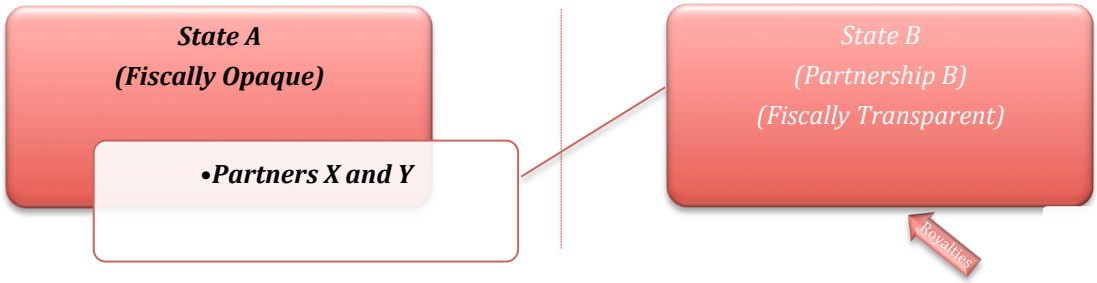
In this case, State B's legislation dictates that Partners X and Y should be treated as taxpayers in State A, and not the partnership itself. Nonetheless the tax rights are allocated to State A anyway for "[R]oyalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."[1521]

ae. Example 5 (Bilateral case) **(Set 2)** [1522]

A partnership properly established in State B, treats partnerships as transparent entities, thus the partners are liable to tax, not the partnership itself whereas State A treats Partnerships as opaque entities. Partnership B receives in State B income (royalties). The income derived in State B is not attributable to a PE, thus Article 12 (1) (3) OECD Model do not apply.[1523]

[1518] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 20.
[1519] Taxable partnerships.
[1520] "1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State. 3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply." OECD Model Article 12 (1) (3).
[1521] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 25.
[1522] Taxable partnerships.
[1523] "1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State. 3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries

Figure 25



State B's legislation dictates that Partners X and Y should be treated as taxpayers, and not the partnership itself. However Partners X and Y are not liable to tax accoding the allocation rules applied by State A, therefore the relevant DTC is not applicable. Note that Partnership B is not a resident of State A, thus it has not connection to State A whatsoever. Partners X and Y would ultimately ***NOT*** be entitled to claim the benefits of the Convention since they are not liable to tax in State A.[1524] In this case, a number of countries would "deny the benefits (…) on concepts of ***bad faith or abuse of treaty rights***. The distributive rules of the Convention are based on the underlying assumption that" X and Y "would be attributed the income on which treaty relief would be granted and where that is not the case, these general concepts would allow" [1525] State A to deny the DTC's benefits to X and Y.

af. Example 6 (Triangular case) **(Set 2)** [1526]

A partnership effectively managed[1527] in State "A" (transparent partnership State – ***recipient State***) own shares of company C resident in State C. Partnership A, resident of State A receives dividends from company C resident of State "C" (***source State***). Partners of Partnership A are residents of State "B". Both State B and State C treats Partnership A as fiscally ***opaque*** while State A treats Partnership A as fiscally transparent. Question: Will the income deriving from State "C" be covered by the relevant DTCs?

Figure 26

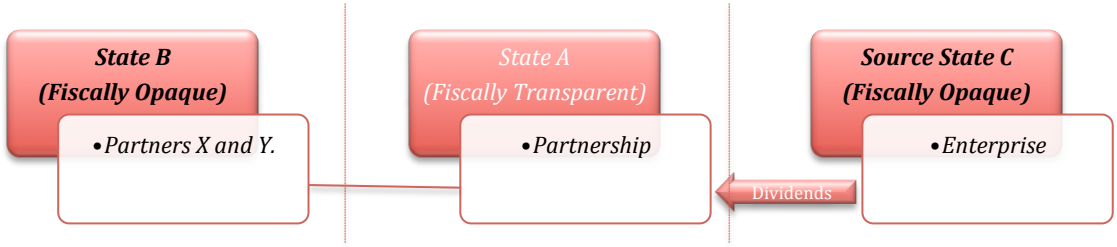
on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply." OECD Model Article 12 (1) (3).

[1524] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 25.

[1525] Ibid 26.

[1526] Taxable partnerships.

[1527] "For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated" OECD Model Article 4(3).



Considering that States B and C treat Partnership A as an ***opaque entity***, A-B and C-A DTCs are not applicable since Partnership A is not a resident for the purposes of both B-A and C-A DTCs. Partners X and Y are tax residents of State "B", therefore B-A DTC cannot be applied, for State "B" treat partnerships as opaque entities, thus according to State's B allocation rules, the income must be allocated to Partnership A, a non-resident entity.[1528] To conclude, X and Y cannot benefit from C-B DTC because partnership A is not a resident of State B. In this case, ***no DTC is applicable whatsoever,*** and State C would be entitled to such taxation rights.

ag. Example 7 (Triangular case) **(Set 2)** [1529]

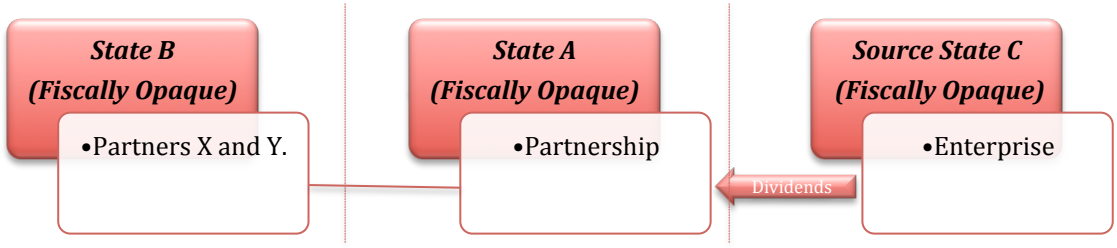
A partnership effectively managed[1530] in State "A" (opaque partnership State – ***recipient State***) own shares of company C resident in State C. Partnership A, resident of State A receives dividends from company C resident of State "C" (***source State***). Partners of Partnership A are residents of State "B". State A, B and C treat Partnership A as fiscally ***opaque***. Question: Will the income deriving from State "C" be covered by the relevant DTCs?

Figure 27

[1528] Such differencial treatments regarding ***partnerships*** caused some States to adopt special provisions in their DTC so that the matter is properly dealt with. For instance, Article 28(6) Austrian-Switzerland DTC provides that partnerships may enjoy the tax relief of Articles 10 (Dividends), 11 (Interest) and 12 (Royalties), considering that such partnershipsare established under the law of that State as well as have their seat in that State "Nach dem Recht eines Vertragsstaats errichtete Personengesellschaften (Offene Handelsgesellschaften, Kolektivgesellschaften, Kommanditgesellschaften), die in diesem Staat ihre Gesellschäftsleitung haben, können die in den Artikeln 10,11 und 12 des Abkommens vorgesehenen Entlastungen von der Steuern des anderen Vertragstaates beanspruchen, sofern midestens drei Viertel der Gewinne der Gesellschaft Personen zustehen, die im erstgenannten Staat ansässig sind."

[1529] Taxable partnerships.

[1530] "For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated" OECD Model Article 4(3).



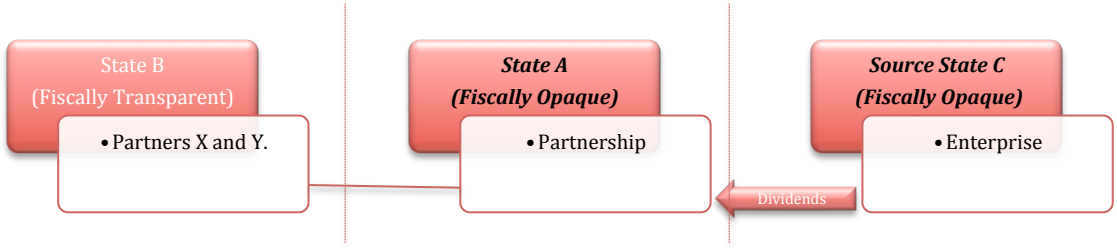
Considering that State A treats Partnership A as an ***opaque entity***, Partnership A is liable to tax in State A. Note that Partners X and Y are not liable to tax on that income therefore they are not entitled to B-C DTC's benefits. On the other hand, Partnership A is considered a resident for the purposes of C-A DTC (both A and C States treat Partnership A as ***opaque***), therefore it shall benefit from that DTC (considering that Partnership A is the beneficial owner of such dividends, if not States may withdrawn the DTC benefits – *conduit companies*). It is important to note that State's C taxing rights are restricted by Article 10 (1) C-A DTC ("Dividends paid by a company which is resident of a Contracting State to a resident of other Contracting State may be taxed in that other State"). However, Article 10 (2) (a) OECD Model, grants State C limited taxing rights on dividends, where expressively excludes Partnerships ("5 per cent of the gross amount of the dividends if the beneficial owner is a company (***other than a partnership***) which holds directly at least 25 per cent of the capital of the company paying the dividends"), therefore, Partnership A would fall under Article 10 (2) (b) OECD Model, which provides for a ***higher rate*** on dividends ("15 per cent of the gross amount of the dividends in all other cases"). Contracting States however are free to modify Article 10 (2) OECD Model in order to extent the lower rate to partnerships "treated as a body corporate".[1531]

ah. Example 8 (Triangular case) **(Set 2)** [1532]

A partnership effectively managed[1533] in State "A" (opaque partnership State – ***recipient State***) own shares of company C resident in State C. Partnership A, resident of State A receives dividends from company C resident of State "C" (***source State***). Partners of Partnership A are residents of State "B". State A and C treat Partnership A as fiscally ***opaque***, whereas State B as fiscally ***transparent***. Question: Will the income deriving from State "C" be covered by the relevant DTCs?

Figure 28

[1531] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 28.
[1532] Taxable partnerships.
[1533] "For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated" OECD Model Article 4(3).



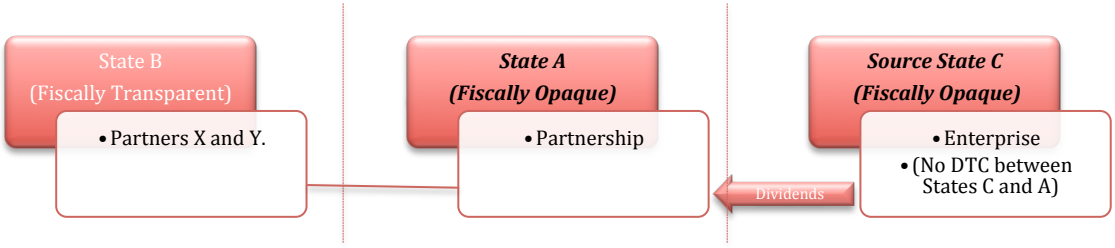
Considering that State A treats Partnership A as an ***opaque entity***, Partnership A is liable to tax in State A. Now, contrary to example 4, Partners X and Y ***are*** liable to tax on Partnership A's income, because State B treats Partnership A as a ***transparent entity***, therefore they ***are*** entitled to C-B DTC's benefits. On the other hand, Partnership A is considered a resident for the purposes of C-A DTC (both A and C States treat Partnership A as ***opaque***), therefore it shall benefit from that DTC (considering that Partnership A is the beneficial owner of such dividends, if not States may withdrawn the DTC benefits – *conduit companies*). Note that both C-B and C-A DTCs are applicable. According to Article 10 (1) of both A-C and C-B DTCs "[D]ividends paid by a company which is resident of a Contracting State to a resident of other Contracting State may be taxed in that other State", therefore both C-A and C-B DTCs will restrict State C's taxing rights. In such a case, the OECD Committee "agreed that this double entitlement to treaty benefits will be satisfied by" State C "imposing the lowest amount of tax allowed under the two treaties". In other words, if C-A DTC limits State C's taxing rights to 15% of the gross dividend amount, whereas C-B limits to 5%, the contracted terms of both DTC will be satisfied if the tax levied by State C do not exceed 5%.[1534] This solution would require administrative collaboration of the States involved to the transaction.

ai. Example 9 (Triangular case) **(Set 2)** [1535]

A partnership effectively managed[1536] in State "A" (opaque partnership State – ***recipient State***) own shares of company C resident in State C. Partnership A, resident of State A receives dividends from company C resident of State "C" (***source State***). Partners of Partnership A are residents of State "B". State A and C treat Partnership A as fiscally ***opaque***, whereas State B as fiscally ***transparent***, nonetheless, States A and C ***do not have a DTC***. Question: Will the income deriving from State "C" be covered by C-B DTC?

Figure 29

[1534] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 30.
[1535] Taxable partnerships.
[1536] "For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated" OECD Model Article 4(3).



Considering that C-B DTC is in force, Partners X and Y would be entitled to C-B DTC's benefits.

In sum, in order for a partnership to entitled to the Convention's benefits, it must be qualified as a person, either "because they fall within the definition of 'company' or, where this is not the case, because they constitute other bodies of persons".[1537] Where a partnership is treated as a company or taxed, the partnership may be considered as a resident of the relevant State therefore entitled to the benefits of DTCs. However, where the partnership is treated as fiscally transparent, the partnership is "not liable to tax" in that State, therefore cannot be a resident for the purposes of the Convention.[1538] In other words, whenre the application of the DTC is denied, the partners are "entitled, with respect to their share of the income of the partnership, to the benefits provided by the COnventionbs entered into by the States of which they are residents to the extent tht the partnership's income is allocated to them for the purposes of taxation in their State of residence". [1539] Leaving aside all complications mentioned in the examples above, one must not loose sight of the main purpose of DTCs, namely, the elimination of double taxation and to prevent double non-taxation.[1540]

b. Collective Investment Vehicles (CIV)

Collective investment vehicles are entities created by small investors who pool their capital (funds) for the purposes of portifolio diversification. The law of State where the CIV[1541] is established will dictate investor-protection rules.[1542] In order for the CIV to benefit from the relevant DTC, the entity must be ***regarded as a person***, that is, a resident of the contracting State, and as a "***beneficial owner***"[1543] of dividends and interest that is receives. The fact of the matter is

[1537] Commentaries on the Articles of the Model Tax Convention 78 Para 2.
[1538] Commentaries on the Articles of the Model Tax Convention 45 Para 5.
[1539] Ibid 45. Para 5.
[1540] *The Application of the OECD Model Tax Convention to Partnerships* (n 1505) 20.
[1541] In order to be classified as a ***CIV*** for DTC purposes, the entity must be widely-held, hold a diversified portifolio of securities and be subject to investor-protection regulation in the country in which it is established. Its managers must also perform significant functions related to investment decisions and the the management of the assets. Commentaries on the Articles of the Model Tax Convention 49.
[1542] Commentaries on the Articles of the Model Tax Convention 48.
[1543] In order to be classified as a ***beneficial owner*** for DTC purposes, the CIV's managers must have discretionary powers to manage the assets generating income. It also should be read broadly, that is to say, "not used in a noarrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fical evasion and avoidance". Commentaries on the Articles of the Model Tax Convention 211. para 9.

that CIV are not always classified as persons, for instance, some States regard CIVs as companies, whereas other States consider the CIVs as ***trusts*** and finally, others may give the entity a simple "contractual arrangement or a form of joint ownership" classification.[1544] If regarded as a company or as a ***trust*** (or trustees "acting collectively in their capacity as such"),[1545] the CIV would clearly be given a person status, nonetheless, States may freely include on their DTCs provisions intended to extend the treaty's benefits to CIVs, therefore avoiding interpretation difficulties. Nevertheless, whether the entity will be deemed as a person in that State, will be not dictated by its corporate form, but by whether the entity is liable to taxation is that State, for instance, some States may treat CIVs as transparent entities, therefore taxing its holders instead of the entity itself, moreover, special tax treatment may also be granted to such entities, such as reduced tax bases (tax only paid upon distribution to its holders), lower tax rates etc. States may also fully tax the relevant CIV with full integration allowing the holder to deducted in full (or partially) the tax paid upon distribution, thus avoiding DT.[1546] In sum, "[T]he goal is to achieve neutrality between a direct investment and an investment through a CIV in the international context, just as the goal of most domestic provisions addressing the treatment of CIVs is to achieve such neutrality in the wholly domestic context".[1547]

c. Sovereign States (subdivisions and wholly-owned entities)

According to Article 4(1) OECD Model, the term "resident of a Contracting State means any person, who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, palce of management or any other criterion of a similar nature, and also includes ***that State and any political subdivision or local authority*** thereof ***as well as a recognized pension fund of that State***".[1548] The ***first emphasized part*** of the Article extents the Treaty's benefits to wholly-owned public companies, such as soverign wealth funds ("arrangements created by a State or a political subdivision for macroeconomic purposes"),[1549] statutory bodies, agencies, instrumentalities or other legal persons of public law, all are covered by the treaty's provisions.[1550] Some States may opt to grant full exemption to certain State-owned entities such as central banks and to "certain items of income such as interest".[1551] The ***second emphasized part*** of the Article was recently added in the last Model's update in 2017, including therefore entities such as "pension funds, charities and other organizations (…) to remove any doubt about the fact that a pension fund meets the definition of ***recognized***

[1544] Commentaries on the Articles of the Model Tax Convention 49.
[1545] Ibid 49.
[1546] Ibid 49.
[1547] Ibid 51.
[1548] Draft 2017 uptdate to the OECD Model Tax Convention Article 4(1).
[1549] ***Sovereign wealth funds*** "hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which may include investing in foreign financial assets. They are commonly established out of balance of payment surpluses, officials foreign currency operations, the proceeds of privatization, fiscal surpluses or receipts resulting from commodity exports". Commentaries on the Articles of the Model Tax Convention 85 Para. 8.5.
[1550] Commentaries on the Articles of the Model Tax Convention 58 Para. 6.36.
[1551] Ibid 58 Para. 6.37.

pension fund in paragraph 1 of Article 3".[1552] To conclude, it is important to not to interpret the Article's provisions as to affect the ***doctrine of sovereign immunity***, which states that, a sovereign State is "immune from the jurisdiction of the courts of another State.[1553] Although the doctrine is mostly applied in respect to legal wrongs (civil and criminal), it may also be applied in respect to tax (exemption).[1554]Nontheless, States may restrict the sovereign immunities doctrine in relation to taxation by granting it on a reciprocal basis or in certain cases where the income is derived from activities of a governmental nature as opposed to activities of a commercial nature, or when the assets and income of the recipient entity are used for public purposes, or whether there is a possibility that these could inure (toughen) to the benefit of a non-governmental person and lastly if the income is derived from a portifolio or direct investment.[1555]

d. *Conduit companies* (the provisions regarding conduit-companies are no longer part of the OECD Commentaries on the Model Convention since its last update 2017 – currently the matter is approach under GAARs implemented/created both by domestic judicial doctrines or through Statutes - *statutory GAARs v. Judge-Made GAARs*).

Conduit-companies, as the name suggests, are compaies that mainly serves as a channel through which income passes before arriving at its final final destination (capital tourism). The problem with conduit companies is that, supposedly, there is low (almost to none) substantial economic activity being conducted in the State where the conduit resides. The OECD commentaries on the Model, suggests that States, in order to avoid abuses such as the constant channeling of exempt income, the inclusion of a "***look-through provision***"[1556] that would "disallow" the DTC's benefits to companies "not owned, directly or indirectly, by residents of the State of which the company is a resident".[1557] The commentaries aso suggest the inclusion of a "subject-to-tax provisions" construed especially for the purposes of neutralizing the activities of such entities, that is, a ***safeguard provision***, which restricts the extension of the DTC's benefits "[W]here income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident of that other Contracting State ***a***) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the

[1552] "(i) the term '***recognized pension fund***' of a State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State (…)" (emphasis added). Draft 2017 update to the OECD Model Tax Convention Article 3(1) (I).
[1553] Commentaries on the Articles of the Model Tax Convention 58 Para. 6.38.
[1554] Ibid 58 Para. 6.38.
[1555] Ibid 58 Para. 6.39.
[1556] The ***look-through provision*** would read: "A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly of through one or more companies, wherever resident, by persons who are not residents of a Contracting State". Commentaries on the Articles of the Model Tax Convention 62 Para. 13.
[1557] Commentaries on the Articles of the Model Tax Convention 62 Para 13.

form of a participation or otherwise, or ***b***) exercise directly or indirectly, alone or together, the management or control of such company".[1558]

The commentaries also suggests a ***channel approach***, which has as its ultimate goal preventing the improper use DTC's provisions, by including a provision limiting the Treaty's substantial scope of application if more than 50% of the income "*is used to satisfiy claims*" of persons who "a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or b) exercise directly or indirectly, alone or together, the management or control of such company". In sum, one has to bear in mind that treaty's provisions should only be granted in *bona fide* cases, therefore, any transaction lacking economic substance will thus be put under suspicion and ultimately be denied the treaty's tax benefits (*treaty shopping*).

e. *Entities that benefit from special tax regimes* (the provisions regarding entities that benefit from special tax regimes are no longer part of the OECD Commentaries on the Model Convention since its last update 2017)[1559]

The OECD Commentaries on the Model Convention raised a red flag to companies enjoying tax privileges in their State of residence, that are "tax-exempt (or nearly tax exempt) (…) distinguished by special legal characteristics" [1560] (churches, [1561] for instance), [1562] which could use in an

[1558] Commentaries on the Articles of the Model Tax Convention 63 Para 15.
[1559] Michael Lang (n 461) 79.
[1560] Commentaries on the Articles of the Model Tax Convention 67 Para 21.
[1561] In an interview to an Italian newspaper, *Virginia Raggi* (mayor of Rome), stated that the unpaid taxes of the Vatican's real estate holdings and other assets amount to $ 270 million and $ 430 million in revenues, that is, 1 out of 4 private hotels in Rome are owned by the Vatican and 38% of such hotels have never paid IMU (Municipal Property Tax), and 24% paid only occasionally. *Will the Vatican finally "Render unto Ceasar" and pay Italian Taxes*? (2017) https://cruxnow.com/vatican/2017/01/25/will-vatican-finally-render-unto-caesar-pay-italian-taxes/ Accessed in 10 Feb 2018.
[1562] The taxation of entities with beneficial tax regimes is a matter of great concern amongst tax jurisdicitons that consider the term *exemption* almost as dirty word. *Ann O'Connel* and *Joyce Chia*'s study on the history of religion and tax, namely, "*The advancement (or retreat?) of religion as a head of charity: a historical perspective*" (*studies in the history of tax law*. 2013. pag. 367-391), depicts in a very clear manner the historical background of such relationship. In ancient Egypt tax exemption were given to priests, according to writings in the Rosetta Stone. In ancient Rome, secred places of creed were not taxed for it was believed that they were passed on by the gods. The institute of modern taxation begins with canon law, for the church was the "principal taxing agent and revenues were applied for such purposes as the church determine". After the concept of taxation became universal in the 19th century, exemption had to be justified and could no longer count on ***divine rights.*** Nonetheless, tax exemption was intimately connected to *charity,* which changed its meaning throughout history. In the *judeo-christian* tradition, charity has a wider meaning than it had in ancient cultures (relieving the poor by the implementation of "distributive programs"). *Judaism* adhered to virtues such as *zeddakah* (righteousness) and *hesed* (graciousness), which have a deeper meaning than that of simple *charity*. However *tithing* and *alms-giving* were requested by rabins. *Christians* preached according to three main principles: for the (***1***) ever love of god, exercise by self sacrificing; for the (***2***) love of one's neighbour, exercised by mutual assistance; and for the (***3***) "evil lay in too great attachment to material goods and wealth". With the demise of the Roman Empire, Christianism paved the way to centuries of prosperity, and gave the term "*charity*" a new scope, such as the promise of "rewards in heaven

for those who gave and punishments for those who did not, encouraging donations of surperfluous wealth, especially upon one's death", a practice still largelly applied by *televangelists* (Prosperity Gospels) with great sucess in certain countries ("even in more highly developed religions, where divine retribution is no longer or not only realized here, but in the hereafter, the idea of a punishment to be expected after death holds first place. In the actual beliefs of mankind, fear of hell is much more alive, and the picture of a place of punishment is much more concrete, that the usually very vague hope of a future paradise where our virtue shall find its reward" Hans Kelsen – see citation 97). In sum, the Holy Church became the main "distributions center for state welfare programms, and its leaders responsible for the poor and otherwise disadvantave". Nevertheless, the theory that backed tax exemption to the Church due to its divine purpose in Earth, which relieved the institution from taxes such as the *danegeld* (tax paid to pirates in order to prevent them from attacking the state, a sort of a *mafia* tax levied to this date) was accepted by the State. The turning point of tax exemption's conncession to the church occured in England at the beginning of the 11th century when king Willian I (Willian the Conqueror 1027 – 1087) levied taxes on a number of religious houses in order to finance its military programs. The practice was carried out by King Henry II (1133-1189), which instituted a tax on bishops in 1192 in order to raise capital to pay the Austrian Emperor a ranson for the release of King Richard I (Richard the Lionheart), detained when returning from the crusades in the holy land. King Henry II made other changes in the legal order of the State by replacing the infamous *trial by ordeal* (trials by torture that relied on the defendent's ability to endure pain, that is, if the individual was able to go through the process, then he/she cetainly had God by their side, therefore should be considered not guilty) for a jury system, and instituted personal taxes. In 1296, Pape Boniface VIII prohibited clergymen from paying taxes without his consent, however King Edward I 1239-1307 (Edward Longshanks) response was to allow lay persons to charge ecclesiastics on courts of law, and taking their right to legal remedies in order to challenge oppinions of the court. Soonly after all cleargymen started collecting their dues. These are just a few examples of the process that ultimately "culminated in the reformation in the sixteenth century, which was to have profound and long-lasting implications for the wealth and taxation of religion". The meaning of *charity* changed with the reformation's advent (initiated by Martin Luther 1483-1546), which consisted mainly in honoring "god and the church, (…) gifts for the saying of masses, the repair of churches and the maintenance of religious houses, as well as gifts for the relief of distress and suffering on earth, including bequests for the poor and suffering, and the upkeep and repair of hospitals, briges, roads and dykes. This definition of pious causes was, until the reformation, synonymous with the legal definition of charity". In 1601 the Tudors passed "the most important social legislation of the era" which shaped the manner in which social services would ultimately be delivered for more than three centuries, namely, the Poor Law. Subsequently to the Poor Law of 1601, the Statute of Use (also called as the statute of Elizabeth I) was passed. In that statute, Elizabeth I "recognized the need to attract religious money for secular purposes" and listed a number of charitable actions, such as "the relief of aged, impotent, and poor people; the maintenance of sick and maimed soldiers and mariners, schools or learning, free schools and scholars of universities; the repair of briges, havens, causeways, churches, sea banks and highways; the education and preferment of orphans; the relief, stock or maintenance of houses of correction; marriges of poor maids; supportation, aid and help of young tradesman, handicraftsmen and persons decayed; the relief of redemption of prisioners or captives and the aid or ease of any poor inhabitants concerning payments of fifteens, setting out of soldiers and other taxes" that would be within the meaning of the word *charity,* insofar the donated assests were used to the secular society's benefit. In 1736 the Mortmain act prohibited testamentary gifts to chuches, by considering such testaments as void, thus reverting the assets to the testator's heirs (clearly an anti-clerical connotation). After the 1842 Income Tax act which exempted from tax charitable institutions, tax authorities, concerned of potential abusive behaviours, denied a "charitable status to a trust established for the Moravian Church" under the reasoning that "charity was limited to its popular meaning, namely, relief of poverty". After challenging the commissioner's refuse, the "law lords (4-2) accepted the wider legal definition of charity. Lord Macnaghton categorized its constituent divisions as: the relief of poverty; the advancement of education; the ***advancement of religion***; and 'other' purposes beneficial to the community". This of course is a very sensitive matter that apparently will not be solved very soon, for those who are ***for*** the taxation of religious temples operate under the reasoning that abuses must be contained, however if one were to levy taxes on churches, all other charitable

abusive manner the DTC's benefits. One way of tackling the matter would be to exclude such companies, that is, denying the "treaty benefits to these companies (***exclusion approach***)".[1563] According to the OECD Commentaries, "[E]xclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may

institutions would also possibly be taxed, moreover, "million dollar churches" would have an advantage over small churches when organizing their tax schemes (this is the actually the current problem with Europe's internal market, that is, reducing the advantage that MNEs have over small companies that operate throughout the common market. Those who are ***against*** taxing religious temples defend the idea of freedom of religion, and levying taxes would circumvent that freedom, which brings us to another question: *what in fact could be considered a religion and therefore eligible for tax concessions*? A number of countries, for example, have denied the status of Scientology as a religion, ultimately leading to its taxation, for instance Ireland, Belgium, the Netherlands etc. Nonetheless, the taxation of charitable institutions is still an ongoing discussion amongst industrialized countries and apparently is not close to an end. The Brazilian Federal Court (Superior Tribunal de Justiça) confirmed the decision of lower courts regarding a donation made out to the Universal Church of the Kingdom of God (UCKG), imposing upon the church the restitution of the donated property added to a 20 000 00 reais (approximately 6 000 00 euros) of damages. It is fair to assume that, many people who experience some sort of crises (financial, personal, spiritual etc) become more vulnerable, that is, prone to moral coersion. C.D, a brazilian business woman, owner of a small business in south Brazil, found in the UCKG the solution to her problems. With the deterioration of her financial situation, she took the preaches' word that, in order to prosper, one should give everything that one has to the chuch (Properity Gospel). According to C.D's claim, people would come to the church's meetings to donate houses, money, cars etc (she sold her car at a lower price and donated the proceeds to the church). In sum, her donations were made to an extent that compromised her ability to maintain her own basic needs (housing, cloathing etc). After her husband became aware of such facts, he disagreed firmly with the excessiveness of her charity. In the same day, she went to the church with her husband to recover the donated goods, and even though she explained the church that the donations compromised her ability to feed her family, they denied the restitution. Moreover, the church "*advertised*" throughout the region the ludicrousness of C.D's conduct towards the church in demanding back her donations, which eventually made her close her business, putting her in an even worse situation than before. Brazilian courts ruled that "article 5 (vi) of the 1988 federal constitution states that 'the right to religious beliefs and its practices should be deemed as an inviolable right'. The Federal Constitution provided for a secular state, that is to say, it has determined the complete separation of religion from the state. (…) there is no doubt that the conduct of voluntariousness collaboration with a religious temple should be characterized as a donation (…) the main characteristic of a donation "contract" is necessarily based on its *animus donandi,* which presupposes the conduct's free willingness (…) nevertheless, the law restricts the donator's over generosity to the extent that such donation: (a) constitutes on the totality of the donator's estate to the donatee, and (b) represents more than 50% of the donator's estate.(…) the donation contract may also be annulled to the extent that a third-person acts upon the donator's *animus* in such a way as to impose upon the donator the duty to dispose of its property in order to avoid a future suffering or punishment, even if religious related. In such cases, the person who suffered the coercion, do not fully exercise its capacity to freely choose its destiny. (…) the psychic violence is so deep and strong causing ultimately the annulament of common sense. Therefore, moral coercion creates the surperstition and an unjustified fear on the victim's senses, who loses the espontanity of judgement (…) the line between religious freedom and the individual's disposition is thin. Nonetheless, one must not consider every moral coercion as annullable, that is, it must be irresistible to the extent that drives the victim to act according to the donator's will." This case is a clear demonstration of the excesses commited by religious temples that abuse their position "in the name of God". Apelação Cível. Nona câmara Cível nº 70051621894. Comarca de Lajeado. Igreja Universal do Reino de Deus. Apelante. Carla Dalvitt. Apelado. Joao Henrique Koefender. Apelado. (2012). pag 10 e seq.

[1563] Commentaries on the Articles of the Model Tax Convention Para. 21. 67.

prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State."[1564]

f. Controlled Foreign company provisions (CFC)

The last Model's update, has ruled out paragraph 23 on Article's 1 OECD Commentary and included comments on CFC legislation, "which are now internationally recognized as a legitimate instrument to protect the domestic tax base"[1565] Although the OECD commentaries recognized the great variety of CFC legislation designs, it concluded that CFC legilation is not contraty to the Model's provisions.[1566]

2. Taxes Covered (Article 2 OECD Model)

The OECD Model regulates taxation on income and capital levied "on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied."[1567], taxing income is *taxing income* regardeless the administrative procedure used by the relevant tax administration (jurisdiction may apply a direct assessment[1568] or apply a source deduction,[1569] use surtaxes or surcharges, or additional taxes etc).[1570] The same article also provides a list of direct taxes that should be covered by the relevant DTC, namely, tax "on total income, on total capital, or on elements of income or of

[1564] Ibid Para. 21.1. 68.
[1565] Draft 2017 update to the OECD Model Tax Convention. Commentary to Article 1. Para 81. Pag 49.
[1566] Draft 2017 update to the OECD Model Tax Convention. Commentary to Article 1. Para 81. Pag 59.
[1567] OECD Model Article 2 (1).
[1568] ***Direct*** or ***Self tax liability assessement***, is an assessing tax liability method conducted by the taxpayer himself, by informing tax authorities as to his annual earnings (independent professionals), business profits etc, in such a way that, after determining the total taxable amount, the taxpayer proceeds to pay the revenue service (according to the State's appropriate administrative procedure – bank transfer, payment of invoice or other accounting voucher) and inform the tax administration of the tax that has been collected providing to the administration the possibility of crosschecking the information presented by the taxpayer against the payment itself. The self-assessment of taxes operates under the principle of ***tax convenience***, that imposes upon the tax administration, ***and not upon the taxpayer***, the duty to facilitate assessing tax liability. According to *Charles F. Bastable* on *Smithian* canons of taxation, "[T]hat taxation should be convenient' is another of the accredited maxims, which almost carries its justification on its face. It includes the selection of suitable objects for taxation, and also the choice of convenient periods for requiring payment. This rule of convenience is but the expression in a special form of the general principle that the public power should as far as possible adjust its proceedings to the habits of the community, and ***avoid any efforts at directing the conduct of the citizens in order to facilitate its own operations***. The sacrifices that inconvenient methods of fiscal administration impose may indeed be treated as violations of both economy and equity." (*emphasis added*). Charles F. Bastable (n 1).
[1569] ***Source Deduction*** method is the duty imposed upon the taxpayer to deduct from certain payments duty percentages. Such method operates under the the principle of ***tax convenience*** (see citation above), providing taxpayers the possibility of paying its taxes on installments instead of making a single payment at the end of the fiscal year, as well as it generates monthly revenue to the State in order to conduct its policies.
[1570] Commentaries on the Articles of the Model Tax Convention Pag.75.

capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation" (***social security duties*** and other ***charges collected in lieu of remunerations*** paid by an undertaing to its employees, "***shall not be regarded as taxes on the amount of wages***").[1571] The *list* provided by the *Model* should not be interpreted in a restrictive manner, that is to say, "any identical or substantially similar taxes that are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes",[1572] shall also be covered by the convention and the fact that the *Model* chose to set its substantial scope as broad as possible by avoiding the term "*direct taxes*", which, is "far too imprecise",[1573] corroborates to that end (*extraordinary taxes*, for instance, were not included in the *Model,* for it would pose great difficulty in properly defining them, for "the manner in which the they are levied, their rates, their objects, etc"[1574] are of an extraordinary nature. Nonetheless, it is under the discretion of the relevant contracting States whether to included the provisions for both *extraordinary* and *ordinary taxes*, if necessary. To conclude, it is a common practice among contracting Countries to include within the provisions of Article 2 an obligation to inform the competent authorities of the other contracting State of any substantial changes regarding taxes regulated by the DTC, that ultimately could influence the DTC's proper functioning.[1575]

3. General Definitions (Article 3 OECD Model)

The *Model*'s personal scope is set by Article 1 (persons who are residents of one or both the contracting States), whereas Article 3 defines the terms *person, company, enterprise, international traffic, competent authority, national and business* of a contracting State. The provisions of Article 3 (2) OECD Model, prevent contracting States from changing their domestic tax law as to the terms (or similar in character) that were previously agreed upon in the DTC that ultimately could render the treaty the status of "partially inoperative".[1576] The provisions reads, "[A]s regards the application of the Convention at any time by the Contracting State, any term not defined therein shall, unless the context otherwise requires, ***have the meaning that it has at the time under the law of that State for the purposes of the taxes to which the Convention applies***, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under the laws of that State." (*emphasis added*).

Person. According to the OECD Commentaries, the term *person* must not be interpreted in a narrowly or exhaustive manner, but in the word's "wider sense", therefore, the Model's provisions may be applied to an individual person, a body of persons (partnerships, whether legal or not), associations, foundations (*Stiftung*) etc.[1577]

[1571] Ibid 75.
[1572] Michael Lang (n 461) 72.
[1573] Ibid 75.
[1574] Ibid 76.
[1575] "(…) The competent authorities of the Contacting States shall notify each other of any significant changes that have been made in their taxation laws." OECD Model Article 2 (4).
[1576] Commentaries on the Articles of the Model Tax Convention 82.
[1577] Commentaries on the Articles of the Model Tax Convention 78.

Company. Corporate bodies are within tbe meaning of company for the *Model*'s purposes, that is to say, an incorporated body according to the laws of the contracting State. [1578]

Enterprise. An enterprise may be a result of an economic activity conducted within the borders or territories of a contracting State by an appropriate entity. The term encompasses the "performance of professional services and of other activities of an independent character", therefore activities performed by an entity (individuals, company, partnerships etc) shall be considered an enterprise within the *Model*'s scope of application.[1579]

International Traffic. The term provides for any "transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State".

Competent Authority. The term competent authority has as its ultimate purpose acknowledging members of tax authorities, regardless of its hierarchical position within the national Organ, as being competent, when properly designated, to carry out functions in respect to the Model's provisions,[1580] for instance, Article 25 (4) OECD Model states that competent authorities may form joint commissions of "themselves or their representatives, for the purpose of reaching an agreement". Such provision extends the possibility to contracting States to delegate functions when necessary.

National. On the one hand, the term national grants "[A]ny individual holding a nationality or citizenship of a contracting State, (…) take cover under the Model's provisions" (Article 3 (1)(g)(i) OECD Model). On the other hand, the term may also refer to "legal persons, partnerships and associations" that gained a national *status* due to the laws of the contracting State (Article 3 (1)(g)(ii) OECD Model). The manner in which a company may be defined as *national* varies from State to State, for example, "certain States have regard less to the law that governs the company than to the origin of the capital which the company was founded or the nationality of the individuals or legal persons controlling it".[1581]

Business. The *business* provision was included in the 2000 OECD Model's revision[1582] to ensure that the provisions of the deleted Article 14 (Independent Personal Services) covered "the performance of professional services, or other activities of an independent character, where the domestic law does not consider that the performance of such services or activities can constitute business".[1583] Again, the *Model*'s provisions merely *charts* States as to avoide double taxation, thus it is entirely under the contracting States' discretion whether to include OECD suggestions.

[1578] Ibid 78.
[1579] Ibid 79.
[1580] Commentaries on the Articles of the Model Tax Convention 79.
[1581] Ibid 80.
[1582] Ibid 81.
[1583] Commentaries on the Articles of the Model Tax Convention 81.

4. Resident (Article 4 OECD Model) – tiebreaker-rule

Article 4 OECD Model's main goal is to provide a clear definition for "resident of a contracting State" and its allocation rules, that is, to determine the Treaty's personal scope and solve matters of double taxation related to double residency and source issues.[1584] In order to be considered a resident of a Contracting State, the entity must be liable to tax in that State "by reason of his ***domicile***, ***residence***, ***place of management*** or other ***criterion of a similar nature***".[1585] It is also important to point out, that the provisions or Article 4 do not apply only to entities that have a domicile in that contracting State ***at the time of the tax is due***, that is to say, the relevant entity may for a period of time remain in that State and therefore be fully liable to taxation in that State even through it does not reside there anymore, for instance, a certain taxpayer is a resident of a certain contracting State from 31 of January till the end of March, and is transferred to work in another contracting State till the year's end, therefore staying in that other State for a period greater than 183 days. Under the laws of second contracting State, the individual is fully liable to taxation in both contracting States, where he worked for two months, and in the other, where he worked till the end of the year.[1586] Question: *which State should be conferred such taxting rights*? Article 4 OECD Model provides the answer to this question with "tiebreaker rules":

Criteria No. 1 – Permanent Home. If the taxpayer is considered a resident of both contracting States, the State where he maintains a permanent home will be entitled to such tax rights. In most cases, this "criterion will frequently be sufficient to solve the conflict"[1587] The term home, should be interpreted in a broad manner, in such a way that an apartment, house, room, rented or not – ownership is not necessary – may be classified as a home for the purposes of the Model. Nonetheless, it is fundamental the taxpayer to have the "dwelling available to him at all times continuously, and not occasionally for the purpose of a stay".[1588] However, if the individual has a home in both States, one should *break the tie* by considering the taxpayer a resident of the State "with which his personal and economic relations are cloaser".[1589]

Criteria No. 2 – Center of vital interests. The center of the vital economic and personal taxpayer's relations is where the taxpayer live with his family, where he practices his social and religious interests, political and cultural activities, place of business, place from where the taxpayer administers his assets etc.[1590] If neither the taxpayer's *permanent home (1)* nor the *center of his vital interests (2)*, can be established, then the criteria bellow should be applied.

Criteria No. 3 – Habitual abode. The place where the taxpayer customarily lives, where the individual "*stays more frequently*"[1591] that is, his habitual abode, must be used if the previous two tiebreak criteria (permamnent home, center of

[1584] Ibid 83.
[1585] OECD Model Convention Article 4(1).
[1586] Commentaries on the Articles of the Model Tax Convention 83.
[1587] Ibid 86.
[1588] Ibid 87.
[1589] OECD Model Article 4 (2)(a).
[1590] Commentaries on the Articles of the Model Tax Convention 87.
[1591] Ibid 88.

vital interest) are inconclusive. The OECD commentaries presents two different situations regarding the taxpayer's personal home, namely, when the (***1***) taxpayer has a home in both States, and when the (***2***) taxpayer does not have a personal home in both States. The ***first*** situation would be solved by ascertaining in which State the taxpayer spends most of his time (not necessarily at his permanent home but also in other locations in that State). As for the ***second*** situation, the taxpayer may jump from a hotel to another in both States. In this case, all taxpayer's stays in that State must be considered, regardless the reasons (work, family etc).

Criteria No. 4 – Nationality. If none of the above tiebreake rules were able to properly allocated taxing rights, then the taxpayer's nationality should put the problem to an end. Nontheless, the *Model* uses the term ***national,*** which can be either applied to "any individual possessing the ***nationality or citizenship of a contracting state***. Thus, nationality or citizenship under domestic law is decisive.[1592]

Criteria No. 5 – MAP. The mutual agreement procedure (MAP), must be applied when all allocation rules have failed to define with certainty which State shall be entitled to rights on the taxpayer's income. Such provision is propery defined in Article 4 (2) (d) OECD Model which reads "if he is a national of both States or neither of them, the competent authorities of the Contracting states shall settle the question by mutual agreement". Although it is not clear as to whether the contracting States are obliged coming to terms regarding the dispute (taxation rights) by MAP,[1593] Article 25 (2) OECD Model states that "[T]he competent authority shall endeavor (…), to resolve the case by mutual agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation which is not in accordance with the Convention."

Criteria No. 6 – Place of effective management criteria was "changed" in the last 2017 Model's update, allowing Contracting State to solve the matter on a case-by-case basis. Currently, the provision reads:

> "3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting State, ~~then it shall be deemed to be a resident only of the State in which its place of effective management is situated~~. ***the competent authorities of the Contracting States shall endeavour to determine by mutual agreement te Contracting State of which such person shall be deemed to a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such a manner as may be agreed upon by the competent authorities of the Contracting States***."

Article 4 (3) concerns ***legal entities*** (whether companies or a body of persons – partnerships). Here, it is not relevant if the person has legal

[1592] Michael Lang (n 461) 86.
[1593] Michael Lang (n 461) 86.

personality or not (transparent partnerships). It is rare a company be considered a tax resident in two or more States[1594] (a certain State may consider a company as a resident for tax purposes according to its registration, insofar the undertaking is managed in that State),[1595] eventually a tiebreaker rule must be applied. This Article is particularly important for shipping and air transport companies (according to Article 8 *OECD Model* profit derived from ***shipping or air transports*** shall be taxable in the contracting State in which the place of management is located – *till 2017 – now the Article provides that profits may be taxed in that State*). Although some DTCs uses the effective management rule, most States agree that profits derived of ships or aircrafts in international traffic shall be taxable in that State, thus not applying the *place of effective management* as the allocation criteria, mainly to avoid tax avoidance schemes by registering the ship, aircraft in low tax jurisdiction in order to avoid taxation – *flag-of-conveniance*.

5. Permanent Establishment (Article 5 OECD Model)

According to Article 7 OECD Model, the profits of an undertaking are taxable only in that State, for example, an Australian company, incorporated in Australia generates income by selling its products in France, according to Article 7 DTC Australia/France, such profits shall be taxed in Australia.[1596] However, if the Australian company's profits were generated through its PE, the income will be taxed in France. The reasoning of such *turn of events* is that the economic connection that the Australian company's PE has to French territory, is greater than that of Austrialia's, that is, the Australian company was allowed to penetrate the French market, establish its PE and generate income, therefore it is only fair the company to contribute to the environment from where it benefited economically. Bellow we have transcribed the recently changed Article 5 OECD Model.

> "5. Notwithstanding the provisions of paragraphs 1 and 2, ***but the subject to the provision of paragraph 6***, where a person ~~— other than an agent of an independent status to whom paragraph 6 applies —~~ is acting ***in a Contracting State*** on behalf of an enterprise and ~~has, and habitually exercises, in a Contracting State an authority to conclude contracts,~~ ***, in doing so, habitually concludes contract, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are a)*** in the name of the enterprise, ***or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that enterprise has the right to use, or c) for the***

[1594] Such rule was included in the 1963 Draft Convention, when the OECD Fiscal Committee expressed that "it may be rare in practice for a company, etc. to be subjected to tax as a resident in more than one State", nevertheless, because such situations may occur, "special rules as to the preference" should be included. Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 72.

[1595] Commentaries on the Articles of the Model Tax Convention 88.

[1596] Convention Between the Government of Australia and the Government of the French Republic for the Avoidance of Double Taxation with Respect to Taxaes on Income and the Prevention of Fiscal Evasion. Article 7.

provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business ***(other than a fixed place of business to which paragraph 4.1 would apply)***, would not make this fixed place of business a permanent establishment under the provisions of that paragraph."

Article 5(6) was also changed

"6. ~~An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.~~***Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.***"

Finally, Article 5(8) was ***included***

"8. For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise in one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if anoter person of enterprise possesses directly or indirectly more tham 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest on the company) in the person and the enterprise or in the two enterprises."

6. OECD Allocation Rules

The following types of income are specifically allocated by the Model, namely, income from ***(i)*** immovable property; ***(ii)*** business profits; ***(iii)*** profits arising from shipping, inland waterway transport and air transport; ***(iv)*** associated enterprises' profits; ***(v)*** dividends; ***(vi)*** royalties; ***(vii)*** capital gains; ***(viii)*** income from employment; ***(ix)*** Independent Personal Services ***(ix)*** director's fees; ***(x)*** entertainers and sportspersons; ***(xi)*** pensions; ***(xii)***

government services; ***(xiii)*** students and finally ***(xiv)*** other forms of income. We will proceed to study the relevant allocation rules in the order in which they were presented.

a. Income from Immovable Property (Article 6 and 22(1) OECD Model)

Income arising of alienation of an immovable property shall be taxed in the Country where the property is located, for the economic connection between the property's income and the Contracting State is stronger. According to Article 6 OECD Model's wording, the concept of immovable property shall be defined by the relevant Contracting State in order to avoid problems of an interpretative nature over what should be considered an immovable property. Nonetheless, the term must include "property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ***ships, boats***[1597] ***and aircraft shall not be regarded as immovable property***".[1598] In such a case, the *situs* takes precedence over other connecting factors, such as residence or place of management provided that the immovable is property of an undertaking. For example, according to the Swiss-Australian DTA, income derived by a resident of a contracting State from immovable property, must be taxed where the property is located at, therefore, if an individual resident of Australia, rents his property located in Switzerdland, the latter will be entiltled to tax such income. According to the DTC, the Australian resident will be granted a tax credit (CEN), thus, when the income is transferred to Australia, the tax administration will tax such income and provide the taxpayer a credit (Article 22 (1) Swiss-Australian DTC). On the other hand, had Australia the taxing rights (were the property located in Australia, for example), the Swiss tax administration would exempt (CIN) such income (Article 22 (2) (a)).[1599] It is important to note that the method for eliminating double taxation varies according to the relevant country. The first paragraph of the Article makes reference to income derived from agriculture or forestry (which can be derive out of a sell of the forestry area or from the acquisition of emissions permits, such as ***carbon credits***)[1600] nonetheless, contracting States may adapt such a

[1597] The Model's new draft (July 2017), excludes from the paragraph the word ~~**boats**~~. *Draft Contents of the 2017 Update to the OECD Model Tax Convention*. (2017). http://www.oecd.org/tax/treaties/draft-contents-2017-update-oecd-model-tax-convention.pdf. Accessed in 10 Feb 2018.

[1598] OECD Model Article 6 (1).

[1599] "2. In the case of Switzerland, double taxation shall be avoided as follows: a) Where a resident of Switzerland derives income which, in accordance with the provisions of this Convention, may be taxed in Australia, Switzerland shall, subject such provisions of subparagraph b), exempt such income from tax but may, in calculanting tax on the remaining income of that resident, apply the rate of tax which would have been applicable if the exempted income had not been so exempt. (…)" Article 22(2)(a) Australia-Switzerland DTC.

[1600] Carbon credits are the product of a growing climate change concern. By pricing carbon emissions into the atmosphere through international trading programs, governments were able to add monetary value to polluting activities using as a benchmark the "historic emissions of a company, site or installation during a specific reference period. (…) Certified Emission Reduction

provision according to their needs.[1601] Notice that although Article 6 defines the allocation rule for income derived from the utilization of the immovable, the same Article to not cover capital gains is the immovable is sold. Nevertheless, in such case, the State where the immovable is located has the taxing rights over that income (Article 13 (1) OECD Model). To conclude Article 6 (4) OECD Model, provides for cases where an undertaking is the owner of the immovable. Therefore, although the income (rental) could also fall under business profits (Article 7 OECD Model), the *situs* criteria takes precedence over other connecting factors, such as place of management, for instance.[1602]

b. Business profits (Article 5, 7 and 22(2) OECD Model)

The main purpose of Article 7 OECD Model is to allocate taxing rights in respect to business profits between the Contracting States. In sum, profits of an undertaking must be taxed in the Contracting State where the taxpayer resides (or in the place of effective management - for example, if an Austrian company provides advisory services to a company resident of Chile, the income should be taxed in Austria, since the Austria company has ***no Permanent Establishment*** in Chile – Article 7 (1)). On the other hand, if the same Austrian company provides advisory services, through its "PE" resident of Chile, to another company also resident in Chile, the source State (Chile) will be entitled to those taxing rights on the PE's profits located therein. In other words, if an "enterprise of a Contracting State has a permanent establishment in the other Contracting State, then it is taxable in the source State ***only on the taxable income attributable to the permanent establishment***". [1603] The example bellow better illustrates the machanics of Article 7. The source State, where the permanent establishment resides, will have the taxing rights without any other considerations. Note that the State B will tax the PE's income, which will consequently either grant a tax credit to the parent company or provide tax exemption, according to the relevant double tax relief method.

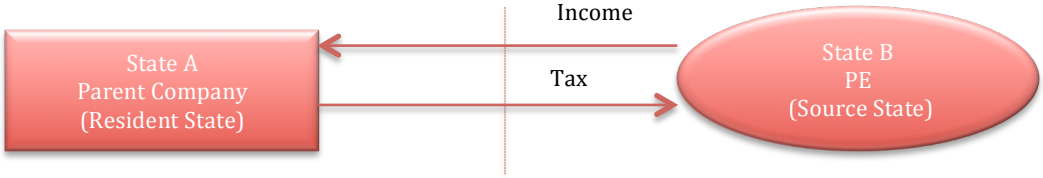
Credits "CERs" and Emission Reduction Units "ERUs" are issued with reference to the verified reductions in greenhouse gas emissions that result from projects initiated specifically to achieve such reductions". The Chicago Climate Exchange (CCX) was an example of carbon credit exchange entity (the entity ceased its operations in 2010 due to United States inaction on the matter). The income derived from such operation may fall under Article 7 (Business Profits), Article 13 (Capital Gains), Article 12 (Royalties) and in some cases under Article 6 (Immovable Property), Article 8 (Shipping, Inland Waterways Transport and Air Transport) or 21 (Other Income) of the Model. Commentaries on the Articles of the Model Tax Convention R (25)-9 e seq.

[1601] New Zealand, for example, reserved the right to include fishing provisions under the Article. Australia, as well as New Zealand, reserved the right also to include rights to all natural resources. Other Countries, such as the United States, reserved the right to allow the taxpayer to elect being taxed by the other State on income from real property. Commentaries on the Articles of the Model Tax Convention C (6)-3 e seq.

[1602] Article 6 of the Austria-Brazil DTC reads "(1) Einkünfte aus unbeweglichem Vermögen dürfen in dem Vertragsstaat besteuert werden, in dem dieses Vermögen liegt. (4) Die absätze 1 und 3 gelten auch für Einkünfte aus unbeweglichem Vermögen, das der Ausübung eines freien Berufes dient"

[1603] Andrea Amatucci (n 2) 166.

Figure 30



An important rule ***not contained*** in the OECD Model Convention, but nevertheless of extreme importance to taxation is the ***force of attraction doctrine***. According to the IBDF International tax Glossary, force of attraction (*Attraktivkraft*) is a tax "[P]rinciple under which a country may tax a foreign enterprise in respect of income it rerives in the other country if the enterprise maintains a permanent establishment in the other country ***irrespective of whether that income is derived through or otherwise economically connection with the permanent establishment*** (…)" (emphasis added). Consider the following example, an Indian company resident in the US sells a certain product independently (without the participation of the PE), as well as through its PE also resident in that State. According to Article 7(1) of the India US Double taxation Avoidance Treaty: [1604]

> "The profits of an enterprise of a contracting State shall be taxable only in that other State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) ***sales*** in that other State of goods or merchandise of the ***same or similar kind*** as those through that permanent establishment; or (c) ***other business activities*** carried on in that other State of the ***same or similar kind*** as those effected through that permanent establishment."[1605]

Note that the DTC affords the US tax authority the right to tax products sold independently by the Indian company, that is, without the support of its PE. As previously mentioned, the general rule is that "*Profits of an enterprise of a contracting State shall be taxable only in that State* (…)" (Article 7 (1) OECD Model). The main *rationale* for such principle, namely, ***force of attraction*** (FoA), is to connect the taxing rights to the country where the economic activity occurred. It must also be noted that, if the parent company resident of India,

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[1604] Generally India adapts Article 7(1) of its DTCs according to the US or the UN Models. Nonetheless, the provision of such article can vary, for instance the India-Gemany DTC, states that, although sales of goods or merchandise of similar kind may be taxed in the other State, such profits will attributable to the PE if it is proved that the transaction had as its ultimate purpose (***i***) avoiding taxation in the PE's State, and if the PE is in any way (***ii***) involed in the relevant transaction. Agreement between the Republic of India and the Federal Republic of Germany for the Avoidance of Double taxation with respect to Taxes on Income and Capital. *No. SO 836(E) [No. 10235 (F. No. 500/47/90-FTD)], dated 29-11-1996.* Protocol. With reference to Article 7(1) (c) (i) (ii).

[1605] Convention Between the Government of the United States of America and the Government of the Republic of India for the avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes and Income. No. GSR 990 (E), Dated 20-12-1990.

were to sell goods ***independently*** or merchandise of a ***different nature*** as those of the permanent establishment or even perform an ***independent business activitiy other than that*** carried out by its permanent establishment, the right to tax such income would fall under the parent company's State, namely, India. Such approach is classified by the tax doctrine as the "***limited force of attraction principle***". It is also important to point that the international community chose not to apply a ***full force attraction principle*** (where all income whether derived through a PE or independently will be taxed in the source State). Note that by applying the *limited force of attraction principle* income derived from the the sell of different goods or services than those of the PE will be taxed in the resident State, that is, in the State other than that where the economic activity occurred (as previously mentioned, such approach grants the State of the parent company taxing rights to income that would otherwise not be entitled to had the DTC been adopted according to the OECD Model, the *Attraktivkraft* principle will not found in the OECD Model, but in the UN Model).[1606]

Pursuing our discussion on the tax allocation of business profits, Article 5 OECD Model provides a definition for "physical PE",[1607] that is, "(…) a fixed[1608] place[1609] of business[1610] through which the business of an enterprise[1611] is wholly or partially carried on."[1612] Such criteria is particularly important as far a allocation rights are concerned, for the contracting State will only be allowed to tax such income where an ***intensive economic conection*** or ***physical location at the disposal of the enterprise*** is proved.[1613] Consider the following example, a company resident in Mexico, enters into a contract with a Canadian individual, in which the Canadian resident will provide a certain traning in the premises of the company resident in that country for a 13 month period. According to the general rule, the income of an enterprise resident of a contracting State shall be taxed in that State, therefore, Canada should be entitled to tax such income.

[1606] United Nations Model Double Taxation Convention between Developed and Developing Countries. United Nations. New York (2011). Article 7(1).

[1607] Andrea Amatucci (n 2) 166.

[1608] The ***fixed*** criteria infer to constant, permanent. Andrea Amatucci (n 2) 167.

[1609] A ***place*** implies a physical location (machinery or equipments etc). The ***place*** of business must also be "***permanent***", that is, a location used by an undertaking occasionally will not constitute a PE for tax purposes. Moreover a conection to a certain point of the earth's surface must exist. For example, in the *Real Resourcing Limited v. DIT* (International Taxation case), a company resident of the UK, collected and analysed information regarding possible candidates for recruitment by companies in India. According to *Real Resourcing Limited,* the company had "(…) an address in New Delhi but this is basically a virtual office i.e., we rent the use of the address and telephone numbers but we do not have an actual office space (…)". The court ruled that "(…) On the facts stated by the applicant, ***it cannot be said that the applicant operates through a permanent establishment in India***. (...) the function of referring the potential Indian candidates to the Indian based recruitment company without creating any commitment to recruit them does not, without anything more, give rise to an inference of PE." *Real Resourcing Limited v. DIT (International Taxation)-II New Delhi, AAR/828/2009.*

[1610] The "***of business***" criteria must be materialized by a productive/commercial activity. Andrea Amatucci (n 2) 167.

[1611] The "***through which business of an enterprise***" PE's criteria, should allow the PE be used as a tool through which the commercial activity is conducted. Andrea Amatucci (n 2) 167.

[1612] The ***carried on*** criteria does not necessary imply the need of a natural person to conduct the relevant commercial activity. An *automated* (sales through the internet) *approach is* ***not possible***, for "(…) a conection to a certain point of the earth's surface must exist." Michael Lang (n 461) 93.

[1613] Michael Lang (n 461) 93.

However, the Canadian individual performed the traning activity within the company's premises located in Mexico, thus such individual will be considered a Mexican PE. Article 5 (3) (b) (c) Mexico-Canada DTC states that "

> 3. The term 'permanent establishment' likewise encompasses: b) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve month period; and the furnishing of professional services or other activities of an ***independent nature by an individual*** within a Contracting State if such person is present in the territory of such Contracting State for a period or periods exceeding in the ***aggregate 183 days*** within any twelve month period." (emphasis added)

It impotant to note that such provision is not applied by all OECD members, therefore, the assessment as to whether the relevant undertaking shall be deemed to have a PE in that State, must be approached on a case-by-case basis, for instance, the Austria-United Arab Emirates DTC contain no such provision broadening PE's the scope ("activities of an independent nature by an individual"), thus under the Austria-United Arab Emirates DTC, ***the general should be applied***,[1614] that is, an individual performing training services would not be considered a PE, therefore, the State where such individual is a resident of, will be entiltled to such taxing rights.[1615]

Building sites, construction or installation projects are also expressively provided for Article 5 (3) OECD Model. According to the OECD Commentaries on the Model Tax Convention, the term "building sites, construction or installation projects" should include the construction of roads, bridges, canals the laying of pipe-lines, excavating, dredging and of course, construction of buildings. The term "installation project" should ***encompass*** constructions projects, and also new equipment.[1616] The same article provides a minimum twelve month period in order for such undertaking to be considered a PE for tax purposes. Nonetheless, such threshold (twelve month period) has been subjected to abuses perpetrated by companies that, in order to avoid taxation, "devide their contracts up into several parts, each covering a period less tham twelve months and attributed to a different company which was (…) owned by the same group"[1617] (tax teaty abuse).

[1614] "(1) The profits of an enterprise of a Contracting State shall be taxable only in that State(…)" Article 7 (1) Convention between the Republic of Austria and the United Arab Emirates with respect to Taxes on Income.

[1615] According Article 7 (6) of the Austrian-United Arab Emirates DTC, a "(…) broker, general commission agent or any other *agent of an independent status* (…)", shall not be deemed to have a PE in that State. On the other hand, if the individual acting on behalf of an enterprise in the other State has authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a PE in the other State.

[1616] OECD Commentaries on the Model Tax Convention 100.

[1617] OECD Commentaries on the Model Tax Convention 100.

Contrary to Article 5(3) OECD Model, Article 5 (3) UN Model covers a wider variety of activities, such as *assembly project* as well as *supervisory activities*.[1618] Another important difference between both Articles is the threshold of twelve months, which is reduced to six months in the UN Model. Nonetheless, still developing countries object to such a short period of time for two main reasons, namely, ***(1)*** due to modern technology, the construction or assembly of the property could take less than that, which consequently would result in the loss of revenue of that jurisdiction and ***(2)*** such countries maintain that "the period during which foreign personnel remain in the source country is irrelevant to their right to tax income (…)"[1619] According to *Michael Lang*, the exclusion range from the meaning of PE is narrower in the UN Model, for it does not provide for "delivery and stock maintained only for the purpose of delivery".[1620]

The physical factor is irrelevant, to the extent that the relevant undertaking is involved in the economy of that State through an ***agent***, therefore where "(…) no physical or project PE subsists, a non-resident can still have a PE (…)" status, and be taxed accordingly.[1621] Such approach is possible if the person ***acting on behalf the of the company in that State*** (agent), has the authority to enter into contracts in the name of the company, and thus generate income. The fact that the agent did not entered into a contract with the company resident in the other State is irrelevant, for the agent's connection with that company will be ascertained under a functional analysis, that is, if the facts point in the direction that the agent habitually exercised "an authority in the name of the enterprise",[1622] such agent[1623] will be considered a PE for tax purposes. [1624]

[1618] United Nations Model Double Taxation Convention between Developed and Developing Countries. Commentaries to Article 5. 107.

[1619] UN Model Convention Commentaries. 108.

[1620] Michael Lang (n 461) 95.

[1621] Andrea Amatucci (n 2) 167.

[1622] Article 5 (5) OECD Model.

[1623] The agent's relation to the enterprise must be that of a paid-employment relationship (dependent agent). The agent's power in relation with "third-parties is irrelevant. It makes no difference whether or not the dependent agent is authorized to conclude contracts if he works at the fixed place of business." Nonetheless, one must approach the matter on a case-by-case basis. In the following case, the Indian company not found to be dependent on the PC, due to the fact that it did not entered into contracts on behalf of the Parent Company nor did maintain a stock of goods for that company. Knowerx Education (India) entered into several contracts with an American company (American Production and Inventory Control Society, Inc. APICS) for the promotion (marketing) of professional examinations/certifications programmes of American institutions. The Indian compay also carried other activies other than those contracted with APICS, such as corporate training, open public training, management consultancy, publishing and trading in educational material etc. The indian company sought advance ruling on the following situation: "*Do we need to deduct any TDS or do we need to pay any income-tax on examination fees collected by us from individuals in India and remitted to APICS/AST&L on behalf of individuals in India*?" The court ruled that "(...) the applicant is not a part of APICS. It does not conclude any contracts on behalf of APICS. The acceptance of candidature of an individual for a certification examination is solely done by APICS. ***The applicant does not maintain stock of goods*** or merchandise belonging to APICS, it does not secure orders wholly or almost wholly for APICS and it does not in any way bind APICS in the conduct of latter's examination programme in India. Similar will be the position in respect of AST&L. ***The applicant thus cannot be regarded as a dependent agent of APICS or AST&L under paragraph 4 of article 5***. (...) In the light of the foregoing discussion, we rule that ***the applicant is not required to either deduct any income-tax or to pay any such tax on the examination fees collected by it for APICS and AST&L and***

The fact that a company has a subsidiary resident of the other contracting country, does not necessarily indicate that the subsidiary will be treated as a PE. Athough it is irrefutable that such subsidiary is an independent undertaking operation in that country, therefore liable to tax, it will only be deemed as a PE for the parent company resident in another State insofar the requirements of Article 5(1) OECD Model are meet. In that case, the parent company will be liable to tax in that State, and ultimately be granted a tax relief (exemption or credit) in the other State. In respect to services, in general, there is no special provisions, that is, in order to be taxed at source State, the company providing the services would have to be considered a PE for tax purposes ("have a fixed place of business through which the business of an enterprise is wholly or partly carried on"). However, Article 5(3)(b) provides for the furnishing of services (consultancy services) for more than "183 days in any 12-month period commencing or ending in the fiscal year." Despite the novelty of such provision, some countries already included such wording in their DTC (Article 5 (3) (b) Austria-Chile DTC (2015)).

As previously studied, if the PE status is recognized in the source country, the parent company will be liable to tax in that country. Nevertheless, the profit of an operation will be calculated according to the expenses of the relevant PE, therefore, inevitably TP issues will occur. According to Article 7(2) OECD Model, the profits of the permanent establishment are expected to be those of what independent undertakings "engaged in the same or similar activities under the same or similar conditions" would be. In other words, the transaction must be assessed under the ALP. Nonetheless, one must not loose sight of the fact that contrary to subsidiaries, PEs are intimately connected (dependable) on the parent company, and although they operate under the "***separate entity approach***", as far as intra-group transactions are concerned, some authors argue that the cost of a relevant transaction must be assessed on a whole-enterprise basis, therefore, limiting the scope of the separate entity approach.[1625] In order to conduct such analysis, tax authorities will be necessarily be drawn to a ***TP analysis*** (authorized OECD approach (AOA)),[1626] that is to say, all necessary steps when evaluating TP transactions previously studied, namely, ***1.*** contractual terms of the transaction, ***2.*** functional (performance) analysis (risks and contribution); ***3.*** transferred property (tangible, service or Intangible), ***4.*** economic circumstances of the parties related to the transaction and ***5***. business strategy, will ultimately be assessed by tax authorities (TP). ***In fact, the application of Article 7(2) OECD Model is amongst the four most common grounds***[1627] ***for double taxation arbitration disputes***. [1628]

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remitted to them as the same is not taxable in India." In the *Knowerx Education (India) v. Commissioner Concerned Dit*. OECD Commentaries on the Model Tax Convention 97.

[1624] Andrea Amatucci (n 2) 167.

[1625] Michael Lang (n 461) 97.

[1626] Ibid 97.

[1627] According to the OECD's commentaries, the four main common cases submitted to arbitration are: ***1.*** application or Article 7(2) OECD Model; ***2.*** relationship between taxation in the State of the payer and the beneficial owner of such income (recipient State), regarding the excess part of royalties and interest (Articles 9, 11(6) and 12(4) OECD Model); ***3.*** treatment of interests and dividends in thin capitalization instances in the debtor's State (Article 9 and 11(6) OECD Model) and finally, ***4.*** instances where the absence of evidence regarding the relevant taxpayer's situation in respect to *residence* (Article 4(2) OECD Model), *existence of a PE* (Article 5 OECD

Article 7 (4) OECD Model provides for a subsidiary clause, that is, allocation rules' provisions (immovable, dividends, royalties etc) ***overrides*** the provisions of Article 7. For example, a Dutch company owns real estate in Malasya from which it derives income. According to Article 8(6) Malaysia-Netherlands DTC (Business income or profits), Article 7(1) Malaysia-Netherlands (income from immovable property) ***overrides*** the former, therefore, Malaysia has the taxing rights over such income, which will be exempt in the Netherands according to Article 23 (2).[1629]

Movable property part of a PE's business operation is regulated by Article 22(2) OECD Model. The article reads "[C]apital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State", thus if the PE's property is situated in a State other than that where the PE is situated, the PE's state will be entitled to such taxing rights.[1630]

c. Profits arising from international shipping and air transport (Article 8 and 22 (3) OECD Model)

The general rule for income derived of *international traffic*[1631] of goods ***was*** that the State where the ***effective management is conducted*** shall be entitled to such taxing rights. However, the OECD established that both OECD and non-OECD members preferred to "assign the taxing right to the State of the enterprise and the Article was changed accordingly".[1632] Nonetheless, a number os State still apply the place of effective management rule. For instance, Article 8(1) of The Netherlands-Viatnam DTC states that "*Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated*."[1633] Therefore, if a Viatnamese airline with offices both in Viatnam and in the Netherlands operates flights from Amsterdam to Ho Chi Minh City, but nonetheless manages its operation from Hanoi, then Viatnam would be entitled to such taxing rights. Athough the company has an office in Amsterdam, the company's head quarters in located in Hanoi (place of effective management), thus Viatnam has exclusive rights over such income. Note that Article 7 Netherlands-Viatnam DTC, if applied, would allocated the taxing rights to the Netherlands, for the company operates through a PE located in Amsterdam,

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Model) or in relation to *temporary services carried out by an employee* (Article 15(2) OECD Model) resulted in the misinterpretation of the relevant DTC.

[1628] OECD Commentaries on the Model Tax Convention 355.

[1629] Agreement between the government of the Kingdom of The Netherlands and the government Malaysia for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. (1988).

[1630] Michael Lang (n 461) 126.

[1631] The term *international traffic* is properly delineate in Article 3 (1) (e) OECD Model, which states that "the term 'international traffic' means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;" According to the *OECD Commentaries*, any activity carried in connection with transportation, whether passengers or cargo, should be considered to be linked with transportation. OECD Commentaries on the Model Tax Convention 175.

[1632] OECD Commentaries on the Model Tax Convention Para 1. 115.

[1633] Double Taxation Avoidance Agreement between The Netherlands and Viatnam. (1995).

nonetheless, according to Article 7(7) "[W]here profits include items of income which are dealt with separately in other Articles (…), then the provisions of those Articles shall not be affected by the provisions of this Article". In other words, 8(1) overrules 7(1). Now consider the following, had the Viatnam airline operate flights only within Dutch territory (The Hague to Groningen, for example), the income derived from those flights would be taxed in the Netherlands, for the route did not involved international traffic.

Comparing both the UN and the OECD Model, the UN Model convention proposes a second allocation alternative (Article 8 (alternative B)), by also granting the contracting State where the bulk of the economic activity occurs limited taxing rights, determining that profits should be taxed on a net profit basis reduced by a percentage which would have to be negociated between the contracting States (limited taxation rights).[1634]

As mentioned earlier, Article 8(2) OECD Model provides that profit derived of aircrafts, ships or inland waterways transport shall be taxable in the contracting State in which the place of management is located. It is important to differentiate ***inland waterway transport*** from ***maritime shipping***. The former stands for lakes, rivers etc, whereas the latter refers to cross-ocean routes. The OECD Model provides for both categories. Some DTCs, such as the Germany-Romania DTC, provides that the State where the effective management of the enterprise is located will be entitled taxing rights over profits. Nonetheless, such approach is not applied by most of OECD Members, for instance, Article 8(1) of the Germany-Austrialia DTC states that profits derived of ships (transport, rental etc) or aircrafts in international traffic shall be taxable in that State. Note that the *place of effective management* was not the tax allocation criteria chosen by those countries.[1635] Nevertheless, this does not come as a surprise for MNEs tend to register their ships in low tax jurisdiction in order to avoid taxation. Consider the following example, a MNE located in Denmark operates as an international transporter of goods in a number of countries. As it is commonly known, a great percentage of the world's fleet is registered in low tax jurisdictions (Panama, Costa Rica, Barbados etc) as a matter of convenience (flag of convenience).[1636]

[1634] Michael Lang (n 461) 99.

[1635] Gesetz zu dem Abkommen zwischen der Bundesrepublik Deutschland und Australien zur Beseitigung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen sowie zur Verhinderung der Steuerverkürzung und –umgehung. (2015).

[1636] The discussion on flag-convenience (FOC) is an interesting one, for it is difficult to conceive how countries with little to none history in the shipping industry managed to become the "largest maritime nations in the world". The reasons that lead ***United Sates*** shipping companies to change their flag to *Panlibhonco* countries (Panama, Libya, Honduras and Costa Rica) are different from those that of ***Europe.*** The main difficulty in ***America*** at that time was tax related, but due to the high operating costs that such companies incurred when building ships. After WWII, America has been unable to cope with maritime expansion of the following decades due to high cost of contruction (in 1948 US ships carried 53% of the US foreign Trade, by 1960, the number had droped to 12%). Although the US government granted subsidies in order to boost the shipping industry and to allow such companies to compete with low wages in competing countries, shipping companies operating *tankers*, *bulk cargo vessels* or *tramp ships* could not benefit from such grants according to US legislation at the time, therefore, such companies opted to transfer their flag to a *Panlibhonco* flags (flag of necessity). Such companies soon after formed the American Committee for Flags of Necessity (ACFN) in 1958. Now, companies would be able substantially reduce their operating costs, for the "annual operating costs of a bulk-cargo vessel under the United States flag are double the costs of a similar ship when operated under the Liberian or Panamenian flag" (under an American flag, the wages must obey the minimum

Now, were such profits taxed in the place of effective management, the income would be transferred to those countries where the ships are registered, where the company sustains almost neutral tax (flag-of-convenience countries generally charge registration fees "*per ton*", some minor annual taxes and other insignificant administrative dues).[1637]

Capital represented by ships and aircraft operating internationally, as well as boats operating "enganed in inland waterways transport, as well as movable property pertaining to the operation of such ships, aircrafts and boats, shall be taxed only in the Contracting States in which the place of effective management os the enterprise is situated" (Article 22(3) OECD Model).

The last Model's update in 2017 deleted paragraphs 2 and 3 Article 8 OECD for the same reasons discussed above, It also deleted the term ***boat*** from the Model in order to avoid problems interpretation issues in order to ensure that "boats are treated in the same way as ships". [1638]

d. Associated enterprises' profits (Article 9 OECD Model)

The definition of ***associated enterprises*** or ***related parties*** is fundamental to the study of taxation. Article 9 (1) OECD Model provides that if an undertaking resident of a certain State acts directly or indirectly in the "management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly". In sum, affiliated companies must apply the ALP to their princing transfers. Consider the following, subsidiary A, resident of State A sells machine parts to PC B, resident of State B at 500. Subsidiary A also sells the same machine parts to independent companies at 1.000. Article 9 (1) A-B DTC provides that transfer prices must be set according to ALP. After careful TP analysis (property, contractual, factual, economical and business strategy. State B demands subsidiary A's profits in respect to the sell made to its PC be adjusted

threshold of that country, which were considerably higher when compared to other jurisdictions). Under a *Panlibhonco* flag, companies were able to hire unlicensed staff (crew) mainly constituted by Indians, Africans and Italians, whilst maintaining British and Germans as officers. As for ***European countries***, the matter at the time were not cost related, but mainly political, due to the great instability post-WWII. In the years following 1945, Greeek ship companies were subjected to heavy taxation and operated under the constant possibility of nationalization of the shipping industry. International investors, therefore, were more inclined to finance operations with other countries' flags (*Panlibhonco*). Nonetheless, the Greek government, aware of the industry's importance to Greece's economic development, passed in 1953 a law granting companies tax benefits (accelerated depreciation, tax exemption etc). Such laws enhanced the government income in that field exponentially (tax was chaged by the registered *ton*, in 1958 450.000 was registered under Greek flag, by 1961, it reached 5.983.652 ton registered under Greece's flag). Adam Boczek Boleslaw. *Flags of Convenience. An International Legal Study*. Harvard University Press. Cambridge. Massachusetts (1962) 45 -57.

[1637] Adam Boczek Boleslaw (n 1678) 58.

[1638] OECD Model 2017. Commentaries Para 16. 116.

to 1.000, that is, the price that was in fact charged for the transaction between independent undertakings (subsidiary A and third parties). Considering that State B agreed to the price adjustment, the difference of 500 would be taxed in the subsidiary's hands and at the level of the PC (economic DTC). Nonetheless, in order to avoid DT, Article 9(2) A-B DTC provides that if the "Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that ***other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits***. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other". Note that Article 9 OECD Model do not provide for an allocation rule as the other Articles previously studied (Articles 6, 7, 8) and others (Article 10, 11, 12, 13, 15, 16, 17, 18, 19, 20, 21 and 22), it simply addresses to "cases of economic double taxation", that is to say, "domestic rules that provide profit adjustments between affiliated companies must apply the arm's length principle".[1639]

e. Dividends (Article 10 OECD Model)

Article 10 (3) OECD Model provides a definition for dividends.[1640] In sum, dividends are income distributed by a certain enterprise derived from profits of that enterprise. Dividends are taxed first as business profits (company perspective), and after distribution (shareholder perspective). As we have already study in other parts of the present investigation, jurisdictions may apply an ***integration system*** (generally higher CIT with the possibility of the shareholder to offset the company's CIT paid against his income – discrimination of foreign shareholders, foreign dividends and foreign profits for it creates no imputation credit internationally, nonetheless domestically neutral and the classic system (the company is liable to tax on its profits and the shareholder pays upon receiving such dividends, who can credit the dividend distribution tax withheld upon distribution against his income – internationally neutral).

> "Apparently, the OECD Model assumes that income from corporate rights can only qualify as "dividends" if it is not deductible when determining the profits of the distributing company.**"**[1]

Defining ***corporate rights*** is extremely important for understanding dividend taxation. Corporate rights are financial privileges onwed by a certain person (individual or company) due to its participation on the company's capital (shares). On the one hand, such income must derive from a ***company*** (Article

[1639] Michael Lang (n 461) 146.

[1640] "The term 'dividends' as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."

3(1)(b) OECD Model), and on the other hand, the person must possess an amount of ***shares*** of that company in order to receive such dividends. [1641] For instance, the transfer of profits from an investment fund to its shareholders was not considered "dividends" for the purposes of the Swedish-Canada DTC. [1642] Nonetheless, according to the OECD Model, dividends may be taxed in the resident State of the recipient (general rule), and on the source State, considering that "the beneficial owner of the dividends is a resident of the other Contracting State (…)".[1643] Such rule was initially provided by the OECD Model due to the fact that, third parties to the transaction (agents, nominees, conduit companies[1644] etc) [1645] appointed by the final recipient of the dividends,[1646] could serve as an intermediary entity before transferring such dividends to its final

[1641] "***Dividends on the stock*** of corporations are declared by the directors, who have power to use their discretion as to the amount to be disbursed in this way. The statutes are, however, very explicit in prohibiting the declaration of any dividends except out of the surplus profits of the business conducted by the corporation. With respect to dividends properly declared, the declaration of the directors generally provides that they shall be paid to all stockholders registered upon the books of the company at a specified date in the future. Hence, if a stockholder should sell or otherwise transfer his stock, after that date to another person, the latter, while becoming the owner of the stock, would not be entitled to the dividend when paid. It would be payable to the former stockholder, although he might, pursuant to the agreement made with the person to whom he sold the stock, turn over to the latter the amount of the dividend. ***Cumulative Dividends.*** It frequently happens that a corporation does not earn any dividends in a particular year. The question arises, is the holder of a 7% preferred stock in a position to demand that the dividend be paid the following year. Suppose the corporation earns nothing in 1921 and earns 14% in 1922. The holder of one share of a non-cumulative preferred stock would receive the usual 7% dividend only in 1922. If the stock were cumulative he would receive 14%. In other words the unearned dividends accumulate and become a charge which the corporation must pay when sufficient is earned in prosperous years before the holders of common stock are entitled to receive any dividend. Usually the stock certificate and the articles of incorporation specify whether stock is cumulative or non-cumulative. If they do not, then reference to the law of the State where the company is incorporated, is necessary to decide such a question." Williston, Samuel, Richard D. Currier, and Richard W. Hill. *Commercial Law*. Auckland: The Floating Press, 2013. *eBook Collection (EBSCOhost)*, EBSCO*host*. Accessed in 10 Feb 2018.

[1642] Finish Supreme Court Adminsitrative Court (*Korkein Hallinto-oikeus*), Case 14.06.1999/1600; KHO: 1999: 34.

[1643] Article 10 (2) OECD Model Convention.

[1644] "***Conduit Entity*** - an intermediate entity whose participation is disregarded in whole or in part under (...) regulations. (...) a district director would be authorized to treat an intermediate entity as a conduit entity (and disregard its participation for withholding tax purposes) where three conditions are met. ***First***, the intermediate entity's participation in the financing arrangement must reduce U.S. withholding tax liability. ***Second***, the intermediate entity's participation must be pursuant to a tax avoidance plan. ***Third***, either the intermediate entity must be related to the financing entity or the financed entity, or the intermediate entity would not have participated in the arrangement on substantially the same terms but for the fact that the financing entity entered into the transaction with the intermediate entity." Mark L. Lubin. Anti-conduit regulation issued. http://archives.cpajournal.com/old/16762563.htm. Accessed in 10 Mar 2018.

[1645] "conduit company cannot normally be regarded as the beneficial owner if, though the former owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties." OECD Commentaries on the Model Tax Convention 211. Para 10.

[1646] A Canadian undertaking paying dividends to a Dutch company owned by a company in the UK (49%) and a Swedish company (51%) entered into an agreement that 80% of the dividends should be distributed to them. Eventually, since the Dutch company was not part to such agreement, it was concluded that such company (Dutch company) should be considered the beneficial owner of the dividends. (2009 FCA 57, The Queen v Prevost Car Inc.).

owner.[1647] Although the recipient State has taxing rights to such income, the source State may also levy tax up to 15% (***limited taxing rights of the source State***). However, if the parent company holds at least 25% on the company's stock, such limitation drops to a 5% figure[1648] considering that the company paid the dividends throughout a 365 day period that includes the day of the payment of the dividend "(for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend)."[1649] Note that the "***other than a partnership***" provision was deleted since the 2017 Model's last update, due to the fact that "if a partnership is treated as a company for tax purposes by the Contracting State in which it is established, it is appropriate for the State to grant the benefits of subparagraph *a)* to a partnership. Indeed, an entity or arrangement (…) that is treated as a company for tax purposes qualifies as a company (…), to the extent that is a resident of the other State, as long as it holds directly at least 25 per cent of the capital of that company. This conclusion holds true regardless of the fact that the State of source (…) may regard that entity or arrangement as fiscally transparent".[1650]

Article 10 UN Model reduces the holding threshold to 10% and provides no specific percentage limitations. It is also important to note that, the company that paid the dividends should be a resident of a different State than the recipient. Such concept is fundamental for the case to fall under the DTCs.[1651]

[1647] An Indonesian company proceeds to issue bonds in the international market in order to raise capital for its operations (bonds are debt related instruments and issued in a foreign country's currency which are expected to generate interest payments on specific intervals and liquidated by the issuer when the bond reaches its maturity). Such company entered into a contract with an American bank registered in London, which would serve as a trustee of the respective bonds. According to the Indonesian law 20% should be retained as withholding tax had the interest been paid directly to the UK. Nonetheless, the Indonesia company established a company in the Mauritius Islands (special purpose vehicle – "SPV" – issuer of the loan notes). According to the late Mauritian-Indonesian DTC (revoked in 2004 by the Indonesian government on grounds of "tax treaty abuses") the Indonesian government shoud be entitled to 10% withholding tax. Due to the termination of the Mauritian-Indonesian DTC, the SPV proceeded to redeem the notes which resisted to liquidate them on grounds that the SPV could benefit from The Netherlands-Indonesia DTC. Nonetheless, the Dutch company would have to be classified as the *beneficial owner* for the purposes of the DTC. Ultimately, the court ruled that the Dutch company could not be deemed as the beneficial owner of such income due to its conduit nature, that is to say, the company served only as an administrator of that income*. Indofood International Finance Lt v JP Morgan Chase Bank NA London Branch* [2006] STC 1195.

[1648] "2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (~~other than a partnership~~) which holds directly at least 25 per cent of the capital of the company paying the dividends ***throughout a 365 day period*** (...) ; b) 15 per cent of the gross amount of the dividends in all other cases. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid." OECD Model Article 10 (2) (a) (b).

[1649] OECD Model 2017.

[1650] OECD Model 2017. Para 11. Pag. 119.

[1651] If a German resident receives dividends from a company that has its legal seat in Austria, but with the ***place of effective management in Germany***, such transaction would fall outside the

Pursuing our discussion on Article 10(2)(a) OECD, when reading the referred Article, is important to associate the word "*capital*"[1652] to holdings and not to types of shares (ordinary, [1653] preference, [1654] deffered ordinary, [1655] cumulative preference, [1656] plural, [1657] non-voting, [1658] bearer, [1659] registered,[1660] redeemable,[1661]redeemable preference[1662] etc). Such classification describes the owner's, and not necessarily "*the extent of his ownership of the capital*" (***power***).[1663] Another important point is that dividends are not only

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DTC (considering that the Parent-Subsidiary Directive is not applicable – holding period less than 2 years or holding threshold below 10%), for according to Article 4(3) Austria-Germany DTC "Ist nach Absatz 1 eine andere als seine natürliche Person in beiden Vertragsstaaten ansässige, so gilt sie als in dem Staat ansässige, in dem sich der Ort ihrer tatsächlichen Gesellschtsleitung befindet." Austria-Germany DTC.

[1652] "(a) 5 per cent of the gross amount of the dividends if the beneficial owner is acompany (other than a partnership) which holds directly at least 25 per cent of the ***capital*** of the company paying them dividends;" OECD Model Article 10(2)(a).

[1653] ***Ordinary Shares*** generally grants shareholders voting rights and no right to dividentds whatsoever.

[1654] The holders of ***preference shares*** are entitled to received dividends every year. However, contrary to ordinary shares, the holder of preference shares do not have voting rights thus he do not participate on the company's decisions. Exceptions to voting rights may apply in the case of the payment of arrears.

[1655] The holders of ***deffered ordinary*** shares will not received dividends until the holders of other shares were paid a certain amount of dividends. In case the company is liquidated, the holders of deffered ordinary shares will only be paid if all the requirements provided in the company's articles of association are met.

[1656] ***Cumulative preference shares*** are shares that carry a cumulative benefit of being paid first if the company for lack of reserves was unable to pay its sharesholders. The holders of cumulative preference shares have the *preference* of receiving dividends before all other class of shareholders, which will not be paid until cumulative preference holders are paid.

[1657] ***Plural voting shares*** allows a shareholder the right to more than one vote. According to *Ronald Charles Wolf*, "[T]he right of plural voting shares cannot be personalizes but must rather be attributable to the quality of the shares, which (…) means a class of shares. (…) besides not being recognized in many jurisdictions, the concept of plural voting is linked with shares and not easily transported to other legal forms where there are no shares. Ronald Charles Wolf. *The Complete Guide to International Joint Ventures with Sample lauses and Contracts. Klumer Law International* (2011). Pag 289.

[1658] Holders of ***non-voting ordinary shares*** may get to vote only on certain instances, that is, they do not participate on the company's decisions on a regular basis, although retaining all other rights of ordinary voting shares.

[1659] ***Bearer shares*** are issued to unregistered holders, in such a way that, the holder is able to transfer the share's title merely by delivering the coupon (document). Beares shares, beares bonds etc, may also be used in estate planning instances, where the asset is protected in the hands of the bearer.

[1660] Contrary to bearer shares, ***registered shares*** are printed with the shareholder's name on the coupon. The shareholder's name is properly registered in the Company's register office, therefore providing more security to the shareholder.

[1661] ***Redeemable shares*** are issued by a company, that ultimately reserves itself the option of buying those shares in the future. The terms of the future operation (buying of the shares), may be previously agreed (nominal value, point in time etc). In sum, companies may not at their discretion exchange reemable shares, that is, they either may redeem shares upon profits.

[1662] ***Redeemable preference shares*** are shares that combine the characteristics of preference and reemable issued shares. In other words, the shareholder will benefit from the right of preference shares (dividends), which may be cumulative or non-cumulative, and the company reserves itself the right of buying those shares in the future according to a pre-established ***re-purchase agreement*** (***repo***).

[1663] OECD Commentaries on the Model Tax Convention 189.

treated by the OECD Model as such, but "*also (…) interest on loans insofar as the lender effectively shares the risks run by the company, i.e. when the repayment depends largely on the success or otherwise of the enterprise's business*"[1664] thus, dividends derived out of *highly geared* undertakings may also be deemed as *capital* for the purposes of Article 10(2)(a) OECD Model, that is, the fact that a company was *thinly capitalized* does not necessarily mean that all payments arising out of that company should be typified as interest.[1665]

Contrary to the Parent-Subsidiary Directive, both the OECD Model as well as the UN Model do not provide for a minimum holding period in order for the transaction to benefit from the DTC's advantages. According to the OECD Commentaries on the Articles of the Model tax Convention, the main reason for such approach is to maintain the provision as broad as possible leaving such choice at the discretion of the contracting parties.[1666]

Article 10(4) of the OECD Model states that, in case dividends are paid by a ***PE*** located in the other State (source State), such payments ***may not be considered as dividends*** under Article 10 OECD, but as ***business profits*** under Article 7. Such rule is particularly important, for a PE is generally fully owned (and dependent) of the PC, therefore transfer of income should be treated as profits, and not dividends (***PE proviso***).[1667]

aa. National, International and Supra-National Taxation Systems (overlapping of Statutes)

As previously studied, the Parent-Subsidiary Directive regulates taxation on profit distribution within the Internal Market (PE, subsidiary and PC). In sum, resident MSs, may only *refrain from taxing profits*[1668] (dividends) if such profits were not deducted by the associated entity (PE) at the source State. As for subsidiaries the, "[P]rofits which a subsidiary distributes to its parent company shall be exempt from withholding tax",[1669] and on the other hand "(…) Member States of a parent company may not charge withholding tax on the profits which such a company receives from a subsidiary."[1670] The question here is the influence (if any) that the relevant DTC has *vis-à-vis* the Parent-Subsidiary Directive, that is to say, in case a conflict between both statutes occurs, should tax authorities apply the DTC instead the Directive? According to *Michael Lang*, when one is confronted with such situations, the EU's Directive preceeds the DTC, thus if the DTC grants a Contracting State taxing rights on distributed

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[1664] OECD Commentaries on the Model Tax Convention 191.
[1665] If the creditor shares the operation's risk, the payment will be regarded as ***dividends***, if not, ***interest***. There is no simple formula to ascertain whether the funder shares the risk of the enterprise, that is, one must approach each case individually. The OECD Commentaries gives guidance on the matter suggesting a number of assertives to be analysed, for instance, (***i***) will the creditor share the eventual company's profits? (***ii***) Does value of the loan exceeds other eventual capital contribution, or even had such loan the purpose of compensating company losses, so that the undertaking could continue operating? (***iii***) Is there any fixed contractual terms as to how such loan should be paid? OECD Commentaries on the Model Tax Convention 192.
[1666] OECD Commentaries on the Model Tax Convention 190.
[1667] Michael Lang (n 461) 103.
[1668] Parent Subsidiary Directive Article 4(1)(a).
[1669] Parent Subsidiary Directive Article 5.
[1670] Parent Subsidiary Directive Article 6.

dividends, and the Parent-Subsiriary provides that such dividends shall be exempt, the relevant tax authority would have to comply with the Directive's wording.[1671]

Consider the following example, an Austrian company holds 5% of shares in a ***subsidiary*** located in Germany. Considering that the associated company resident in Germany remits dividends to its parent company in Austria, and that the rule of control established by Article 3(a)(i) Parent-Subsidiary Directive is not fulfilled (10%), Austria will be entitled to such taxing rights under Article 10 Austria-Germany DTC[1672] and Germany will be also entiltled to limited taxing rights according to Article 10(2)(b) of the same Statute[1673] (if the company remitting those profits were a PE, then Article 10 would not apply, but Article 7, for the benefits of Article 10 are not applicable "if the benefitial owner of the dividends, being a resident of a Contracting State, carries on a business in the other Contracting State of which the company paying the dividends is a resident through a ***permanent establishment*** situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such a case the provisions Article 7 shall apply"). Now, had the Austrian company 100% holdings of the same subsididiary located in Germany, and considering that the 2-year holding period condition is fulfilled (Article 3(2)(b) Parent-Subsidiary Directive), Gemany may not levy tax upon such distribution according to Article 5 Parent-Subsidiary Directive. Nonetheless, under Article 10(2)(a) of the Austria-Germany DTC,[1674] Germany would be entitled to limited taxing rights upon such distribution. However, Germany may not "*exercise its taxing right by reason of the Parent-Subsidiary Directive".*[1675] Now, if it is established that the relevant transaction occurred domestically, both international (DTC) and supra-national (Directives) legislation would ***not*** be applicable, thus national legislation would regulate the matter.

ab. Classical/Integration systems and international tax credits

As previously studied, jurisdictions may operate under an *integration* or *classical system* of taxation, each of those with its respective peculiarities, that is, in classical systems company income will inevitably be double taxed when distributed to its shareholders domestically (with the possibility for the

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[1671] Michael Lang (n 461) 103.

[1672] "(1) Dividenden, die eine in einem Vertragsstaat ansässige Gesellschaft an eine im anderen Vertragsstaat ansässige Person zahlt, dürfen im anderen Staat besteuert werden." Article 10 Austria-Germany DTC. *Gesetz zu dem Abkommen vom 24. August 2000 zwischen der Bundesrepublik Deutschland und der Republik Österreich zur Vermeidung der Doppelesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögem.*

[1673] "(2) Diese Dividenden dürfen jedoch auch in dem Vertragsstaat, in dem die die Dividenden zahlende Gesellschaft ansässig ist, nach dem Recht dieses Staats besteuert werden; die Steuer darf aber, wenn der Nutzungsberechtigte der Dividenden eine in dem anderen Vertragsstaat ansässige Person ist, nicht übersteigen: (b) 15 vom Hundert des Bruttosbetrags der Dividenden in allen anderen Fällen." Austria-Germany DTC Article 10(2)(b).

[1674] "(2)(a) 5 vom Hundert Des Bruttobetrags der Dividenden, wenn der Nutzungsberechtigte eine Gesellschaft (jedoch keine Personengesellschaft) ist, die unmittelbar über mindestens 10 vom Hundert des Kapitals der die Dividenden zahlenden Gesellschaft verfügt;" Austria-Germany DTC Article 10(2)(a).

[1675] Michael Lang (n 461) 103.

shareholder to offset the tax levied upon the distribution of such dividends against its income if charged, that is, the CIT is ***NOT*** credited), whereas in an integration system there will be no economical double taxation on such profits (the shareholder may refund the CIT or offset the CIT against his income). Nonetheless, if a subsidiary resident of an ***integration split-rate system*** State, remits dividends to its parent company resident of a ***classical system*** State, the profit will be ultimately double taxed (once in the hands of the subsidiary, then again upon distribution and finally taxed on the State of the recipient (Article 10 (1) OECD Model)). Note that the holder of the shares (recipient State) was not granted a tax credit over the tax levied in the source State (Article 10(2)(a)(b) OECD Model states that the source State also has limited taxing rights according to the applicable case – 5% or 15%). Although such differences may create obstacles and distortions in respect to international movement of capital, the system allows some sort of international tax relief that would otherwise not exist if both Contracting States operated under a classical system (***classical systems are internationally neutral***). According to OECD Model Commentaries, the "[C]ommittee has recognized that economic double taxation need not be relieved at the international level when such double taxation remains unrelieved at the national level. It therefore considers that in relations between two classical systems (…) the respective levels of company tax in the Contracting States should have no influence on the rate of withholding tax on the dividend in the State of sorce (…)."[1676]

Dividends distributed to natural persons. In order to avoid discrimination of foreign dividends, shareholders or profits, States that operate under a ***classical system*** may eventually grant the shareholder (*natural person*) a tax relief considering that the dividends were already taxed in the hands of the of the enterprise (or even grant a tax refund – Malta). Although most countries that chose to grant such tax relief (***imputation sytem***) have "agreed to extend the credit to shareholder who are residents (and non-residends) of the other Contracting State (…) on a reciprocal basis" [1677] there is no general agreement regarding how the international community should approach the matter. If the the relevant DTC provides that the shareholder of the recipient country should be entitled to a tax credit paid upon distribution in the source State, such relief would obviously create an incentive for individuals and enterprises alike to purchase shares of companies located in that other State in order to benefit from a tax credit that they would not have in their own country.[1678] On the other hand, jurisdictions claim that only the shareholder benefits from such a relief, whereas the CIT levied on the relevant company's profits remains "in its entirely a true company tax", that is to say, the credit is granted to the shareholder in order to relieve "his personal tax liability and in no way constitutes an adjustment of the company's tax. No refund, therefore, is given if the tax credit exceeds that personal tax", [1679] in other words, countries will not grant equalization credits. Listed companies' shareholders circumvent taxation by

[1676] OECD Commentaries on the Model Tax Convention 196.
[1677] OECD Commentaries on the Model Tax Convention 198.
[1678] OECD Commentaries on the Model Tax Convention 198.
[1679] OECD Commentaries on the Model Tax Convention 198.

applying ***dividend stripping***,[1680] a practice not applicable to shareholders of small or medium-sized enterprises.[1681]

Dividends distributed to undertakings. If the dividend's recipient is a company, instead of a natural person, should the relevant tax authority grant a tax credit directly to the PC? Consider the following example, a subsidiary resident of a ***classical system*** jurisdiction (therefore, if such company remits dividends to domestic shareholders, no credit would be granted to the foreign shareholder under regular circumstances), receives dividends of another company resident of an ***integration split-rate system***. According to Article 10(2)(a)(b) OECD Model the source may tax such dividends up to 5% (25% holdings and not partnership) and 15% (all other cases). Therefore, the source State would be entitled to tax (***i***) the undertaking's profits and when (***ii***) dividends are distributed (5% to 15%), whereas the recipient State would be entitled to tax such dividends at full rate, considering that no relief was granted. Note that the dividends were taxed at the source as in the recipient State. Unfortunately there is not simple answer to such problem, thus it is left to States to deal with the matter on a case-by-case basis, that is to say, the recipient State would have to provide a tax credit to the shareholder to foreign dividends (see section xx).

f. Interest (Article 11 OECD Model)

Interest are income derived out of debt claims of any kind, "whether or not secured by mortgage and whether or not carrying a right to ***participate in the debtor's profits*** and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures (…)"[1682] (emphasis added). Although the definition provided for the OECD Model regarding interest is adjustable according to the relevant contacted DTC, the OECD consider as *non-advisable* States to broaden the classification's scope, due to the fact that it deems the formula (***i***) broad enough as to cover the classification in various States from a legal perspective and it believes such formula to (**ii**) offer greater certainty in eventual legislation changes. In sum, the OECD Commission considers that the "Model Convention references to domestic laws should as fas as possible be avoided"[1683] in order to prevent dubious or too wide interpretations. For that matter, the OECD's suggestion to keep the Model Convention as broad as possible is highly welcomed.

The fact that a parent company (borrower) depends highly on the associated company's profits to be paid, may classify such payment as ***dividends*** instead of ***interest*** for the purposes of the DTC, that is to say, if the lender effectively shares the operation's risks the payment may be classified as capital

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[1680] The ***dividend stripping*** practice is commonly used by shareholders'of listed companies who negotiate shares (stocks) on the open market. Such practice consist on purchasing the stock of a dividend paying company before they are actually paid in order to benefit from market volatility (generally the market price of dividend stock tents to rise after the paying announcement, and fall after the *ex-date*) and from an *imputation credit* which may be used afterwards for tax deduction purposes.

[1681] COM (2001) 582 final 299.

[1682] OECD Model Article 11 (3).

[1683] OECD Commentaries on the Model Tax Convention 213.

under Article 10(2)(a) OECD Model (*highly leveraged companies*).[1684] As previously discussed, this assessment must be conducted on a case-by-case basis (is the creditor entitled a share of the enterprise's profits? does the value of the loan exceeds the company's capital? to what extent? are there contractual terms on how should such loan be liquidated?).[1685]

Nevertheless, contrary to dividends, *interest are not double taxed when transferred internationaly*, that is, it will only be taxed (according to the general rule) in the hands of the recipient (Article 11 OECD Model),[1686] in other words, if the creditor is liable to tax in the other country, it will probably pass on the price of such tax to the debtor in the form of a higher interest.[1687] Nonetheless, interest presumes costs, and costs may be deducted at the source State in most cases (for instance, the premium – excess between the amount paid to creditor and the principle - may be deducted from the taxable interest, for it constitutes ***negative interest***.[1688] However, in order to avoid possible abuses, a number of OECD States do not allow such interest to be offset against the debtor's profits, unless the creditor is a resident of the same State or, alternatively, is taxed in that same State[1689] (interest limitation rules). Nonetheless, some DTC's reserve their right not to apply allowances, reliefs and reductions (deductions) to non-resident individuals.

One will not be able to provide a fully study on interest taxation (at least so some extent) without covering some of the categories of such debt-claim instances, thus the following part of the investigation will briefly discuss the classifications of interest according to the applicable transaction.

aa. Interest paid by States or its political subdivisions

A number of Contracting States abstain from taxing income derived in another State (to the extent that such income is related to governmental activities). There are two possible approaches to the matter: ***(i)*** States may apply the ***sovereign immunity principle*** to its agents, property and activities in general (such rule provides that States are immune to the "jurisdiction of the courts of another State"[1690] or ***(ii)*** include on the relevant DTC an interest exemption provison.[1691]

[1684] A number ***non-traditional financial instruments*** are excluded from interest classification (interest rate swaps). ***Annuities*** are also not classified as interest (annual payment to civil institutions – *British Accreditation Regency* (Bar association) for example).

[1685] An ***exception to the rule*** regards *bonds* and *debentures*, that is, such financial instruments are highly dependable on the company's profits in order to be properly liquidated when reaching its maturity date, nevertheless the *Model* expessively classify such instruments as loans (thus debt related). However, the interest derived from such instruments may also be characterized as ***dividends***. OECD Commentaries on the Model Tax Convention 212.

[1686] "Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State" OECD Model Article 11 (1).

[1687] OECD Commentaries on the Model Tax Convention 206.

[1688] Ibid 213.

[1689] Ibid 206.

[1690] OECD Commentaries on the Model Tax Convention 59.

[1691] "(3) Notwithstanding the provisions of paragraph (2) of this Article, interest arising in a Contracting State ***shall be exempt from tax*** in that State if: (a) it is derived and beneficially owned by the Government of the other Contracting State, or a political subdivision or a local authority threof, or the central bank of that State, or by any agency or instrumentality of, or any

ab. Interest paid to States of its political subdivisions and Central Banks

According to Kelsen, "the State as a juristic person, is the personification of a legal order (…) the State – being merely the personification of the legal order by which obligations and rights are stipulated – can itself, as a juristic person, have obligations and rights",[1692] therefore as a person, it may enter into contracts with another States (or enterprises resident in other States – wheter public or private). If the payer of such interest is the State itself (political subdivision or statutory body), the State (on a reciprocity basis) may exempt taxation on interest in the source State[1693] (the creditor may raise its interest rate in order to recover the tax levied in its State, thus on such grounds jurisdictions exempt interest taxation at the source).

ac. Export finance loans

Interest payments related to export finance programmes are generally tax exempt due to the fact that the funds are public.[1694] In sum export finance loans are important tools to enhance international trade. The OECD Commentaries also provides guidance on the matter and suggests the following text: "if the interest is paid in respect of a loan, debt-claim or credit that is owed to, or made, provided, guaranteed or insured by, that State or a political subdivision, local authority or export financing agency thereof;".[1695] As the name suggests, export finance do not finance the operation *pe se*, but shipping. For instance, a foreign (dictatorial) government contracts the services of a private undertaking resident in another government to build a subway (construction contract). The relevant undertaking then contracts with a public bank an "export finance loan" (either pos- or pre-boarding, but in this particular case, pos-boarding) exporting thus construction services to this dictatorial State. Now, if this dictatorial State defaults on the loan the *bill* will be passed on to taxpayers, therefore, it is only fair such loan be *previously* approved by Congresss, if not, such loan will be considered ***illegal***. Nonetheless, when *properly* and *rightfully* granted, export finance loans are important mechanisms in promoting international trade.

ad. Interest paid to financial institutions

Banks are fundamental to the development of international trade for they provide finance to operations that otherwise would be unlikely to occur, for instance, a company wishes to export a certain product to a new client. Although the export company has made all the necessary verifications in order to ascertain its client's credibility in the international market, unforeseeable circumstances could cause the buyer to default on the payment. Therefore, the exporter

financial institution wholly owned by, that Government;" (emphasis added) UK-Indonesia DTC Article 11 (3)(a) (b).

[1692] Hans Kelsen (n 34) 197.

[1693] OECD Commentaries on the Model Tax Convention 208.

[1694] OECD Commentaries on the Model Tax Convention 209.

[1695] OECD Commentaries on the Model Tax Convention 209.

requests its client to provide a letter of credit (LC) from a bank that will guarantee the payment in case the importer (buyer) fails to pay. Consider the following example, a MNE with access to the international financial markets, borrows capital from a certain bank at a competitive rate and ultimately schedules a payment plan that would otherwise not be possible with domestic financial institutions. Therefore, it is fair to say that such institution have contributed to economic growth. Here, tax policies play also an important role, for overtaxation would most certainly prevent such transactions from occurring whether on the financial institution's side (liable to tax upon receiving the interest) as well as on debtor side (which would be taxed when paying the creditor). In order to avoid such problems, Contracting States may agree to exempt interest derived from such transactions.[1696]

ae. Interest on sales on credit

Interent on sales on credit are generally related to international purchases of equipment or other products. In this case, the seller of such equipment will in most cases pass on to the consumer all its costs in producing and exporting such product (bank interest, export financing charges (LC) etc – see previous topic). According to the OECD Commentaries on the *Model,* the interest paid by the buyer "is more an element of the selling price than income from invested capital", therefore separating such costs from the actual product's sold price tends to be difficult. For that matter Contracting States may also include in the relevant DTC a clause enabling interest related to sales on credit be exempt.[1697]

Article 11(1) OECD Model provides that interest "arising in a Contracting State and paid to a resident of the other Contractinbg Sate may be taxed in that other State". However, Article 11(2) grants the source State limited taxing rights which shall not exceed 10% of the gross amount of the dividends. It is important to remember that although Article 11(2) provides limited taxing rights to the source State, that State did already tax the profits produced on its territory "by investments financed out of borrowed maney", therefore Contracting State are free to lower such threshold.[1698] To conclude, Article 11 (4) provides for a PE proviso, that is, the porovisions of Article 11 shall not apply if the "beneficial

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[1696] "Notwithstanding the provisions of paragraph 2 interest arising in a Contracting State and derived by the Government of the other Contracting State, a political subdivision or local authority, the Central Bank of that other Contracting State or any financial institution wholly owned by that Government or by any other resident of that other Contracting State with respect to debt-claims of that resident which are financed, guaranteed or insured by the Government of that other Contracting State, a political subdivision or local authority, the Central Bank of the other Contracting State or any financial institution wholly owned by that Government shall be exempt from tax in the first-mentioned Contracting State" Article 11(3) Ageement between the Government of New Zealand and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (1997).

[1697] "3. Notwithstanding the provisions of paragraph 2, ***interest*** arising in a Contacting State ***shall be exempt from tax*** in that State if: (d) The interest is beneficially owned by a seller who is a resident of the other Contracting State and is ***paid by a purchaser in connection with the sale on credit of any equipment, merchandise or services***, except where the sale is made between persons dealing with each other not at arms's length;" (emphaisi added). United States – Canada Income Tax Convention (1984).

[1698] OECD Commentaries on the Model Tax Convention Para 7. 207.

owner of the interest, being a resident of a contracting State, carries on a business in the other Contracting State in which the interest arises through a permanent establish,ment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case provisions of Article 7 (Business profits) shall apply".

g. Royalties (Article 12 OECD Model)

Article 12(2) Model Convention defines royalties as a payment "received as a consideration for the use of, of the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model plan, secret formula or process, or for information concerning industrial commercial or scientific experience". Although certain types of payments present little difficulties as to wherther it should be considered royalty (arrangements between a software copyright holder and a distribution intermediary,[1699] ease reproducing of computer programs, in which the client purchases the right to make various copies of the program – site licenses, enterprise licenses, network licenses[1700], payments regarding the supply of know-how, where the supplier provides a service which requires a special knowledge, skill and expertise, although not transferring such knowledge, skill and expertise to the third party),[1701] it has been argued whether payments made to broadcasting and telecommunication enterprises under "transponder leasing contracts" should be considered royalties due to the fact that customers are utilizing the "capacity of a satellite transponder to transmit over large geographical areas".[1702] According to the OECD commentaries on the Model, such payments are "not made in consideration for ***the use of, or right to use, property, or for information***, (…) (they cannot be viewed, for instance, as payments for information or for the use of, or right to use, a secret process since the ***satellite technology is not transferred to the customer***)".[1703] Payments between telecommunication network operators under a "***roaming agreement***" are also not considered royalties, for "these payments are not made in consideration for the use of, or right to use, property, or for information, (…) (they cannot be viewed, for instance, as payments for the use of, or right to use, a secret process since no secret technology is used or transferred to the operator".[1704] ***Exclusive distribution contracts*** do not also constitute royalties under the meaning of Article 12(2) OECD Model.[1705]

[1699] OECD Commentaries on the Model Tax Convention Para 14.4. 229.
[1700] Ibid Para 14.2. 229.
[1701] Ibid Para 11.3. 225.
[1702] Ibid Para 9.1. 223.
[1703] "As regards treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties, the characterisation of the payment will depend to a large extent on the relevant contractual arrangements. Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of ***payments for services, to which Article 7 applies, rather than payments for the use, or right to use, ICS equipment***" (emphasis added). OECD Commentaries on the Model Tax Convention Para 9.1. 223.
[1704] OECD Commentaries on the Model Tax Convention Para 9.2. 224.
[1705] OECD Commentaries on the Model Tax Convention Para 10.1. 224.

Article 12(1) Model allocates taxing rights to the resident State, that is, "[R]oyalties arising in a Contracting State and beneficially owned by a resident of the other Contracting Satte shall be taxable only in that other Contracting State". In order for the provision to be applicable, the payment must be borne in one of the Contracting States and paid to a person resident in another Contracting State, that is, if the payment is made to a person resident in the same Contracting State where the payment was born, the Treaty's provisions will not be applied.[1706]

It is also important to point out that, if the payee entity operates through a PE in the source State, that State will entitled to such taxing rights, in other words, Article 7 OECD Model shall dictate the allocation rights (Article 12(3) OECD Model). [1707] Nonetheless, paragraph 3 "is not based on such conception which is sometimes reffered to as 'the ***force of attraction*** of the permanent establishment'. It does not estipulate that royalties arising to a resident of a Contracting State from a source situated in the other State must, by kind of a legal presumption, or fiction, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case" [1708] (*Attraktivkraft*).

By inverting the taxing rights through a PE, MNEs are able to abuse their position, for instance, a company may transfer a IP to that State (usually a low tax jurisdiction, or instances where the associate company could not maintain a minimum threshold of control after a merger, the company proceeds to transfer a IP to that company and it licenses back, ultimately offsetting its losses against the royalty payments – *loss shifting schemes*). To conclude, Article 12(5) UN Model grants the source State limited taxation rights, insofar the taxpayer is a resident of that State (*limited taxation rights*).[1709]

h. Capital gains (Article 13 and 22 OECD Model)

Capital gains taxation varies from State to State, for example, somes countries tax capital gains only if it derives from business activities, that is to say, capital gains derived from operations outside the course of business trade are not taxed, other States may tax individuals on capital gains even though if accrued outside the course of business, but only in specific cases, "*e.g.* profits from the sale of immovable property or speculative gains (bought to be sold)", and lastly, some State do not tax capital gains at all.[1710] In numerous OECD States, capital gains are subjected to special taxes, such as "taxes on profits from

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[1706] Michael Lang (n 461) 106.

[1707] "The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply". OECD Model. Article 12(3)

[1708] OECD Commentaries on the Model Tax Convention Para 20. 231.

[1709] "Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated." UN Model Article 12(5).

[1710] OECD Commentaries on the Model Tax Convention Para 1. 238.

the alienation of immovable property, or general capital gains taxes, or taxes on capital appreciation (increment taxes). Such taxes are levied on each capital gain or on the sum of the capital gains accrued during a year, mostely in spectial rates" etc. This brief introduction to capital gains only intents to demonstrated that although States may gave different approaches to capital gains, the relevant DTC may not impose on a State which do not tax capital gains, the right to levy such tax domestically. [1711]

Capital gains presupposes alienation (transfer of ownership of an asset resulting in capital gains, exchange of property and also from a "partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death").[1712] The OECD commentaries to the Model also recommends that capital appreciation and revaluation of business assets, when alienated, should also fall under the auspies of Article 13 OECD Model. Some OECD countries assimilate the transfer of an asset from a permanent establishment "situated in the territory of such State to a permanent establishment or the head office of the same enterprise situated in anpther State" as property alienation, thus under Article 13 OECD Model. [1713] An important point to stress here is that, regardless the manner in which the capital gains were accrued (whether over a long period of time – a land's appreciation over a long period of time – or short period – capital gains generated on financial markets due to speculation) are covered.[1714] Now, as a general rule, capital gains (as profits) must be calculated "deducting the cost from the selling price", that is to say, in order to arrive on the final taxable gains, all incidental expenses to the relevant purchase as well as all the expenditure related to the asset's improvements, must be added to the purchased price (depreciation rules are particular important to capital gains for they have direct influence on the asset's final value – depreciation rules). Depreciation is particularly important when assessing capital gains, and in some cases, when tax bases do not coincide, revenue may be lost. Consider the following example extracted from he OECD Commentaries, a certain company resident of State A purchased an immovable property located in State B. The same company opted for a certain depreciation regime in State A, allowing the immovable to depreciate according the relevant regime. In the future, if the property is sold above cost, thus realizing capital gains. The allowance granted by State A will be recovered by taxing such gains. However, State B do not compute the depreciation allowance granted by State A to that company is respect to the immovable located in its territory. Moreover, State B cannot "substitute the value of the immovable property shown in the books" kept in the other State "for the cost at the time of the alienation". [1715] Therefore, the capital gains from the immovable's alienation did ultimately not "coincide with the capital gain computed in the other State under the accounting rules used there", [1716] particularly because the State of the *situs* and the other State also have taxing rights on such income. [1717] Problems regarding exchange

[1711] Ibid Para 3. 238.
[1712] Ibid Para 5. 239.
[1713] Ibid Para 9. 239.
[1714] Ibid Para 1. 238.
[1715] Ibid Para 14. 240.
[1716] OECD Commentaries on the Model Tax Convention Para 13. 240.
[1717] "(…) State A of which the alienator is a resident, cannot be obliged in all cases to exempt such

rates may also emerge when assessing taxable capital gains, for example, a certain enterprise may proceed to increase the book value of certain assets located in other States due to currency variation (obligations contracted in foreign currency, for example). Going back to the property's purchase just referred to above. If the relevant company resides in the Netherlands and sells an immovable in Austria, of course there would be no currency variations attached to such transaction. However, if the immovable's *situs* is in New Zealand (or in Brazil, where currency is as unstable as *Francium* or *Caesium* for that matter) and the currency depreciates, "the alienator will sustain a loss which will not be recognized" [1718] in the State where the immovable was sold. Although Article 13 OECD Model do not provide a solution to those problems briefly presented above, it is important to point out that such "gains are in most cases not connected with an alienation of the assets", that is to say, "they may not even be determine in the State on which the right to tax capital gains is conferred by the Article". [1719] Im sum, Article 13's ultimate goal is to ***allocate gains to the State where the alienated property is situated***, and all other gains, are regulated by paragraph 5. Premiums, prize attached to bonds or debentures or prizes related to lottery winnings are not within the Articles main scope. [1720]

Article 6(1) OECD Model provides that gains "derived by a resident of a Contacting State from the alienation of immovable property reffered to in Article 6 and situated in the other Contracting State may be taxed in that other State". The concept of immovable property has been already scrutinized in other parts of this investigation. In sum, the immovable's *situs* allocates such rights. Article 13 (2) provides for movable property, that is, gains derived from the "alienation of movable property part of a business of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienationof such permanent establishment (alone or with the enterprise), may be taxed in that other State". Here again the same rule described above is applied here (PE State is entitled to such taxing rights). Nonetheless, for the purposes of para. 2, property will form a part of the PE's business property if the economic ownershio of the property is allocated to the PE "for the purposes of the application of paragraph 2 of Article 7", that is to say, the economic ownership means the "equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (*e.g.* the right to any income attributable to the ownership exposure to gains or losses from the appreciation or depreciation of that property)". [1721] Accordin to the OECD commentaries, on the matter, the fact that the PE recorded in its books the relevant movable property is "not sufficient to concluyde that it is effectively connected with that permanent establishment". [1722] Article 13 (3) ***allocated***

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book profits fully from its taxes under paragraph 1 of the Article and Article 23 A (there will be hardly any problems for States applying the tax credit method). To the extent that such book profits are due to the realisation of the depreciation allowances previously claimed in State A and which had reduced the income or profits taxable in such State A, that State cannot be prevented from taxingsuch book profits.." Commentaries on the Articles of the Model Tax Convention Para 15. 239.

[1718] OECD Commentaries on the Model Tax Convention Para 17. 241.

[1719] OECD Commentaries on the Model Tax Convention Para 17. 241.

[1720] Ibid Paras 19 and 20. 242.

[1721] OECD Commentaries on the Model Tax Convention Para. 27.1 243.

[1722] OECD Commentaries on the Model Tax Convention Para. 27.1 243.

capitals gains from the alienation of ships or aircrafts operating in international traffic "boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats" to the Contracting State in which the place of effective management is situated. After the 2017 refresh, "Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or from immovable property pertaining to the operation of such ships or aircraft, ***shall be taxable only in that State***".[1723] Article 13 (4) establishes that "gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other State may be taxed in that other State.

V. Tax Planning and Schemes (evasion x avoidance)

"*It seems that we know*
tax avoidance when we see
*it, but we have to see it to know it***"**[1724]

John Prebble

1. Introduction

When entering the field of evasion/avoidance, one inevitably comes across moral dilemmas, and we inevitably see ourselves contantly asking, "well, why shoudn't we do that if the isn't any law against it? I have mouths to feed, bills to pay, kids to put through school/college etc". *The right thing do to*, leads to those eternal unsovable philosophical questions of justice, ethics, morals, fairness etc. Professor *Michael J. Sandels,* in 2009, during a lecture in Harvard, posed the following question: "if you had to choose between killing one person to save the lives of five others or do nothing even through that person would die before you, what would you do?" Although reluctantly, the vast majority of the audience

[1723] OECD Model 2017.

[1724] We only recognize what we see. However, the fact that we do not see something, does not necessarily mean that is not there. Lord Denning's ruling in *Newton v Commissioner*, created so-called ***Predication Test***, which later came to be adopted by the Commonwealth as it follows: "In order to bring the arrangement within the section you must be able to **predicate** – by looking at the overt acts which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. (…) Applying these principles to the present case, the first question is – Was there an arrangement? The answer is "Yes". The whole complicated series of transactions must have been the result of the concerted plan; and the nature of the plan is to be ascertained by the overt acts done in pursuance of it." Summarizing, if the ***predicated object*** is a set of facts (arrangement), the tax administration, arbiter or taxpayer should leave all the arrangement's details aside and ask: "Do the facts amount to an arrangement for tax avoidance?" if the answer to that question is Yes, the arrangement would fall under GAARs' provisions. According to *John Prebble*, the predication test is the only possible way to "move directly from a set of facts to their legal result without using any intermediate or additional rules or glosses." John Prebble, Hamish McIntosh. *Predication: The Test for Tax Avoidance in New Zealand from Newton to Ben Nevis*.. 46 VUWLR (2015). 1016.

chose to kill one person instead of killing five, nonetheless the matter of killing a person (even though passively) was brought up, testing thus the students preconceived philosophical assumptions which at first hand seem obvious, but at the end, things are not so black and white as we sometimes imagine. In his lecture, he also discusses forms of moral reasoning, for instance ***consequentialist moral reasoning***, locating morality in the consequences of an act, and ***categorical moral reasoning***, which locates morality in certain duties and rights. However, it is not our intention to go through all moral cunundrums that professor *Michal J. Sanders* takes us, for although interesting, they would lead us out of our main path, business taxation. Nonetheless, take categorical imperative moral reasoning for example, a concept brought up by Immanuel Kant. According to the German philosopher "[A]ct only according to that maxim by which you can at the same time will that is should become a universal law", simplifying this last rather obscure statement, you should "do unto others as you would have them do unto you". This maxim is actually used by most religions. In sum, by testing the morality of an action, Immanuel Kant imagined how would the world be if that morality rule was generally practiced by everybody. Imagine that you are by a river in a hot Saturday morning with your friends bathing, and after a nice swim all get together for a picnic by that same river. If one of your friends lacked environmental consciousness thus throwing into the river a plastic bottle, certainly you would protest and he would say "don't worry, it's just one bottle". The fact of the matter is that, categorical moral reasoning determines that throwing a bottle into a river is wrong, regardless if it is one bottle or a thousand bottles. Now, imagine a Country with no criminal legislation in respect to tax evasion whatsoever, where citizens are free whether to choose paying taxes. If 99% of citizens of this imaginary State opts for paying their taxes no ***collective harm*** is caused, for only 1% of citizens decided to ***free load***, but *what if evebody did it*?[1725] Should your friend's *micro-crime* of throwing the bottle into the river or the 1% free-loaders of that State be repremended considering the harm's extent? Consequentialist moral reasoning focuses on the consequences of the relevant conduct, that is to say, the right thing to do would be that which eventually causes the best result, the best outcome, for society as a whole. Consequentialism is the basis for a number of other ethical theories, nonetheless, the most known consequentialist theory is the already discussed utilitarianism, where the right action is those that maximizes pleasure, therefore, if the conduct maximizes pleasure, it must moral (transfer pricing and philosophical concept of property).

As human kind enhances its knowledge of nature, the necessity and urge in finding answers to unsolved questions intensifies, in order to make matters that were before unorganized and chaotic more approachable and coherent. "[O]ne thing I know. I was blind but now I see".[1726] The main reason for such reasoning is that, as man evolves, man "*is not at all satisfied with what his own senses present and his own reason comprehends*."[1727] This temptation shift, in order "*to*

[1725] Augusto Silva Dias. *What if everybody did it*?: Sobre a (in)capacidade de Ressonancia do Direito Penal à Figura da Acumulacao. RPCC (2003) Universidade de Coimbra.

[1726] John 9:25.

[1727] "It is a peculiar and often fact that human cognition, (…) has the tendency to duplicate its object. The reason is that man is not at all satisfied with what his own senses present and his own reason comprehends. His first passionate urge for knowledge remains unsatisfied, if he is to stop

see the world theologically ordered" [1728] is the result of an inevitable culturalization process embedded in today's society. The transformation of a society ruled by the supernatural (religion) to the metaphysical (consisted of a beyond or absolute truth and an empirical world which transcends experience),[1729] is parallel to the shift from the natural law doctrine to a positive law doctrine.[1730] The natural order of things (*Naturrecht*) emanates from God, whereas positive law (*Positives Recht*) emanates from the *artificially created* State.[1731]

2. Tax Evasion as White Colllar Crimilality

Tax evasion is illegal, a crime (an action or an omission performed by an agent punishable by law). However, tax evasion fall under a special category of crime, that is to say, one cannot associate *Beccaria's* idea of an offender, victim and crime or even *Lombroso's* theories of hereditary borne criminals, to tax evasion. The term "*white-collar crime*" was coined by *Edwin Sutherland*, who

within the boundaries of what is given in his own being, with nature as he can sense and comprehend it through the energies of his own soul. The desire to penetrate into the essence of things moves him to inquire what is "behind things". And because he cannot find an answer to this question within his experience, that is, in the sphere of the world of his senses as it is controlled and ordered by this reason, he boldly assumes a sphere beyond his experience. This is the sphere which is said to hide the grounds and causes he seeks, the ideas or archetypes of all earthly things experienced, the things as they are, the "things in themselves" as they exist independently of sense and reason, a sphere which, because it is inaccessible to his senses, is at the same time said to be eternally concealed from him. This strange hypothesis, by which man produces the illusion of growing beyond himself, this curious attempt of the eternal Munchausen to climb on his shoulders, forms the elementary kernel of all metaphysics and religion. (…) Only because man evidently lacks full confidence in his own senses and his own reason is he restless in his self-created and self-arranged world of knowledge. Only this under evaluation of his own self induces him to consider the world this self recognizes as a mere fragment, an inferior seedling of another world which is beyond its knowledge just because and as far as it is the 'real,' 'final,' 'perfect,' and 'true' world." Hans Kelsen (n 34) 419.

[1728] Michael J. Sandel. *Justice. What's the right thing to do?* 1st Ed. Farrar, Straus and Giroux (2009) 189.

[1729] Hans Kelsen (n 34) 423.

[1730] *Michael J. Sandel* makes an interesting connection between the "***evolution***" process from a theological system to a mechanical system: "(…) In the ancient world, teleological thinking was more prevalent than it is today. Plato and Aristotle thought that fire rose because it was reaching for the sky, its natural home, and that stones fell because they were striving to get closer to earth, where they belong. (…) With the advent of modern science, nature ceased to be seen as a meaningful order. Instead, it came to be understood mechanically, governed by the laws of physics. (…) Despite this shift, the temptation to see the world as theologically ordered, as a powerful whole, is not wholly absent. It persists, specially in children, who have to be educated out of seeing the world in this way." We conclude professor *Michael J. Sandel*'s reasoning with an interview granted by an Uruguain poet (Eduardo Galeano) to *Sangue Latino* "(…) children, what happens is that, we adults, spend a great deal of time to turn them, into "us", thus destroying their lives. But what exactly is being a child? Are they not pagans? (…) The other day I was walking in the neighborhood, it was early in the morning. I couldn't sleep, so I've got dressed and went for a walk, and came across a little girl, whom I believe was about two years old, and she was greeting the plants, the grass, the plants 'Good morning plants! Good morning grass!'. Therefore, at this age, we are all pagans, and at this age, we are all poets. After we grow the world works to reduce ourselves, our souls. This is what we call 'growing up' and 'evolving' (…)." Michael J. Sandel (n 1728) 189.

[1731] Hans Kelsen (n 34) 392.

defined white-collar crime as "(…) a crime committed by a person of respectability and high social status in the course of his occupation."[1732] According to Sutherland's studies on criminal law, the classical theories that argued that *poverty*, *offender's age* or *mental illnesses* as main reasons for criminal conducts, could not solve problems of crimes committed by persons of "*respectability and high social status*". According to Sutherland, one has

> "(…) *no reason to think that General Motors has an inferiority complex or that the Alumunium Company of America frustration or segregation complex, or that US Steel has an Oedipus complex, or that the Armor Company has a death wish or that Duponts desire to retun to the womb*."[1733]

It is fair to say that, were the Nobel prize awarded to advancements on the legal field, Sutherland certainly would have been a laureate.[1734] In the criminal law field, he contributed with the "*differencial association theory*" which states that an offender is more likely to associate with those within its social circle, and therefore commit crimes according to the a specific nature, for example, an individual may initiate its carrer in economically depressed regions, with families also economically detiorated, where he meets other members in the same sub-population, as well as the *proper crime* techniques. The white collar criminal has studied in reputable schools, lived in well structured neighbourhoords and families, therefore it is expected that such individual to have learned its crime techniques associated to its social class. Moreover, Sutherland defends the idea that unorganized economic and social environments, may trigger the occurance of such crimes, affecting therefore low as well as high classes alike.[1735] *Herbert Edelhertz* defines white-collar crime as an act "(…) committed by nonphysical means and by concealment or guile, to obtain money or property (…) or to obtain business or a personal advantage."[1736] Tax avasion falls under the white-collar crime category, for there is no physical violence and there is transfer of property from the State (loss of revenue) to the offender. The direct victim to such a crime is the public administration itself and indirectly the citizens who will have to compensate for the evader's unpaid taxes. By punishing such crime, the State "*retributes for undesirable, immoral and harmful conduct*" of the offender and prevents (theoretically) future crimes by other possible offenders.[1737] Generally, tax evasion is carried out by deliberate *under-reporting of VAT and sales taxes*, *evasion of customs duties*, *non-reporting of income*, *false claim to deductions* etc. The penalty for such crimes varies from country to country. In Brazil, for example, when authorities gather enough material to initiate a tax evasion procedure, an administrative process is

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[1732] David O. Friedrichs. *Trusted Criminals.* Ed. Wadswortg Publishing Company (1996) 65.
[1733] Russell L. Bintliff. *Complete Manual of White Collar Crime Detection and Prevention*. Ed. Englewood Cliffs: Prentice Hall. (1993) 5.
[1734] David O. Friedrichs (n 1732) 65.
[1735] Luiz Henrique de Lacerda Sanglard (n 639) 10.
[1736] Herbert Hedelhertz. *The Nature, Impact, and prosecution of White-Collar Crime*. Washington, D.C.: National Institute of Law Enforcement and Criminal Justice, Law Enforcement Administration, U.S. Department of Justice (1970) 3.
[1737] Girandine Szott Moohr. *Introduction: Tax Avoidance as White Collar Frau*d. Houston Business and Tax Journal. (2009) 209.

instaured, which consequently is judicialized (if he dispute is not solved throughout administrative procedure). The taxpayer may confess to the evasion before the criminal procedings is instaured, enter into an instalment plan with tax authorities that will suspend the State's right to punish such conduct under criminal law or proceed to paid the outstanding tax debt in full, which will cause the procedure's termination with no other penalties whatsoever.[1738] If convicted (considering that the taxpayer has been convicted on only one count of tax evasion), he may be imprisoned for 6 six months to 2 years and be fined up to 5 times the evaded amount.[1739] In China, for example, before 2011, tax evasion was punishable by death (a number of other non-violent crimes still are punishable by death, such as corruption, financial fraud,[1740] drug trafficking, prison escape, sale of manufacturing of counterfeited drugs etc). Tax evasion consisits in a "(…) *wilful violation or circumvention of applicable tax laws in order to minimize tax liability*",[1741] and is unquestionably immoral. Nevertheless, can one assume that tax avoidance is as immoral as tax evasion? Well, the law allows the taxpayer to mitigate its tax liability under certain circumstances (tax deduction, depreciation etc). However, when the conduct of the relevant taxpayer is such that is considered abusive, tax authorities will withdrawal such benefits and apply penalties seeking to main results: (***i***) retribution for that undesirable, immoral conduct in order to (***ii***) prevent other taxpayers from acting in the same manner.[1742] Although it is considerably hard to estimate the real costs of tax evasion to society as a whole Sutherland argues that the social cost of such actions are exponentially higher when compared to other common crimes.[1743]

In 2017 following the *Oslo Dialogue* on fighting tax crimes and other financial crimes, the OECD working group published the study "Fighting Tax crime: The Ten Global Principles"[1744] (*Report*) where it presents 10 principles in which State should implement as public policies in order to properly tackle tax

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[1738] "Art. 83. A representação fiscal para fins penais relativa aos crimes contra a ordem tributária (...), será encaminhada ao Ministério Público depois de proferida a decisão final, na esfera administrativa, sobre a exigência fiscal do crédito tributário correspondente. (...), aplicam-se aos processos administrativos e aos inquéritos e processos em curso, desde que não recebida a denúncia pelo juiz." (*Art. 83. The instaurement of criminal proceedings due to tax related crimes* (...), *will be conducted by the Government Agency for Enforcement and Prosecution of Crimes after final decision on the adminsitative proceedings have been rendered over the tax in question*. (...) *such law is applicable on administrative instances, tax investigation, and already active administrative proceedings, till the a criminal prosecution is properly instaured*." Lei n 9.430/96 Dispoe sobre a legislação federal, as contribuições para a seguridade federal, o processo administrativo de consulta e da outras providencias.

[1739] Lei No. 4.729/65. Define o crime de sonegacao fiscal e dá outras providencias. Art. 1 (v).

[1740] In 2013 a Chinese businessman was executed for illegal fundraising and financial fraud of approximately U$ 460 million dollars. The money was used to finance his company that participated in tenders for urban development projects in *Jishou* (small city in Hunan). *Zeng Chengjie's* (offender) familie was only notified of the execution after the body was cremated. Rachel Lu. *China's Bernie Madoff Was Executed for Fraud-and Nobody Told His Family* (2013). https://www.theatlantic.com/china/archive/2013/07/chinas-bernie-madoff-was-executed-for-fraud-and-nobody-told-his-family/277789/. Accessed in 21 January 2018.

[1741] Zoë Prebble, John Prebble. *The Morality of Tax Avoidance*. Creighton Law Review. Vol. 43. 702.

[1742] Girandine Szott Moohr (n 1737) 209.

[1743] Gilber Geis, Robert F. Meier, Lawrence M. Salinger. *White Collar Crime Classic and Contemporary Views*. Ed. New York. The Free Press (1995). 32.

[1744] *Fighting Tax Crime (The Ten Global Principles).* OECD Publishing, Paris. (2017) http://www.oecd.org/tax/crime/fighting-tax-crime-the-ten-global-principles.pdf.

avasion. According to the *Report,* States should: ***1.*** Ensure tax offences are criminalised; ***2.*** Devise an effective strategy for addressing tax crimes; ***3.*** Have adequate investigative powers; ***4.*** Have effective powers to freeze, seize and confiscate assets; ***5.*** Put in place an organizational structure with defined responsabilities; ***6.*** Provide adequate resources for tax crime investigation; ***7.*** Make tax crimes a predicate offence of money laudering; ***8.*** Have an effective framework for domestic inter-agency co-operation; ***9.*** Ensure international co-operation mechanisms are available, and ***10.*** Protect suspect's rights.

Principle 1. *Ensure tax offences are criminalised.* States must criminalize the offensive tax behaviour of those taxpayers who have failed to comply with their tax obligations, treating it with the right dose of seriousness it deserves. By acting in such a manner, States ultimately ***(i)*** send a message to those entities that they will not accept lack of integrity, neutrality and fairness on the treatment in the law of their State, ***(ii)*** deter people that could be tempted to "evade their obligations if the opportunity arose, by providing seiours reputation and punitive consequences of criminal activity and ***(iii)*** deter people that have already been "convicted and sanctioned in the past, (…) from doing so again".[1745]

Principle 2. *Devise an effective strategy for addressing tax crimes.* In order to effectively tackle tax crimes, tax authorities may encourage compliance, "to respond to (…) taxpayers (…) applying with their obligations", ensure that laws in respect to tax crimes are "effective in practice" added to the coherent strategy in enforcing such laws, consequently "encouraging voluntary compliance" etc.[1746]

Principle 3. *Have adequate investigative powers.* Close and adequante work between all competent investigation and prosecution of tax crimes' spheres (tax administration, customs administration, police and law enforcement agencies, financial intelligence units (FIU), corruption investigative units, prosecution authorities and financial regulators).[1747]

Principle 4. *Have effective powers to freeze, seize and confiscate assets.* Assuming the control of the supect's assets "on the basis of a legal order issued by a court or other competent authority" is fundamental to the institute's success. By temporarily restraining assets (seizing/freezing), or placing it under "custody of the government" (confiscating), authorities guarantee the effectiveness of the legal proceeding, for a criminal investigation would ultimately be taken as partially (un)successful only by ceasing the criminal conduct, that is, the State must also guarantee that the assets product of tax crime are adequaly transfer back to the State.[1748]

Principle 5. *Put in place an organizational structure with defined responsabilities.* With an organization model, tax administrations are able to allocate responsibility more efficiently, allowing greater transparency and accountibilityin the use of the State's resources in securing tax claims. The following are examples of organizational models: ***Model 1.*** "The tax

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[1745] Fighting Tax Crime (n 1744) 14.
[1746] Fighting Tax Crime (n 1744) 20.
[1747] *Effective Inter-agency Co-operation in Fighting Tax Crimes and Other Financial Crimes*. Third Edition. OECD (2017) Effective Inter-agency Co-operation in Fighting Tax Crimes and Other Financial Crimes. – Third Edition, OECD Publishing, Paris. http://www.oecd.org/tax/crime/effective-inter-agency-co-operation-in-fighting-tax-crimes-and-other-financial-crimes-third-edition.pdf.
[1748] Fighting Tax Crime (n 1744) 38.

administration has reponsability for directing and conducting investigations, often through a specialist criminal investigations division. The public prosecutor's office does not have a direct role in investigations, through a prosecutor may provide advice to investigators with respect to matters such as legal process and the laws of evidence." ***Model 2.*** "The tax administration has responsibility for conducting investigations, under the direction of the public prosecutor or, exceptionally, examining judges". ***Model 3.*** "A specialist tax agency, under the supervision of the Ministry of Finance but outside the tax administration, has responsibility for conducting investigations, which may involve public prosecutors". ***Model 4.*** "The police or public prosecutor has responsibility for conducting investigations." [1749]

Principle 6. *Provide adequate resources for tax crime investigation.* Whatever the organizational model the relevant State follows, it is mandatory the State to allocate resources to investigate and "take enforcement action in respect to tax crimes". [1750] Resources may be allocated in the form of: financial resources, human resources, traning, infrastructure resources, organizational resources and data/technological resources. [1751]

Principle 7. *Make tax crimes a predicate offence of money laudering.* Predicate offenses are "specified types of criminal activity that give rise to funds or assets. Those funds/assets may then be 'laundered' to obscure the illegal source". In the last FATF's (Financial Action Task Force) recommendations version in 2012, the group "recognized the linkages between tax crimes and money laundering by adding tax crimes to the list of designated predicate offences for money laundering".[1752] Jurisdictions may designate tax crimes as predicate offenses for money laudering using three possible approaches: an ***(i) inclusive approach*** (include and identify all related criminal offenses as predicate offenses), a ***(ii) threshold approach*** (designate as predica offences is surpassing a pre-established threshold, "such as being punishable by one year imprisonment or more, or offences designated in the category of serious offences") [1753] and a ***(iii) list approach*** (create a list with predicate offenses). [1754]

Principle 8. *Have an effective framework for domestic inter-agency co-operation.* Tackling tax crimes (and financial crimes in general) is a process (prevention > detection > prosecution > recovery). Domestic cooperation therefore is fundamental during both the investigative and enforcement phases so that recovery is achieved. [1755]

Principle 9. *Ensure international co-operation mechaninsms are available.* Perpetrators make use of international markets in order to hide proceeds derived of illicit activites, therefore international cooperation is not only fundamental, but a condition in order to tackle tax crime, International cooperation may take a number of forms, for instance, by sharing information, "service of documents; obtaining evidence; facilitating the taking of testimony from witnesses; transferring persons for questioning; executing freezing and

[1749] Fighting Tax Crime (n 1744) 44.
[1750] Fighting Tax Crime (n 1744) 48.
[1751] Fighting Tax Crime (n 1744) 48.
[1752] Effective Inter-agency Co-operation in Fighting Tax Crimes (n 1747) 5.
[1753] Fighting Tax Crime (n 1744) 55.
[1754] Fighting Tax Crime (n 1744) 55.
[1755] Fighting Tax Crime (n 1744) 58.

seizing orders; and joint investigation". Cooperation agreements are also important tools in fighting such problems (TIEAs or MLATs, for example).[1756]

Principle 10. *Protect suspect's rights.* Persons accused of a crime must also be afforded certain fundamental rights, such as ***(1)*** the right to be advised of their rights; ***(2)*** the right to be advised of the particulars of what one is accused of; ***(3)*** the right to remain silent; (4) the right to acesse and consult a lawyer and entitlement to free legal advice; ***(5)*** the right to interpretation and legal translation; (the right to access documents and case material, also known as a right to full disclosure; ***(6)*** the right to a speed trial; ***(7)*** the right to protection from double jeorpardy (ne bis in idem) and finally ***(8)*** the right to a presumption of innocence.

The next topic will study in more depth the morality of tax avoidance.

3. The Morality of Edge Sorting (edge sorted decks)

The professional card player *Phil Ivey* won in 2012 in Atlantic City almost U$ 10 million on the card game of Baccarat. In the same year, the player managed to beat another London casino earning a total of £ 7.7 million.[1757] Both casinos sued *Phil Ivey* on grounds that the player used illegitimate methods in order to beat the casino. According to both casinos, the player applied a technique called "edge sorting". The technique consists in reading the card's printed "unintentional edge irregularities" created during the manufacturing process, allowing the player to "read" the card, that is to say, by sorting the card's edges, the player is able to identify the cards value by the design on the back of the card, therefore determining the subsets of cards. *Edge sorting* is used in each card game differently, for instance in Blackjack, one distinguishes faces and aces from low cards, whereas in Baccarat[1758] 6, 7, 8 and 9 from other cards. *Card counting* (used in blackjack) is another advantage play method used by professional players. Although not illegal, casinos may prohibit players from playing if it suspects the player uses such methods. The pertaining question here is: *Is there a difference difference between cheating and creating an advantage play?*[1759] According to the player, yes! *Advantage playing* is not illegal, nevertheless, casinos are allowed to ban players who make use of such techniques. However, casinos may allow advantage players to participate to their games under certain conditions, by rising the player's minimum bets, obliging the player to join a variety of games also with high stakes (poker, blackjack, baccaract etc), down deposits etc.[1760] The fact of the matter is that Mr. Ivey imposed to the casino's board, a number conditions in order for he to play, such

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[1756] Fighting Tax Crime (n 1744) 64.

[1757] *Supreme Court dismisses top poker player's bid to recover £ 7.7m winnings from London casino. The Telegraph.* (2017). http://www.telegraph.co.uk/news/2017/10/25/supreme-court-dismisses-top-poker-players-bid-recover-77m-winnings/. Accessed in 18 Mar 2018.

[1758] The objective in Baccarat it to get 9, whereas in Blackjack 21.

[1759] Term employed for any number strategy used by players to exploit weeknesess in the house. Advantage playing is generally accepted amongst gamblers but discourage by casinos.

[1760] In order to be able to play, Phil Ivey had to wire U$ 3 million to the American casino, and £ 1 million pounds the the casino in London. Phil Ivey Interview on "cheating" at Borgata and Crockford. *60 Minutes*. https://www.youtube.com/watch?v=Z1w7NEqLbAM. Accessed in 18 Mar 2018.

as the use of a specific card brand, that the same deck of cards should be used throughout the entire game, a specific electronic card shuffler (shuffle machine) and an *Asian dealer*. All requests were accepted by the casino.[1761] In June 6 2017, the ***US Court*** of appeals for the Third Circuit denied Mr. Ivey's motion challenging the ruling of the lower Court that considered Mr. Ivey's conduct to be in breach of the New Jersey Casino Control Act. In October 2017, the Court of appeals in ***England*** dismissed the criminal charges against Mr. Ivey under the understanding that dishonesty was not a mandatory part to the act of "cheating". Ok, interesting, but what the "*BEPS*" has gambling techniques to do with tax avoidance? Well, as we are about to discuss in the following paragraphs, when tackling abusive tax schemes (or techniques, if you will), one of the major difficulties that tax administrations are confronted with is the fact that tax optimization (advantage playing) is not illegal *per se*, therefore, ***if a certain MNE*** on grounds of market/economic strategy, restructures its operations (corporate restructurings), or transfers IP property to a loss making company for which it will pay royalties (debt and profit shifting), or charges associated companies lower prices than those that would have charged were those companies not related (transfer pricing exploitation), or maintain a never ending cycle of losses in a certain country that under normal *pressure and temperature* conditions would prove impossible to sustain an operating business (non-arm's lengh pricing), or enters into intra-group loans ultimately generating artificial tax credits to other group members (hybrid mismatches) etc, ***therefore reducing its tax liability***, this undertaking did not (at least at first sight), commit any "*wilful violation or circumvention of applicable tax*"[1762] (crime). In fact they have played according to a set of predefined rules (standards) of international tax law, like *Mr. Ivey* who demanded an Asian dealer in order to play, apparently, did not commit any crime. However, the manner in which the scheme (or advantage play) is *played*, can create a disadvantage to the other participant players, who may find themselves in a more unfavourable and disproportional situation in relation to the advantage player, ultimately having the *weather gage*. One could say that in a fair game, all players have the same winning probability. Take insider trading for example. A company knowing that its shares will suffer strong market fluctuations due to negociations with the a certain government on a leniency agreement, where the controllers of such company confessed to a curruption scheme construed mainly by paying kickbacks to public officials in order to raise capital with a certain national bank at subsidized rates, in order to buy companies in various Countries, only to become the one the largests meet processing companies in the world. If that company sells a substantial number of its shares days before the leniency agreement was released to the press, should one assume that the company made use of such information? Well, financial crimes are different from murders, which may leave behind, at least in most cases, material traces (nonetheless, there is nothing more difficult to hide than money). Therefore it is fair to assume that certain types of crimes may demand a

[1761] According to the casinos' defense, the requests were granted on the basis of *superstition* pretenses, but in fact, the actual intention of the player was to *edge sort*. *Federal Appeals Court Denies Ivey's $10 Million Borgata Casino Case Appeal…For Now*. (2017). https://www.njgamblingwebsites.com/phil-ivey-borgata-nj-casino-appeal/. Accessed in 18 Mar 2018.

[1762] Zoë Prebble, John Prebble (n 1741) 702.

lower burden of proof than others. From this point on, one may start to doubt the fairness of such techniques. Contrary to casinos, Countries cannot ban undertakings for engaging in agreessive tax planning, however they may deny tax privileges for those that/who commit abuses by imposing a set of measures intended to frustrate the taxpayer's dubious ambitions, such as limiting interest deduction, levying exit taxes due to asset transfers, ignoring arrangements put into place mainly for obtaining tax advantages, imposing CFC rules in order to avoid profit shifting, tax (or deny deductibility of) mismatched payments etc.

4. Estate Planning and Tax Avoidance

Before discussing the morality of tax avoidance, regard must be given to estate planning. It is only natural that persons and companies alike, who wish to protect their property to take the necessary precautions in order to do so, for example, an individual before marrying may decide to separate his property from his *future ex-wife's* property in order to avoid *future certainties* (prenuptial agreement), a natural person may invest capital in private pension plans so that his/her heirs pay no "estate duty" upon his death,[1763] partners to a company, may decide to incorporate under a Limited Liability Company instead of other company forms in order to protect their property, *skip-transferring*[1764] etc, thus ***estate planning*** does not necessarily accompanies ***tax planning***, nevertheless, tax avoidance invariably is the result of a tax planning.[1765] For that matter, we understand that it is important to differentiate tax avoidance from an: ***estate planning perspective*** and tax avoidance from a ***general perspective***. From an *estate planning perspective*, the taxpayer proceeds to adjust "*transactions and structures that the taxpayer was proposing to enter, or has already entered, in any event.*"[1766] In other words, the transaction has economic substance, purpose. Such approach is also referred to by scholars as ***endogenous tax avoidance***. Alternatively, conceptualizing tax avoidance from a *general perspective*, suggests a taxpayer that conducts transactions, or build tax structures (a loss generating tax shelter, for instance)[1767] independent from economic activity, that is to say, a

[1763] According to Brazilian tax law, ***estate duties***' fall under the State's territories competence. Prior to 2016, private pension plans were tax exempt when transferred to heirs upon the death of the plan holder (Plano Gerador de Beneficio Livre – PGBL and Vida Gerador de Beneficio Livre – VGBL). However, due to economic crises, Brazilian territories suffered a high loss of revenue making a number of Territories levy such taxes (Santa Catarina, Parana, Sao Paulo, Minas Gerais, Rio de Janeiro, Mato Grosso, Goias, Tocantins, Alagoas, Pernanbuco, Paraiba, Rio Grande do Norte, Ceara, Para, Roraima, Amazonas and Distrito Federal). Felipe Oliveira. *Estados taxam planos de previdencia privada na transmissao de heranca*. (2016) http://www1.folha.uol.com.br/mercado/2016/08/1800069-estados-taxam-planos-de-previdencia-privada-na-transmissao-de-heranca.shtml. Accessed in 18 Mar 2018.

[1764] See citation 526 (GSTT).

[1765] Zoë Prebble, John Prebble (n 1741) 696.

[1766] Zoë Prebble, John Prebble (n 1741) 698.

[1767] Zoë Prebble and John Prebble provide an interesting example of tax shelters generating losses. In *Cridland v. Federal Commissioner of Taxation (1977) 140 C.L.R. 330 (Austrl.),* a university student (Cridland), bought a share in a unit trust (a primary farmer producer) for which he would receive one dollar a year of interest. The subsequent years in which he was a trust's (one dollar) beneficiary, he claimed to average his income as a primary farmer producer (at that time, primary farming producers were allowed to average their income over the years they were active, and pay tax over that fluctuation). The fact is that Cridland's income average from the time he was a student to the time he became economically active, reduced substantially his tax

fiction is created by the taxpayer to avoid paying taxes (formally, such structure exists, however it did not carried any business which may have given rise to deductible losses). Such procedure is generally referred as ***exogenous tax avoidance***.[1768] *Estate Planning* involves only ***endogenous avoidance***, whereas *general tax avoidance* involves both ***endogenous*** and ***exogenous avoidance***.[1769] Nevertheless, one must not deviate from the fact that, an endogenous avoidance is not less moral *vis-à-vis* an exogenous avoidance, for in both instances the ultimate goal of taxpayers is tax optimization, that is, "*You must (…) look at the arrangement itself and see which is its effect-which it does-irrespective of the motives of the persons who made it*".[1770] It is important to keep in mind that the transaction *per se*, aimed at avoiding taxation is merely incidental when analysing its morality. In this part of the study, we will provide the answer to the three questions propose by *Lord Wilberforce* in the *Mangin v Commissioner of Inland Revenue* case when discussing the New Zealand GAAR of 1971:[1771] **1.** "*Is it legitimate to take advantage of these* (avoiding schemes) *so as to avoid or reduce tax?* (…) **2.** *Is there a distinction between 'proper' tax avoidance and 'improper' tax avoidance*? **3.** *By what sense is this distinction perceived*?" In order to answer these questions, we will use the 3 assumptions proposed by professor *John Prebble* and *Zoe Prebble* as to the (I)morality of tax avoidance, namely, (***i***) moral entitlement to ***pre-tax income***, (***ii***) ***lack of harmfulness*** of tax avoidance and tax avasion and finally (***iii***) ***malum prohibitum*** of tax evasion.

a. *Is it legitimate to take advantage of these* (avoiding schemes) *so as to avoid or reduce tax?* Traditionally, tax law must be strictly and literally interpreted. Tax law and criminal are substantially alike from this perspective, that is to say, there is not crime without previously law, as it is no tax without a law backing its levy. Yes, it is true that taxpayers have the right to minimize their taxes, therefore, taxpayers have the "moral and legal right to their pre-tax income; if an individual accumulates property through commercial and social transactions, the state cannot deprive the individual of it without unambiguous legal authority".[1772] Here, private property plays a fundamental role. Constituting the individual's natural right, ***(i) pre-tax income*** resource allocation is, an "appropriate starting point from which to assess the morality taxation systems".[1773] We have throughout this study discussed various philosophical ideas

liability. In sum, Cridland's claimed to average his income as a primary farmer producer. The Australia's High Court ultimately upheld his claim. Zoë Prebble, John Prebble (n 1741) 698.

[1768] Zoë Prebble, John Prebble (n 1741) 698.

[1769] In 1940 the Supreme Court of the United States reversed the Court of Appeals for the Second Circuit's decision that granted a deduction regarding a book loss in respect to the purchase of stocks from a company from the same group. The Court of Appeals upheld the taxpayers stating that the transaction "*involved a real sale to an actual buyer*" (endogenous). However the Supreme Court understood that the transaction lacked business purpose and was contracted solely to reduce tax liability (exogenous). Zoë Prebble, John Prebble (n 1741) 698.

[1770] *Newton v. Comm'r*, (1958) 98 C.L.R. 1(Austrl) (P.C.).

[1771] *Mangin v Commissioner of Inland Revenue [1971] NZLR 591, 602 per Lord Wilberforce (PC).*

[1772] Zoë Prebble, John Prebble (n 1741) 719.

[1773] Ibid 720.

regarding property and its "ability to advance values such as *utility*, *justice*, *liberty* and *self-expression* and *social evolution*"[1774] (transfer-pricing). Novertheless, regardless the philosophical concept intended to place the taxpayer's rights obove that of the State regarding pre-tax income, it is logical to assume that in order for such market to exist, and therefore *blow gold* over its players, a law must also exist, actually, a "working legal system is a necessary precondition for the existence of money, banks, corporations, stock exchange, patents, or a modern market economy…the institutions that make possible the existence of almost all contemporary forms of income and wealth",[1775] consequently markets depend on governments, and governments depends of taxes, therefore, a government cannot exist without taxes. Note that, in our view, there are a certain *cynicism* to such argument, for MNEs claim that tax avoindance is not immoral *per se*, and even less illegal, although those same undertakings depend on maket rules to exist. Assuming that government's interference in the "natural and moral order"[1776] of pre-tax income, "does not by itself allow us to conclude that tax avoidance is necessarily immoral. However, rejecting this assumption (that avoidance is in fact moral) removes part of the basis for the conclusion that tax avoidance is moral". [1777] If in order to be legitimate, the conduct must be moral, then immoral conducts cannot be legitimate.

b. *Is there a distinction between 'proper' tax avoidance and 'improper' tax avoidance*? In order to criminalize a certain action, three main elements must invariably be present, namely, culpability, social harmfulness and wrongfulness (wrongfulness exclusions: [1778] consent, [1779] self-defense, [1780] countermeasures, [1781] force majeure, [1782] distress [1783] and

[1774] Robert Cooter and Thomas Unlen (n 15) 109.
[1775] Liam Murphy, Thomas Nagel. *The Myth of Ownership: Taxes and Justice*. Oxford University Press, New York (2002) 32.
[1776] Zoë Prebble, John Prebble (n 1741) 721.
[1777] Zoë Prebble, John Prebble (n 1741) 722.
[1778] In order to keep our study as international as possible (thus neutral), we have choosen as a base for discussing circumstances precluding wrongfulness the UN Articles on Responsibility of the State for Internationally Wrongful Acts (ARSIWA).
[1779] "Valid ***consent*** by a State to the commission of a given act by another State precludes the wrongfulness of that act in relation to the former State to the extent that act remains within the limits of that consent" (emphasis added) ARSIWA Article 20.
[1780] "The wrongfulness of an act of a State is precluded if the act constitutes a lawful measure of ***self-defence*** taken in conformity with the Charter of the United Nations" (emphasis added) ARSIWA Article 21.
[1781] "The wrongfulness of an act of a State not in corformity with an international obligation towards another State is precluded if and to the extent that the act constitutes a ***countermeasure*** taken agasint the latter State in accordance with charpter II of Part Three" (emphasis added) ARSIWA Article 22.
[1782] "1. The wrongfulness of an act of a State not in conformity with an international obligation of that State is precluded if the act is due to ***force majeure***, that is the occurrence of an irresistible force or of an unforeseen event, beyond the control of the State, making it materially impossible

necessity)[1784]. For example, imagine that a certain State uses the airspace or internal waters of another State. If that other State ***consented*** the other State to navegate through its airspace or internal, no responsibility may be assumed. If in the event of an arm attack, the relevant State, for example, engage military troops of another State, that State may evoke ***self-defense***, thus excluding wrongfulness. A State, that levies a certain tax on imported products in breach of GATT or NAFTA regulations in response to the levy of the other State, may invoke ***countermeasure***, and thus be excluded from responsibility. The property of a non-resident is destroyed in a certain State due to a military operation carried out by a third State (irresistible, unforeseen, beyond control and materially impossible to prevent *human intervention*), or that same property is destroyed by a *Tsunami* (irresistible, unforeseen, beyond control and materially impossible to prevent *natural event*), or both, that State may take cover under ***force majeure*** provisions. A State shoots down a military airplane that entered its airspace without authotization to do so, may evoke ***distress*** and preclude wrongfulness. In the *Russion Indemnity* case, the Ottman Empire justified its delay in paying its debt to Russian, invoking the fact that "it had been in an extremely difficult financial situation, which which it described as "force majeure" but which was more like a state of necessity".[1785] Culpability consists in four elements (the act may have be conducted purposely, knowingly, recklessly or negligently) and social harmfulness is ascertained by injury and/or harm. If one of these three criteria is not fulfilled (culpability, social harmfulness or wrongfulness), the conduct ***is not punishable***.

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in the circumstances to perform the obligation. 2. Paragraph 1 does not apply if: (a) the situation of *force majeure* is due, either alone or in combination with other factors, to the conduct of the State invoking it; or (b) the State has assumed the risk of that situation occurring." (emphasis added) ARSIWA Article 23.

[1783] "1. The wrongfulness of an act of a State not in conformity with an international obligation of that State is precluded if the author ot the act in question has no other reasonable way, in a situation of ***distress***, of saving the author's life or the lives of other persons entrusted to the author's care. 2. Paragraph 1 does not apply if: (a) the situation of distress is due, either alone or in combination with other factors, to the conduct of the State invonking it; or (b) the act in question is likely to create a comparable or greater peril." (emphasis added) Article 24 ARSIWA.

[1784] "1. ***Necessity*** may not be invoked by a State as a ground for precluding wrongfulness of an act not in conformity with an international obligation of that State unless the act: (a) in the only way for the State to safeguard an essential interest against a grave and imminent peril; and (b) does not seriously impair an essential interest of the State or State towards which the obligation exists, or of the international community as a whole. 2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if: (a) the international pobligation in question excludes the possibility of invoking necessity; or (b) the State has contributed to the situation of necessity." (emphasis added) ARSIWA Article 25.

[1785] "The exception of force majeure, invoked in the first place, is arguable in international public law, as well as in private; international law must adapt itself to political exigencies. The Imperial Russian Government expressly admist… that the obligation for a State to execute treaties may be weakned "if every existence of the State is endangered, if observation of the international duty is…self-destructive" UNRIAA, vol. XI (Sales No. 61. V.4),p. 421, at p.443 (1912).

Now, evasion or avoidance easily satisfy the ***culpability factor*** (evaders or avoiders act purposely, knowingly, recklessly or negligently, thus optimizing tax liability). Tax avoidance's harmfulness may seem counterintuitive, that is, a victimless crime. No, forget that! Victimless crimes or victimless conducts "tend to be considered victimless if only consenting adults are involved, for example, illicit drug use or consensual incest or consensual sexual deviancy".[1786] Remember the *Kantian's*[1787] picnic story, throwing a bottle into a river may not pollute the river inhabitable, but throwing 1 million may. From an economic perspective, tax avoidance and tax evasion are not different at all, both minimize tax liability,[1788] and generalizing "tax evasion is more likely to be carried out on a smaller scale than tax avoidance. For instance an individual taxpayer who engages in evasion by not declaring under the table income from that individual's second job might thereby deprive the revenue of a few hundred dollars over a year. However, ***a company that structures a series of artificial transactions may generate legal tax deductions with millions of dollars***". [1789] In order to ascertain the wrongfulness of avoidance, some sort of morality standard must be violated,[1790] and a conduct's morality is highly dependenble on the law. When subsuming the morally reprovable act to the relevant law, "judges dot not usually engage in detailed theoretical discussions of political obligation", [1791] that is, they do not go beyond the pre-established legal boundaries which are imposed to them by the law. Nevertheless, there is a moral obligation to obey the law, therefore, since avoinding *typified* taxes carrries ***harmfulness***, it must be immoral. As for ***wrongfulness***, a few remarks on morality are necessary. Basically, a moral principle is a rule, that is to say, how one should behave. Nevertheless, some moral principles are not embedded in legal statutes and are often substantially general. For example, one cannot be arrested for not being grateful, or pay a fine for lack of kindness, or be charged for *Unbescheidenheit*. These are all moral principles that gravitate in our daily lives. Encouraging

[1786] Zoë Prebble, John Prebble (n 1741) 723.

[1787] "Tax avoidance, and tax evasion (…), fail to satisfy the moral theory that Immanuel Kant called the "categorical imperative." The categorical imperative is a moral requirement deduced as a rational argument. Its essential postulate is that conduct is only moral if it would be acceptable even if all adopted it. (…) The categorical imperative would proceed as follows: to see whether tax avoidance is moral, one must consider whether it would be rational behaviour for everyone to engage in it. We have seen that universal tax avoidance cannot be rationally justified. Everyone would be worse off if all taxpayers avoided tax: tax rates would rise and since avoidance is a deadweight cost, all would be worse off. Tax avoidance thus fails to satisfy the categorical imperative." Zoë Prebble, John Prebble (n 1741) 726.

[1788] Ibid 725.

[1789] Ibid 726.

[1790] Ibid 727.

[1791] Ibid 732.

the return to traditional moral values (family values) in order to create a more just *society* is also a moral principle. The concept of *society* was not borne when communities were formed, but by restricting incestuous relations between its members. Now, the abstract moral duty which relates to evasion could be something along the lines of "to contribute to one's cooperative *society*".[1792] To conclude, "[C]onsidering that ***tax evasion*** is morally wrong in virtue of its content as well as its legal status, it is not convincing to suggest that the mere fact that ***tax avoidance*** is not illegal means that it is also not immoral. From this perspective, the factual similarity between avoidance and evasion and the fineness of the legal line between them suggest (…) ***tax avoidance*** (…) factually almost indistinguishable from ***tax evasion***, and if despite being a legal construct ***tax evasion*** is in a deep sense immoral, then ***tax avoidance is similarly immoral***." [1793]

c. *By what sense is this distinction perceived*? When hearing the term "tax evasion", one automatically associate it with wrongfulness (at least derogatively), but technically this is not so. Yes! tax evasion is a "wilful attempt to defeat or circumvent the tax law so as to reduce one's tax liability", [1794] nevertheless, if there if no tax law, "there is nothing wilfully to defeat". In other words, "no conduct that could even arguably independently be immoral". [1795] Professor *Prebble,* in his study "*The Morality of Tax Avoidance*" stresses the point of New Zealand having no "genuine capital gains tax"[1796] and presents the following hypothetical case: "Consider two identical taxpayers, each with the same business and earnings structures. One is based in the United State and the other in New Zealand. Each makes identical capital gains, but only the first taxpayer is liable to capital gains. We know that the New Zealand taxpayer is not legally guilty of capital gains tax evasion because of the absence of any law imposing that tax. But more than this, we are sure that the taxpayer has done nothing that is morally wrong." [1797] Under this reasoning, it is fair to assume that *malum in se* do not necessarily constitutes *malum prohibitum,* that is, "the United States taxpayers who evades the capital gains tax is morally culpable for breaking a valid law, but would not be morally culpable had that law not existed. Accordingly, if tax evasion is not *malum in se*, ***it must be*** *malum prohibitum"* [1798] (such assumption is based on

[1792] Ibid 736.
[1793] Ibid 737.
[1794] Zoë Prebble, John Prebble (n 1741) 729.
[1795] Ibid 729.
[1796] Ibid 729.
[1797] Ibid 729.
[1798] Ibid 729.

Aristotle's principle of non-contradiction).[1799] However, should we consider avoidance to be moral since avoidance lacks illegality the one quality that differentiates it from evasion and the one source of evasion's immorality?[1800] Well, classing avoidance as moral for lack of illegality, certainly infringes our legal and societal moral order, consequently by no means can be taken as moral.

One may define tax avoidance as "[*C*]*ontriving transactions and structures that reduce tax in ways that are contrary to the policy or spirit of the legislation*"[1801]and as we briefly studied above, there is a thin line between what is acceptable tax planning and unacceptable tax avoidance.[1802]

5. Anti-Avoidance Directive[1803]

In order to conduct a more organized study, we will dicuss the anti-avoidance measures according to the order presented on the new Anti-avoidance Directive (ATAD)[1804]. The anti-avoidance directive presents the following measures to tackle evasion and avoidance: (***i***) *Interest Limitation (Article 4),* (***ii***) *Exit taxation (Article 5),* (***iii***) *GAAR (Article 6), (**iv**) CFC (Article 7 and 8)* and (***v***) *Hybrid mismatch arrangements (Article 9).* Although the *(**vi**) Switch-over rule (ex-Article 6)* was deleted from the 2016 ATAD, we will briefly discuss the measure.

a. Interest Limitation (Article 4 ATAD) [1805]

The OECD report "*Addressing the Tax challenges of the Digital Economy*", stresses the importance of finance to innovation's success. Most players within the tech world are "cash rich and they often finance new ventures, the acquisition of start-ups, or assets with ***intra-group debt***",[1806] therefore creating an interest limitation rule in order to discourage abusive practices by "limiting the deductibility of taxpayer's borrowing costs" is absolutely necessary. According to the ATAD, interest deductibility is limited on an EBITDA-ratio basis,

[1799] Gottlieb recognizes three possible approaches to the non-contradiction principle "1. It is impossible for the same thing belong and not to belong at the same time to the same thing and in the same respect (*Metaph* IV 3 1005b19-20). 2. Ir is impossible to hold the same thing to be and not to be (*Metaph* IV 3 1005b24 cf.1005b29-30). 3. Opposite assertions cannot be true at the same time (Metaph IV 6 1011b13-20). Paula Gottlieb. *Aristotle on Non-Contradiction*, The Standford Encyclopedia of Philosophy (Spring 2013 Edition), Edward N. Zalta (ed.). https://plato.stanford.edu/entries/aristotle-noncontradiction/. Accessed in 18 Mar 2018.
[1800] Zoë Prebble, John Prebble (n 1741) 698.
[1801] Ibid 696.
[1802] Ibid 698.
[1803] Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal Market. COM/2016/026 final – 2016/011 (CNS).
[1804] Council Directive 2016/1164.
[1805] *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments,* Action 4 – 2016 Update: Inclusive Framework on BEPS. OECD (2017). http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2016-update_9789264268333-en#.WbB2xq35TG4#page3.
[1806] Addressing the Tax Challenges of the Digital Economy (n 257).

measured either under an earnings-based fixed ratio or under a asset-based ratio. Both are briefly explained bellow.

aa. Interest to EBITDA Ratio rules (earnings-based fixed ratio and assets-based group ratio rules)

Both *fixed* and *group ratio rules* "restrict the ability on an entity to deduct interest expense based on an objective measure of its economic activity",[1807] therefore linking the amount of interest generated by a certain entity to the level of its "taxable economic activity".[1808] The OECD report on the subject, makes interesting remarks on possible best practices in order to properly and effectively block abusive interest deductions, for instance, it suggests the creation of a mechanism to "identify the maximum interest on the permitted level of debt",[1809] computed under AL or by apportioning the relevant group's actual interest expenses (taking into account that entities with the same amount of debt, may be subjected to different interest rates, different currencies and even different credit scores), it also advises attracting to the relevant rule payments economically equivalent to interest,[1810] but of course taking into

[1807] Limiting Base Erosion (n 1805) 43.
[1808] Ibid 37.
[1809] Ibid 38.
[1810] *The cost of money is measure by* ***interest***. Nevertheless, restricting the interest limitation rule strictly to interest would "fail to address the range of base erosion and profit shifting risks that countries face in relation to interest dedcutions and similar payments. (…) reduce fairness by applying a different treatment to groups that are in the same economic position but use different forms of financing arrangements", and its effect would easily be avoided by "groups re-structuring loans into other forms of financing arangemnts". Therefore, in order to prevent such effects, it is important to apply interest limitation rule to "(i) interest and all forms of debt ***(IafD)***; (ii) payments economically equivalent to interest ***(PEEI)***; and (iii) expenses incurred in connection with the raising of finance" ***(EIRF)***. These should include: ***1.*** Payments under profit participating loans; ***2.*** Imputed interest on instruments such as convertible bonds and zero coupon bonds; ***3.*** Amounts under alternative financing arrangements, such as *Islamic finance* (***Islamic Finance*** operate under Islamic religious principles, that is, in accordance with Shari'ah Islamic law. Shari'ah, for example, do not allow receipt and payment of "riba" (interest), "gharar" (excessive uncertainty), "maysir" (gambling) etc. According to islamic law, financing activites as generally applied, are harmful to society, therefore, if a person wishes to purchase a house, for example, an Islamic bank would not grant the relevant individual a loan, instead the bank purchases the house and the individual pays the bank a rent, which will be based on the banks costs. In other words, the parties involved to the transaction share the risk and rewards. Islamic finance do not allow speculation nor exploitation of parties involved with Islamic capital, nor include in their portifolios shares of companies which sells products contrary to Islamic law, such as gambling and alcohol, nor would a Islamic bank provide capital to finance such activities); ***4.*** The finance cost element of finance lease payment; ***5.*** Capitalised interest included in the balance sheet value of a related asset, or the amortizations of capitalized interest; ***6.*** Amounts measured by reference to a funding return under transfer pricing rules, where applicable; ***7.*** Notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowing; ***8.*** Certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance arrangements; ***9.*** Arrangement fees and similar costs related to the borrowing of funds etc. Nevertheless, Article 4(4)(a)(b) ATAD, expressively excludes borrowing costs on: "(a) loans which were concluded before 17 June 2016, but the exclusion shall not extend to any subsequent modification of such loans; (b) loans used to fund a long term public infrastructure project where the project operator, borrowing costs, assets and income are all in the Union."

consideration ***long term borrowing projects*** (Article 4(4) (b) ATAD – *grandfathering clause*)[1811] based on variable interest rates that ultimately could influence the undertaking's debt, consequently disallowing future interest deductible expenses due to pre-established thresholds.

It is important to note that the "best practice approach" [1812] should ***not attract*** payments, which are not interest, nor not economically equivalent to interest, nor "incurred in connection with the raising of finance". [1813] In other words, payments borne out of ***(a)*** foreign exchange gains and losses on monetary items which are not connected with the raising of finance, ***(b)*** amounts under derivative instruments or hedging arrangements which are not related to borrowing, for example commodity derivatives, ***(c)*** discounts on provisions not related to borrowings, ***(d)*** operating leasing expenses, ***(e)*** royalties, ***(f)*** accrued interest with respect to a defined benefit pension plans etc, ***should not be prevented from being deducted***.

An important matter also raised by the OECD report is whether to limit the entity's ***gross interest expense*** or ***net interest expense***. Establishing thresholds under ***gross interest expenses*** reduces complexity and is more effective against possible circumvention measures, however a gross interest rule could possibly lead to DT where "each entity is subject to tax on its full gross interest income, but part of its gross interest expenses is disallowed".[1814] On the other hand, when applying a ***net interest expense*** rule, States would certainly reduce DT risks as an "entity's interest income would be set agaisnt its interest expense before the interest limitation is applied. It would also allow an entity to raise third party debt and on-lend borrowed funds within its group, whithout the entity incurring in disallowance of part of its gross interest expense". [1815]

Article 4 (1) ATAD reads "Exceeding borrowing costs shall be deductible in the tax period in which they are incurred up to 30% of the taxpayer's ***earnings*** before interest, tax, depreciation and amortization (EBITDA)". Here EBITDA plays a fundamental role, therefore some regard must be given to ***earnings. Earnings before interest, tax, depreciation and amortization*** (EBITDA) are, *kurzgesagt,* ***pre-tax income***. The Europen legislator chose EBITDA instead of EBIT, that is to say, it excluded the "two major non-cash costs in a typical income statement (depreciation of fixed assets and amortization of intangible assets)", moreover, it also chose ***earnings*** instead of ***asset values***[1816] as a measure for

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[1811] "For the purposes of point (b) of the first subparagraph, a long-term public infrastructure project means a project to provide, upgrade, operate and/or maintain a large-scale that is considered in the general public interest by a Member State. Where point (b) of the first subparagraph applies, any income arising from a long-term public infrastructure project shall be excluded from EBITDA of the taxpeyrs, and any excluded excessing borrowing cost shall not be included in the exceeding borrowing costs of the group vis-à-vis third parties referred to in point (b) of paragraph 5." ATAD Article 4(4) (b)

[1812] Limiting Base Erosion (n 1805) 30.

[1813] Ibid 30.

[1814] Ibid 38.

[1815] Ibid 38.

[1816] The OECD report on interest deductions discusses the benefits and disadvantages of measuring economic activity through earnings and asset values. An ***earning-base approach*** "makes a general interest limitation rule more robust against planning. Where the level of deductible interest expense in an entity is linked to earnings, a group can only increase net interest deductions in a particular country by increasing earnings in that country. Similarly, any restructuring to move profits out of a country will also reduce net interest deduction in that

assessing economic activity (although Article 4(1)(a)(b) ATAD provide a *fixed ratio rule based on earnings*, Article 4(5)(a)(b) ATAD provides for a *group ratio rule based on total assets/equity* (*assets-based ratio*) – ***equity escape clause*** -, that is to say, the fixed ratio rule based on net interest/EBITDA ***does not apply*** if an entity can demonstrate that its equity/total assets ratio is ***equal*** to or ***exceeds*** that of its group, that is, "(i) the ratio of the taxpayer's equity over its total assets is considered to be ***equal*** to the equivalent ratio of the group if the ratio of the taxpayer's equity over its total assets is ***lower by up to two percentage points***; and (ii) ***all assets and liabilities*** are valued using the ***same method as in the consolidated financial statements*** (…)", in such a case, the taxpayer may be given the right either to "(a) fully deduct its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is ***equal*** to or ***higher*** than the equivalent ratio of the group (…) or (b) deduct exceeding borrowing costs at an amount in excess of what it would be entitled to deduct under paragraph 1. This higher limit to the deductibility of exceeding borrowing costs shall refer to the consolidated group for financial accounting purposes in which the taxpayer is a member and be calculated in two steps: (i) first, the group ratio is determined by dividing the exceeding borrowing costs of the group vis-à-vis third parties over the EBITDA of the group; and (ii) second, the group ratio is multiplied by the EBITDA of the taxpayer calculated pursuant to paragraph 2").[1817]

When analysing credit, financial institutions generally measure the undertaking's ability to repay the debt by assessing EBITDA, that is "how much

country. On the assumption that an increase in earnings will also give rise to an increase in taxable income, it is unlikely that the level of earning will be manipulated in order to increase the interest deductions in a country. (…) The main ***disadvantage*** of earnings as a measure of economic activity, is that an entity's earnings may be relatively volatile and there is a limit to the extent this can be controlled by a group. This means that under an earnings-base rule it may be hard for an entity to anticipate the level of net interest expense that will be permitted from year to year. This could make it difficult for an entity to calculate a cost of debt for long term projects. Without knowing the extent to which its interest cost will be deductible.(…) A particular aspect of earnings volatility is the possibility that an entity may be in a negative earnings (i.e. loss making) position. Under an earnings-based approach, an entity with negative earnings will be unable to deduct its net interest expense in the current period. In principle, this could mean that an entity with losses could be required to pay taxes as a result of a disallowance. (…) The main ***benefit*** of an ***assets-based approach*** on measuring economic activity is that in general asset values are typically more stable. (…) This means that using asset values as a basis for measuring economic activity within a group should give rise to a relatively steady and predictable limit on the level of interest relief that can be claimed. This would improve certainty for groups and could also reduce compliance costs. In addition, an approach based on asset valued would mean that entities with losses would still be able to deduct an amount of net interest expense, which may not be possible under an earnings-based approach. (…) However, a key issue surrounding an assets' based approach for the purposes of applying a ***fixed ratio rule*** is achieving a consistent and acceptable model for valuing each class of assets. In terms of tangible assets, such as land, buildings, plant and equipment, a requirement to use market values of assets would be impractical and impose an excessive compliance burden on groups.(…) Concerns over the recognition and valuation of assets may be less of an issue in applying a ***group ratio rule***, so long as a consistent approach is taken at entity and group level." Limiting Base Erosion (n 1805) 43.

[1817] "The EBITDA shall be calculated by adding back to the income subjected to corporate tax in the Member State of the taxpayers the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortisation. Tax exempt income shall be excluded from the EBIDTA of a taxpayer." ATAD Article 4(2).

interest expense an entity can reasonably afford to bear".[1818] It is also important to note that certain sectors are potentially favoured by using EBITDA as *paradigm* mainly because EBITDA does not "include the write-down of capitalized costs such as investment in plant and machinery, whereas it does take into account revenue costs which are the majority of the costs base for entities in other sectors"[1819] (EBITDA is in fact the most common measure of earnings used by States applying earnings-based tests).[1820] The OECD report pointed out that "across all industry sectors, average gross interest/EBIT ratios based on information taken from consolidated financial statements are approximately 40% higher than average gross interest/EBITDA ratios, although there can be significant variation between different industry sectors". [1821] When calculating EBITDA (and EBIT), it is important ***to exclude*** "non-taxable income such as branch profits or dividend income that benefited from a participation exemption"[1822] (*Schachtelprivileg*). Such provision is expressively referred to in Article 4(2) ATAD "The EBITDA shall be calculated by adding back to the income subjected to corporate tax in the Member State of the taxpayer the tax-adjusted amounts for excessing borrowing costs as well as the adjusted amounts for depreciation and amortization. ***Tax exempt income shall be excluded from the EBITDA of a taxpayer***". The OECD report suggests that "[W]here branch profits benefit from a participation exemption, the entity's EBITDA or EBIT should be reduced by an amount equal to the EBITDA or EBIT of the branch. Where branch profits are taxed, an entity's EBITDA or EBIT should be reduced by an amount equal to the branch's EBITDA or EBIT, in proportion to the extent that the tax on branch profits is sheltered by tax credits. For example, under one possible approach if 25% of the entity's tax liability in the branch's profits is sheltered by tax credits, the entity's EBITDA or EBIT should be reduced by an amount equal to 25% of the EBITDA or EBIT of the branch."[1823]

Article 4(1) ATAD provides the so-called ***fixed ratio rule*** to "(a) an entity which is permitted or required to apply the rules on behalf of a group, as defined according to national tax law" and/or to "(b) an entity in a group, as defined according to national tax law, which does not consolidate the results of its members for tax purposes." However, if the relevant group ***consolidates its results for accounting purposes***, Article 4(5) ATAD applies, that is, the "indebtedness of the overall group at worldwide level may be considered for the purpose of granting taxpayers entitlement to deduct higher amounts of exceeding borrowing costs" [1824] (***group ratio rule***). Under both ratio rules (fixed and group), the entity, or group can deduct "net interest expense up to a fixed percentage of its EBITDA."[1825]

[1818] Limiting Base Erosion (n 1805) 44.
[1819] Ibid 44.
[1820] Ibid 44.
[1821] Ibid 44.
[1822] Ibid 44.
[1823] Limiting Base Erosion (n 1805) 46.
[1824] ATAD Preamble. Pararaph 7.
[1825] Limiting Base Erosion (n 1805) 57.

ab. Measuring earnings on fixed ratio

Measuring the amount of interest expense disallowance under a fixed ratio rule consists mainly of three steps: ***(1)*** calculating EBITDA's measurement; ***(2)*** application of the relevant statutory benchmark fixed ratio to the relevant undertaking's EBITDA in order to determine the maximum interest's expense amount; and ***(3)*** comparing the result with the "actual interest expense of the entity."[1826]

(1) The company's EBITDA, must be calculated by "adding back to its income, the tax values for: ***(i)*** net interest and net payments equivalent to interest payments (…) and ***(ii)*** depreciation and amortization".[1827] As previously mentioned, tax exempt income should not be included (Article 4(2) ATAD).

(2) After calculating the undertaking's EBITDA, we apply the statutory benchmark to that amount. Article 4(1) ATAD provides that "Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to ***30 percent*** of the taxpayer's earnings before interest, tax, depreciation and amortization".

(3) Then, the maximum amount that the relevant undertaking is permitted to deduct is compared "with the entity's actual net expense"[1828]

The following example will put things into a better perspective. Company A resident of MS A is in need of capital in order to finance its operations, therefore Company ***(a)*** issues EUR 100 million of debentures with a floating interest rate of 6% plus LIBOR. After issuing such debentures, Company A ***(b)*** contracts with a third party financial institution an interest rate swap, in which it receives floating rate payments and pays fixed rate (2%) payments on a notional value of EUR 100 million. Company B (Company A's subsidiary resident of MS B), ***(c)*** contracts a loan of EUR 50 million with a third party financial institution for which it pays a fixed interest rate. However, Company B alone could not provide the necessary collateral requested by the third party financial institution, therefore Company A ***(d)*** provides the necessary guarantee, while Company B pays Company A a ***fee***. In order to finance its day-to-day operations, Company B also ***(e)*** requests the third party financial institution a line of credit which will be used only for short periods of time (overdraft of EUR 500.000), for which it pays the bank a certain fee. Company B also ***(f)*** contracts with a third party financial institution a ***finance lease*** for the purchase of machinery.

[1826] Ibid 48.
[1827] Ibid 48.
[1828] Ibid 48.

	Single entity taxation		Group Taxation	
	Company A	***Company B***	***Total***	***Group AB***
Taxable income before fixed ration rule	140	50	190	190
+ net interest expense	25	100	125	125
+ depreciation and amortizations	35	50	85	85
= tax-EBITDA	200	200	400	400
x benchmark fixed ratio	30%	30%	-	30%
= maximum allowable deduction	60	60	-	120
Disallowed interest expense	0	40	40	5

Company B also enters into a ***(g) operating lease*** in order to purchase office equipment (computers). In the same fiscal year, Company B ***(h)*** enters into a contract with a client in which it will provide a certain service for a period of four years. Nonetheless, Company A is also included in the contract in order to guarantee performace, thus Company B pays a ***fee*** to Company A. Company B, ***(i)*** purchases various future contracts to protect itself against iron fluctuations. To conclude, in the end of that year, Company A ***(j)*** pays EUR 2 million to holders of its preference shares. Note that ***(a)***, ***(b)***, ***(c)***, ***(d)***, ***(e)*** and ***(f)*** are all IafD,[1829] PEEI[1830] or EIRF.[1831] However ***(g)***, ***(h)***, ***(i)*** and ***(j)*** are not IafD, PEEI nor EIRF. Another fact that should be stressed here is the difference of disallowed interest expense when calculated on a ***separate entity basis*** as opposed to a ***group basis***, that is to say, the group was able to absorb a much greater interest amount than each entity separately, mainly because Company A is not fully utilizing its capacity to absorb interest deductions.

The OECD *Report* on limiting interest deduction must provide an international solution to the matter, consequently it has to take into consideration that, contrary to the EU, the international community operate under different sets of laws, therefore it cannot count only on one benchmark as the EU does (Article 4(1) ATAD). In other words, there is a "risk that competitiveness (...) would drive countries to adopt benchmark fixed ratios at a level which allow more interest expense to be deducted and reduce the effectiveness of the rule in tackling base erosion and profit shifting",[1832] therefore it suggests the OECD members to apply the so-called ***corridor fixed ratio***. By setting a "***best practice corridor***", govenments will "limit the extent to which groups can use intragroup interest expense to claim total net interest deductions in excess of their net third party interest expense" while allowing the "majority of groups to deduct the amount equivalent to their net third party

[1829] Interest and all forms of debt ***(IafD)***.
[1830] Payments economically equivalent to interest ***(PEEI)***.
[1831] Expenses incurred in connection with the raising of finance ***(EIRF)***.
[1832] Limiting Base Erosion (n 1805) 48.

expenses (assuming net interest expenses is spread around the group in accordance with accounting–EBITDA)"[1833]

In sum, by using fixed ratio rules, the "potential base erosion and profit shifting risk posed by ***hybrid mismatch arrangements*** is reduced, as the overall level of net interest deductions an entity may claim is restricted", nonetheless, rules addressing HMA should be applied ***before*** both fixed and group ratio rules are applied, that is, ***only after hybrid mismatches are neutralized,*** according to OECD recommendations, that the total "net interest expense (…) should be applied to establish whether the full amount may be deducted, or to what extent net interest expense should be disallowed".[1834]

ac. Measuring the group's ratio

The purpose of determining the maximum amount of net interest expense on a group ratio basis is to reduce a possible negative impact on more highly geared groups. Consequently, allowing an entity to "deduct net interest expense ***in excess of the amount permitted under the fixed ratios rule***, based on the relevant financial ratio of the worldwide group"[1835] is not only important but fundamental. Not considering that "groups in different sectors may be leveraged differently" [1836] seems unfair, thus in order to "reduce the impact on more highly leveraged groups, it is recommended (…) combining a fixed ratio rule (…) with a group ratio rule". [1837] Article 4(5)(b)(i)(ii) ATAD (***equity escape clause***), states that exceeding borrowing costs shall be calculated in two steps ***(1)*** Determining the group's net third party interest/EBITDA ratio and ***(2)*** Applying the group's ratio to the entity's EBITDA.[1838]

(1) *Determining the group's net third party interest/EBITDA ratio*. [1839] Determinig the net third party interest expense may be conducted under three different approaches, namely ***(a)*** using unadjusted financial reporting figures,[1840] ***(b)*** using financial reporting figures adjusted for certain amounts [1841] and ***(c)*** using a financial reporting valuation of

[1833] For further discussion on fixed ratio benchmark corridor see: Limiting Base Erosion (n 1805) 49.
[1834] Limiting Base Erosion (n 1805) 81.
[1835] Ibid 57.
[1836] Ibid 57.
[1837] Ibid 57.
[1838] Ibid 60.
[1839] "first, the group ratio is determined by dividing the exceeding borrowing costs of the group vis-à-vis third-parties over the EBITDA of the group" ATAD Article 4(5)(b)(i).
[1840] Using ***unadjusted financial reporting*** figures is considered the most straightforward approach in determining net third party interest expense. "Depending upon the accounting standards and policies applied, these may be described as interest income and expense, finance income and expense, or a similar term (…) However, a risk remains as using unadjusted figures could mean that a group's net third party interest expense may be overstated or understated, resulting in a limit on an entity's net interest deduction which it too high (giving rise to possible base erosion and profit shifting) or too low (giving rise to double taxation)" Limiting Base Erosion (n 1805) 61.
[1841] Athough resulting in a slightly more complex rule, using financial reporting figures ***adjusted for certain amounts*** addresses "some of the differences between accounting standards" therefore reflecting with greater certainty the actual group's economic activity. Possible adjustments in determining the net third party interest expense could include: (i) the removal of

interest and other payments.[1842] Currently, a number of countries, including Germany and Finland, base their "*equity escape clause*" on audited consolidated financial statements of a group in accordance with IFRS.[1843] After determining the net third party interest expense (which should involve interest and payments economically equivalent to interest), we divide the third party interest expense over the group's EBITDA. In order to avoid double counting "where the net third party interest expense has been adjusted to include capitalised interest (or the amortisation of capitalised interest), depreciation and amortisation should be adjusted to strip out any amounts that represent the amortisation or interest included in the value of capitalised assets."[1844]

(2) *Apply the group's ratio to an entity's EBITDA.*[1845] According to the OECD best practices, States may calculate an entity's EBITDA using ***accounting-EBITDA***[1846] or ***tax-EBITDA***.[1847] Article 4(2) ATAD provides that "The

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payments which are not economically equivalent to interest, ***(ii)*** the addition of capitalised interest ("included in the balance sheet valuation of an asset and is not included in the group's finance expense. The amount of interest capitalised in a year will often be indentified in a group's consolidated financial statement"), and ***(iii)*** the addition of interest income or expense recognised within a different category of income or expense ("This cinlu include interest income which is included within gross revenue, or interest expense which is included within cost of sales or in tax line"). Ibid 61.

[1842] Using a ***financial reporting valuation*** of interest is certainly the most accurate, and complex approach. Although in most cases it will "give substantially the same value for net third party interest expense" where there is a non-adjusted difference between the item's included in a group's finance income and expense and interest comprised by other forms of debt ***(IafD)***, payments economically equivalent to interest ***(PEEI)*** or expenses incurred in connection with the raising of finance ***(EIRF),*** such method would certainly present the more "precise and targeted result". Ibid 62.

[1843] Ibid 91.

[1844] Ibid 63.

[1845] "second, the group ratio is multiplied by the EBITDA of the taxpayer calculated pursuant to paragraph 2." ATAD Article 4(5)(b)(ii).

[1846] "An entity's ***accounting-EBITDA*** should be determined using the same formula as for group EBITDA. However, any income which is not subject to tax, such as dividends or branch profits which fall within a participation exemption, should be excluded. ***This is to ensure that an entity does not attract a higher level of interest capacity as a result of receiving tax exempt income, which could give rise to base erosion and profit shifting***. In principle, an entity's accounting-EBITDA should be based on financial reporting figures prepared under the same accounting rules as used in the consolidated financial statements. (…) In determining an entity's accounting-EBITDA, it is also recommended that no adjustment should be made to strip out the profit or loss arising from intragroup transations. This may mean that in some case the aggregate EBITDA of the entities in a group may exceed the consolidated EBITDA of the group as a whole. This may arise, for example where one entity in a group recognises the profit arising on the sale of goods to another group entity, but the purchase price is not included in the second entity's cost of sales as the goods have not been sold outside the group." Limiting Base Erosion (n 1805) 64.

[1847] "An entity's ***tax-EBITDA*** is equal to its taxable profit after adding back tax values for net interest expense, depreciation and amortization. These values are determined under the tax rules of the country applying the rule. Non-taxable income such as branch profits or dividend income that benefit from a participation exemption should not be included within tax-EBITDA (…) Determining EBITDA using tax principles is consistent with the approach ***recommended for calculating*** entity earnings under the ***fixed ratio rule***. It is also ***straightforward for groups to apply and tax authorities to audit***, and as an approach to tackle base erosion and profit shifting it has the benefit that an entity's interest deductions are linked to its level of taxable income. This means that where as entity's taxable income is higher than its accounting income, its ability to

EBITDA shall be calculated by adding back to the income subjected to corporate tax in the Member State of the taxpayer the ***tax-adjusted*** amounts for exceeding borrowing costs as well as the ***tax-adjusted*** amounts for depreciation and amortization. Tax exempt income shall be excluded from EBITDA" (emphasis added). In the example bellow we deal with both cases.

Consider the following example. Under the ***fixed ratio rule***, Company A's interest capacity is calculated by applying the benchmark fixed ratio of 30% to its EBITDA of 200 million. Therefore Company A has an interest capacity of EUR 60 million. Now applying the group ratio rule, company A calculates its group's net third party interest/EBITDA ratio, based on the group's net third party interest expense of EUR 200 million and the group's EBITDA of EUR 2 billion, thus the group's ratio is 10%. Then we multiply the group's ratio to Company A's ***tax-EBITDA***, totalling 32 million (20% x 160). Therefore, Company can absorb 32 million in interest expense and 4 million is disallowed.

	Financial reporting		Tax	
	Net interest expense EUR	***EBITDA EUR***	***NET interest expense EUR***	***EBITDA EUR***
Group	(200 million)	2 billion	n/a	n/a
Company A	(40 million)	200 million	(36)	160
Group net third party interest/EBITDA ratio = (EUR 200/EUR 2 billion) x 200 = 20 %				

However, when using the ***accounting-EBITDA,*** we multiply the group's ratio to Company's A accounting-EBITDA 200. Now Company A can absorb 40 million in interest expense (200 x 20%). Under ***tax-EBITDA***, Company A was not able to absorb all of its interest expense, that is, ***4 million*** was disallowed. Article 4(6)(a)(b)(c) ATAD provides that MS should allow "exceeding borrowing costs which cannot be deducted in the current tax period under paragraph 1 to 5" to either be carried–forward without limitation, or carry-forward and back, for a maximum period of three years, or to carry forward, without time limitation, for a maximum period of five years. Article 7 ATAD excludes, financial undertakings from the scope of paragraphs 1 to 6, as long as they are not part of the consolidated group. For the purposes of Article 4 ATAD, the "consolidated group for financial accounting purposes consists of all entities which are fully included in consolidated financial statement drawn up in accordance with the international financial reporting standards (IFRS) or the national reporting system of a Member State. The taxpayer may be given the right to use consolidated financial statements prepared under other accounting standards" (Article 8 ATAD).

Article 4(3) ATAD provides for a *minimis clause*, that is, "the taxpayer may be given the right (a) to deducted exceeding borrowing costs up to EUR 3 000 000;" or "(b) to fully deducted exceeding borrowing costs in the taxpayer is a

deduct interest expense will be correspondingly greater. Similarly if an entity undertakes planning to reduce its taxable income, it will be able to deduct less net interest expense." Ibid 64.

standalone entity".[1848] Article 69 CCCTB[1849] Directive proposal offers a more generous approach to companies operating under a CCCTB, raising from EUR 3 000 000 to EUR 5 000 000 the maximum interest deductible amount of Article 13 (2) CCTB[1850] which reads "Exceeding borrowing costs shall be deductible in the tax year in which they are incurred for a maximum of 30% of the taxpayer's earnings before interest, tax, depreciation and amortisation ('EBITDA') or for a maximum amount of EUR 5 000 000, whichever is higher."

b. Exit Taxation (Article 5 ATAD)

Exit taxes have as its main purpose maintaining the integrity of country's tax system which may be compromised by the transfer assets to other MSs which were subjected to taxation, that is, if a taxpayer transfer assets (permanently) from one MS to another, or even transfer his residence. Nonetheless "*claw-back tax rules*" (exit and recapturing tax deferral), and the right to tax unrealized assets are dangerous hindrances to the freedoms contained in the Treaty.

In order to tackle the problem, tax authorities demand that the relevant expatriate pay the outstanding tax debt, or pay a tax according to the present market value of the assets, before emigration. Countries that apply the EET (exemption exemption taxation), where the tax payer deducts contribution payments made out from pension funds (pension's earnings tax exempted) may suffer a loss of tax income if the retiree decides to enjoy his retirement in other MS meaning that the ***integrity of the tax system*** might be compromised.

Levying taxes *before the realization of capital gains*, that is to say, before the company sell its shares or assets, was considered proportionate by the ECJ.[1851] Although such exit taxes are not considered to be of a discriminatory nature, it is taken as a restrictive measure, for an ***advance payment is required***, creating an immediate cash-flow disadvantage for the taxpayer.[1852] However, exit taxes (when a company changes the seat of management for instance, was deemed as proportionate measure by the ECJ). Nevertheless, taxing the exit of "individuals and legal entities (…) of unrealized capital gains upon emigration to another Member State, whereas no such taxation is provided for purely domestic situations, runs the risk of infringing the fundamental freedoms, primarily the freedom of establishment according to Art. 49 TFEU"[1853]

Article 5(1) ATAD provides that a "taxpayer shall be subjected to tax at an amount equal to the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes" if the taxpayer transfer assets from the PC to its PE in another MS or third State or if the PE transfers to its PC in another MS or a in a third State, insofar both companies no longer have the right to tax the transferred assets by reason of that transfer. (Article 5(1)(a)(b) ATAD). Such article merely protects the tax claims of MS which may suffer

[1848] "For the purposes of point (b) of the first subparagraph, a standalone entity means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment" ATAD Article 4(3).
[1849] COM(2016) 683 final.
[1850] COM(2016) 685 final.
[1851] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 90.
[1852] Ben Terra and Peter Wattel (n 60) 33.
[1853] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 165.

revenue loss in the event of a transfer. Article 5(1)(c) ATAD provides that in case there is a transfer of tax residence to another MS or third State, exit tax is due "except for those assets which remain effectively connected with a permanen establishment on the first member State". Transfer of the PE's business grom a MS to another also triggers exit taxation, in fo far the "Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer" (Article 5(1)(d) ATAD). However, the relevant taxpayer may be granted an instalment plan, which shall not exceed 60 months (5 years), it the ***assets***, ***tax residence*** or ***business carried by a PE*** are transferred to another MS of the EU or to a State member of the Agreement on the European Economic Area (EEA Agreement) (Article 5(2)(a)(b)(c)(d) ATAD), under the condition that the EEA State "concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in the Council Directive 2010/24/EU." Member State may charge interest according to the legislation of the relevant MS, require collateral "***if*** there is a demonstrable and actual risk of non-recovery" (Article 5(3) ATAD), or even discontinue the installmetn plan if "***(a)*** the transferred assets or business carried by the permanent establishment are sold or other wise disposed of; ***(b)*** the transferred assets are subsequently treansferred to a third country;[1854] ***(c)*** the taxpayer's tax residence of the business carried on by its permanent establishemtn is subsequently transferred to a thir country;[1855] ***(d)*** the taxpayer goes bankrupt or is wound up; ***(e)*** the taxpayer fails to honour its obligations in relation to the instalments and does not correct its situation over a reasonable period of time, which shall not exceed 12 months" (Article 5(4)(a)(b)(c)(d)(e) ATAD). Artile 5(7) ATAD exclude from the article scope assets transferred due to the "financing os securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirement or for the purpose of liquidity management". Here the Commission acknowledged that imposing exit taxes on assets which merely serve as collateral would certainly compromise the group's ability of raising capital.

c. General Anti-Avoidance Rule

Although it is not the purpose of this investigation discussing the evolutionary process of taxation, a few remarks will help us *stay on the ball*. The *first text on GAARs* was draft in New Zealand in 1878, as part of the Land Tax act, which later came to be amended by the first New Zealand's income tax Statute, namely, the Land and Income Assessment Act of 1891.[1856] Other countries only recently adopted such provisions in its legal statutes (China 2007, USA 2010, UK and India in 2013).[1857] Basically GAARs provide tax authorities the power to

[1854] Not applied if the third country are part to the EEA Agreement and is such country have concluded an agreement within the MS of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalente to the mutual assistance provided for the Directive 2010/24/EU. ATAD Article 5(4).
[1855] See citation above.
[1856] Zoë Prebble, John Prebble (n 1741) 704.
[1857] John Prebble. *Kelsen, the Principle of Exclusion of Contradictions, and General Anti-Avoidance Rules in Tax Law*. WU International Taxation Research Paper Series. No. 23 (2015). 3.

"*look behind legal appearances of tax avoidance schemes and to give effect to their true substance*",[1858] which is, according to *tax newspeak*, to ***neutralize*** the effect of taxes. By acting in such a manner, taxpayers are able to reduce tax liability without incurring in the economic consequences (or imprisonment) that the legislator intended the taxpayer should suffer due to its *unjust enrichment*. For example, when the taxpayer splits its income among Group members in order to reduce tax liability, or even generate deductions to offset against its income, the GAARs institute allow tax authorities to "*un-split*" such income or even to "*un-generate*" such deductions.[1859] Nonetheless, the applicability of GAARs has stirred discussion amongst scholars due to the fact that it is within the discretionary power of the State to decide whether or not to withdrawal the benefits of a conduct that is not *per se* illegal. In fact, such conduct is permissible under the rule of law. Note that there is a contradiction here, for on the one hand, tax administrations allow taxpayers to benefit from a certain tax incentive (deduction of losses), on the other hand, it creates upon taxpayers the uncertainty that, even though they are acting within what is permissible by the law, he may eventually suffer a penalty if the conduct is considered abusive by the relevant authority.[1860] Generally, the main problem with GAARs provisions is that tax codes allow taxpayers to enjoy fiscal benefits (deductions, depreciation etc), but it prevents the taxpayer from enjoying such benefits. Here, *John Prebble* compares this duality, psychotic and bipolar characteristic of the statute (allowing and at the same time denying a taxpayer his rights) with the philosophical principle of ***non-contradiction***. It is impossible for something (or someone) *to be* and *not to be* at the same time,[1861] as much as it is impossible for two States to "*exist within the same space and at the same time*."[1862] Under this reasoning one must conclude that a taxpayer could not be relieved and taxed at the same time on the same income by the same set of laws. Nevertheless, according to *Kelsen,* conflicting statements are "***ought***" statements and not "***is***" statements, for since "(…) *neither statement claims that something "is", the statements cannot contradict or be contradicted*."[1863]

[1858] Zoë Prebble, John Prebble (n 1741) 698.
[1859] Ibid 704.
[1860] John Prebble (n 1857) 1.
[1861] "According to Aristotle, first philosophy, or metaphysics, deals with ontology and first principles, of which the principle (or law) of non-contradiction is the firmest. Aristotle says that without the principle of non-contradiction we could not know anything that we do know. Presumably, we could not demarcate the subject matter of any of the special sciences, for example, biology or mathematics, and we would not be able to distinguish between what something is, for example a human being or a rabbit, and what it is like, for example pale or white. Aristotle's own distinction between essence and accident would be impossible to draw, and the inability to draw distinctions in general would make rational discussion impossible. According to Aristotle, the principle of non-contradiction is a principle of scientific inquiry, reasoning and communication that we cannot do without." Gottlieb, Paula, *"Aristotle on Non-contradiction"*. The Stanford Encyclopedia of Philosophy. Edward N. Zalta (ed.) (2015) URL = https://plato.stanford.edu/archives/sum2015/entries/aristotle-noncontradiction/. Accessed in 18 Mar 2018.
[1862] Hans Kelsen (n 34) 218.
[1863] John Prebble (n 1857) 8.

Professor *Prebble*, makes reference to the Cridland's case in order to confirm the assertive contained in the box bellow, that is, Cridland could have earned his income as everyone else, and consequently pay tax on that salary, or he could pretend being a farmer and spread his wage through a long period of time thereby decreasing his income ratio to tax. Note that there are two possibilities in this case. In other words, where "(…) there is ***only one*** possible legal form for a transaction then employing that form cannot be stigmatised as tax avoidance." Generally, tax authorities apply GAARs provisions if the individual opts for the (***i***) cheapest tax liability scheme or if the tax arrangement may (***ii***) be impugned due to any particular characteristic that may untimately attract GAAR (arrangement's complexity, artificial evaluations etc).[1865] Note that, if tax authorities conclude that a taxpayer acted according to the both conditions just presented, it is likely that the transaction will be scrutinized under GAAR. An interesting doctrine that is worth mentioning is the almost extinguished ***doctrine of choice*** created by the Australian's High Court in *W.P. Keighery Pty Ltd v Federal Commissioner of Taxation* in 1957 which states that "(…) *Whatever difficulties there may be in interpreting s. 260*, (Australian GAAR), *one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any* ***right of choice*** *between alternatives which the Act itself lays open to them*"[1866] (emphasis added). In other words, in a case where GAAR is applicable as well as the doctrine of choice, the latter would rule out the former, under the condition that the relevant taxpayer had more than one alternative as to the tax arrangement it wished to build. The doctrine of choice broadened the possibility to avoid tax, leading courts to abandon its application in countries with already mature GAARs provisions.[1867] Nevertheless, the CCCTB Proposal (2011) contained the doctrine of choice provision, which was later rejected according to the last CCCTB 2016 Proposal.

> "The existence of a GAAR is not caused by, nor does it cause, a transaction to be able to take more than on legal form. Rather, the only cases where authorities may need to call on a GAAR are cases of transactions that permit two or more legal forms."[1864]

aa. Statutory GAARs v. Judge-Made GAARs (positive and negative harmonization)

As we have previously studied, tax administrations will apply GAARs provisions if the taxpayer opts for the most optimal tax scheme or by reason as to avoid the relevant authority's impugnation due to complexity, artificial evaluations etc.[1868] Nevertheless, sometimes courts are unable to solve the case strictly under legal rules, ultimately leading courts to seek answers under the ***economic substance principle***. Such principle will be properly dicussed in a moment, but first, it is important to differentiate the two main approaches to GAARs, namely, ***standard GAAR*** (sGAAR) and ***candid GAAR*** (cGAAR). The former

[1864] Ibid 18.
[1865] Ibid 18.
[1866] *W.P. Keighery Pty Ltd v Federal Commissioner of Taxation.* [1957] 100 CLR 66 (HCA,FC).
[1867] John Prebble (n 1857) 18.
[1868] Ibid 18.

(sGAAR) simply repels any tax arrangement or scheme created for the sole purpose of obtaining a tax advantage.[1869] The latter (cGAAR), broadens the analysis as to the economic result of the scheme, that is to say, the *economic substance* of the arrangement.[1870] It is important to point that both *sGAAR* and *cGAAR* generally have the same effect over the measure it intents to *un-do*. In other words, the main difference between both approaches is the *means* by which the operation is *broken*. Pursuing our discussion on GAARs, the US Internal Revenue in 2010 included a *cGAARs* definition in its Code: "(…) In the case of any transaction to which the ***economic substance doctrine*** is relevant, such transaction shall be treated as having economic substance only if— *(A)* the transaction ***changes in a meaningful way*** (apart from Federal income tax effects) the taxpayer's economic position, and *(B)* the ***taxpayer has a substantial purpose*** (apart from Federal income tax effects) for entering into such transaction." Moreover, the statute also defines economic substance doctrine: "(...) The term "***economic substance doctrine***" means the common law doctrine under which tax benefits (...) with respect to a transaction *are not allowable if the transaction does not have economic substance or lacks a business purpose*."[1871]

ab. GAARs and Recommendation C (2012) 8806 (Aggressive tax planning definition)

In order to deter the effects of aggressive tax planning, the Commission issued in 2012 a guidance on how MSs should approach such practices in case their specific anti-avoidance rules failed to correct distortions, by incorporating into their legal framework the following clause:

> "An ***artificial arrangement***[1872] or an artificial ***series of arrangements***[1873] which has been put into place for the ***essencial purpose***[1874] of avoiding

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[1869] Examples ***sGAARs***. "For the purposes of calculating the tax base under the rules of this Directive, a Member State shall disregard an arrangement or a series of arrangements which, having been put in place for the essential purpose 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." Article 58 (1) CCCTB Proposal (2016), *and* "A tax avoidance arrangement is void as against the Commissioner for income tax purposes." and BG 1 (1) Income Tax Act 2007 New Zealand.

[1870] John Prebble (n 1857) 19.

[1871] § 7701 (o) United States Internal Revenue Code.

[1872] An ***arrangement is artificial*** "where it lacks commercial substance. In determining whether the arrangement or series or arrangements is artificial, national authorities are invited to consider whether they involve one or more of the following situations: (a) the legal characterization of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole; (b) the arrangement or series of arrangements is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct; (c) the arrangement includes elements which have the effect of offsetting or cancelling each other; (d) transactions concluded are circular in nature; (e) the arrangement or series of arrangements results in a significant tax benefit but this is not reflected in the business risks undertaken by the taxpayer or its cash flows; (f) the expected pre-tax profit is insignificant in comparison to the amount of the expected tax benefit." Recommendation C(2012) 8806. Para. 4.4.

[1873] An ***arrangement means*** any "transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event. An arrangement may comprise more than one

taxation and leads to a tax benfit shall be ignored. National authorities shall treaty these arrangements for tax purposes by reference to their ***economic substance***" (*emphasis added*).[1875]

In order to determine if the relevant taxpayer was able to reduce tax liability through an arrangement, the Recommendation suggests MSs to "compare the amount of tax due to a taxpayer, having regard to those arrangement(s), with the amount that the same taxpayer would owe under the same ciscumstances in the absence of the arrangement(s)".[1876] To that effect MSs should be attentive on the following situations: ***(a)*** amounts not included in the tax base; ***(b)*** the benefits of a taxpayer in respect to possible deductions; ***(c)*** loss for tax purposes; ***(d)*** the absence of withholding taxes; ***(e)*** offset of foreign tax.[1877]

ac. GAARs and the Parent-Subsidiary Directive

In 2015 the Parent Subsidiary Directive was amended and a GAAR clause (Article 1 (2))[1878] was included. The clause basically provides that, MSs will only be allowed to deny the Directives benefits if the four conditions contained in that Article are ***cumulative*** meet: (***i***) the existence of an arrangement (or a series of arrangements), (***ii***) the arrangement must have as its main purpose reducing the taxpayer's tax liability (***subjective approach***), (***iii***) such arrangement overcomes the Directive's objective (***objective approach***) and finally (***iv***) the arrangement does not relate to the commercial reality that gave rise to its benefits.[1879] It is also important to point that MSs are not prevented from applying stricter rules when compared to the Directive's wording, that is, the *minimis rule* is applicable in relation to GAARs under the Parent-Subsidiary Directive.[1880]

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step or part." Commission Recommendation of 6.12.2012 on aggressive tax planning Recommendation C(2012) 8806. Para. 4.3.

[1874] Tax authorities do not necessarily need to demonstrate that the taxpayer's ***essencial purpose*** was to avoid taxation in order to apply GAARs ("*You must (...) look at the arrangement itself and see which is its effect-which it does-irrespective of the motives of the persons who made it*"). According to Recommendation C(2012) 8806 "(...) the purpose of an arrangement or series of arrangements consists in avoiding taxation where, regardless of any subjective intentions of the taxpayer, it defeats the object, spirit and purpose of the tax provisions that would otherwise apply. 4.6. (...) the purpose is to be considered essencial where any other purpose that is or could be attributed to the arrangement or series of arrangements appears at most negligible, in view of all the circumstances of the case". Paras. 4.5 and 4.6 Recommendation C(2012) 8806.

[1875] Recommendation C(2012) 8806. Para. 4.2.

[1876] Recommendation C(2012) 8806. Para. 4.7.

[1877] Recommendation C(2012) 8806. Para. 4.7.

[1878] "Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the objective or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances." Parent-Subsidiary Directive Article 1(2).

[1879] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 151.

[1880] Although the *minimis rule* is applicable under the Parent-Subsidiary, Interest and Royalty and Merger Directives alike, one must not conclude that Member States are allowed to introduce stricter rules than those that Union legislation (Directives) provides, into their statutes irrespectively. Such reasoning was confirmed by the ECJ in the *Ratti case*: "(...) the system introduced by Directive No 73/173 that a Member State ***may not introduced into its national***

ad. GAARs and the Interest and Royalty Directive

The Union legislator wisely chose to limit the benefits of the Interest and Royalty Directive to PEs, subsidiaries or parent companies located in other MSs of the Union if the "principal motive or one of the principal motives for the transaction is tax evasion, tax avoidance or abuse".[1881] Such rule is one of the many GAARs contained in the Directive, for instance "Art. 1(4), 1(5)(b), 1(8), 1(10), Art. 3(a)(iii) and Art. 4". [1882] As provided in the Parent-Subsidiary Directive's GAARs, the Interest and Royalty Directive's GAARs are also contrued to tackle tax evasion and avoidance, therefore the conditions set out by the Article 1(2) and (3) Parent-Subsidiary Directive could also "be used for the interpretation of Art. 5(2) Interest Royalty Directive". [1883] However, after the Interest Royalty Directive entered in force (2003), it suffered no amendments whatsoever as the Parent-Subsidiary did, therefore its wording does not refer to group arrangements primarily build to avoid taxes. Nevertheless, according to *Dimitar Hristov* on his recent study on the Interest and Royalty Directive, the author understands that, not applying the rule to possible abusive group arrangements, contradicts and infringes the spirit of the GAARs' institute.[1884] Concluding, here the *minimis rule* is also applicable, that is, MSs may apply stricter rules than thse contained in the Directive.

ae. GAARs and the Merger Directive[1885]

The GAAR provision is stated on Article 15(1) of the Merger Directive, which allows MSs to deny the Directive's benefits in case the relevant tax administration suspects the transaction has as one of its main goals, avoiding or evading taxes. According to the Directive's wording, if the group restructuring is not conducted under "valid commercial reasons", it is presumed that the restructure has as one of its main objectives evading of avoiding taxes.[1886] Nonetheless, every situation should be approach on a case-by-case basis, for instance, in the *Foggia* case the ECJ ruled that a merger between two companies of the same group, where the acquired company did not actively conduct business in the open market (only intra-group), and has no financial holdings, could not be validated on grounds of transferring the associated company's losses to the acquiring company, even though such re-arrangement would be

legislation conditions which are more restrictive than those laid down in the Directive in question, or which are even more detailed or in any event different, as regards the classification, packaging and labelling of solvents and that this prohibition on the imposition of restrictions not provided for applies both to the direct marketing of the products on the home market and to imported products." Judgment of the Court of 5 April 1979. - Criminal proceedings against Tullio Ratti. - Reference for a preliminary ruling: Pretura di Milano - Italy. - Dangerous preparations. - Case 148/78. ECLI:EU:C:1979:110.

[1881] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 197.

[1882] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 197.

[1883] Ibid 198.

[1884] Ibid 198.

[1885] Ibid 177.

[1886] Merger Directive Article 15(1) (a).

beneficial to the group as a whole.[1887] Contrary to the Parent-Subsidiary and Interest and Royalty Directives, the conditions set forth that allow MSs to deny the Directive's benefits (existence of an arrangement with purpose of reducing tax liability, which overcomes the Directive's objective with no commercial connection with the event that gave rise to such tax), are not applicable, therefore, tax authorities must assess each transaction independently and evaluate whether the reorganization's intention is reprovable for tax purposes. Member States may apply stricter rules than those of the Merger Directive, as long as the *minimis rule* is respected.

af. GAAR and the Avoidance Directive (Article 6 ATAD)

GAARs provisions is one of the many measures provided by ATAD (CFC, exit taxation, interest limitation and hybrid mismatches), and operates basically, within the same lines as other GAARs do, that is, ignoring "an arrangement or series of arrangements which, having been put into place for the main purpose or one of the main pusposes of obtaining a tax advantage that defeats the object of purpose of the applicable tax law" (Article 6(1) ATAD). Is is mandatory for an arrangement to have "valid commercial reasons which reflect economic reality", otherwise it "shall be regarded as non-genuine", being therefore ignored (Article 6(2) ATAD).

ag. GAAR and CCTB Directive Proposal

Although the *doctrine of choice* is not used by most countries with already *mature* GAARs statutes,[1888] the CCCTB draft in 2011 applied such doctrine as a main element.[1889] Nonetheless, the wording of Article 58 on the CCTB Proposal (2016) is now in tune with other GAARs provisions, it reads "For the purposes of calculating the tax base under the rules of this Directive, a Member State shall disregard an arrangement or a series of arrangements which, ***having been put in place*** for the essential purpose of obtaining a tax advantage that defeats the object and purpose of this Directive (…)" (emphasis added). Note that we have emphasised "having been put into place". The Commission, wisely (once more) altered the text of Article 80 CCCTB Directive proposal (2011), which read "Artificial transactions ***carried out for the sole purpose*** of avoiding taxation"[1890] mainly to avoid interpretation issues as to whether ***sole purpose*** should be interpreted restrictively (solely) or broadly (wholly).[1891] Remember, GAARs provide tax authorities the power to "*look behind legal appearances of tax avoidance schemes and to give effect to their true substance*".[1892]

[1887] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 178.
[1888] John Prebble (n 1857) 18.
[1889] "Artificial transactions carried out for the main purpose of avoiding taxation shall be ignored for the purposes of calculating tax base. (…) The first paragraph shall not apply to genuine commercial activities where the taxpayer is ***able to choose between two or more possible transactions*** which have the same commercial result but which produce different taxable amounts." (emphasis added) Article 80 General anti-abuse rule. COM (2011)121/4.
[1890] See citation above.
[1891] Denis Weber (n 45) 286.
[1892] Zoë Prebble, John Prebble (n 1741) 698.

d. Controlled Foreign Company (CFC)

Control foreign company rules (CFC) are a response from jurisdictions to taxpayers that optimize tax liability by shifting income into foreign subsidiaries. In 2013, the OECD issued a report *Action Plan on Base Erosion and Profit Shifting*, where it recognized the necessity of building a set of rules that could prevent MNEs from conduting such abusive measures. As previously studied, the effects of profit shifting surpass that of eroding the State's tax base. Profit shifting creates negative impacts on competition,[1893] efficiency,[1894] transparency[1895] and fairness. In sum, CFC rules enable "jurisdiction to tax income earned by foreign subsidiaries where certain conditions are met".[1896]

According to the OECD report on *Designing Effective Controlled Foreign Company Rules*, there are 4 main policy considerations that serve to all CFC rules regulations, namely, (***i***) their part in deterring abuse measures, (***ii***) how CFC rules complement transfer pricing rules, (***iii***) the necessity of balancing effectiveness as well as reducing administrative/compliance burdens and lastly, the ***(iv)*** need to balance the rules' effectiveness and preventing or eliminating DT.

(i) *Deterring abusive measure.* The main purpose of CFC rules is to prevent, thwart, discourage or deter the shifting of income to low tax jurisdictions, in other words, "they are designed to protect revenue by ensuring profits remain within the tax base of the parent or, in the case of CFC regimes that also target the stripping of third countries' bases ("Foreign-foreign stripping"), other group companies".[1897]

(ii) *Complementation of TP rules.* Transfer pricing rules are mainly used to adjust profits of an associated company under ALP, therefore eliminating possible distortions (and abuses), by assessing price conditions in which related enterprises *would* charge other enterprises were they *not* controlled. When conducting a TP analysis, tax jurisdictions wll assess the facts and circumstances that lead the relevant company to charge that price, and if necessary, impose on an adjustment. Contrary to TP rules, CFC rules are of a more mechanical nature, for "many CFC rules ***automatically attribute certain categories of income*** that is more likely to be geographically mobile and therefore easy to shift into a low-tax foreign jurisdictions,

[1893] Multi-national emterprises have access to financial instruments and know-how not available to small-and medium-size enterprises, placing MNEs in considerable advantanged in relation to small and medium-size companies, therefore distorting the ***competitive process***. *Hybrid Mismatch Arrangements. Tax Policy and Compliance Issues*. OECD Publications (2012) 11.

[1894] Market ***efficiency*** may also be compromised to the extent that CFCs may influence investment decisions.

[1895] The higher the ***transparency***, the higher the public awareness in respect to tax policies conducted in a relevant country. Alternatively, the lower the transparency, the more difficult will be for taxpayers to properly establish a more sound financial and budgetary forecast.

[1896] *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, (2015) 11. http://dx.doi.org/10.1787/9789264241152-en.

[1897] Designing Effective Controlled Foreign Company Rules (n 1896) 13.

regardless of whether the income was earned from a related party" (*emphasis added*).[1898] According to the OECD CFC *Report, "**Transfer pricing rules should generally apply before CFC rules***, but (…) there will be situations where income allocated to a CFC could be subject to CFC rules. For example, current work on transfer pricing allow a funding return to be allocated to a low-functioning cash box that just provided financing. If that cash box were a low-tax foreign subsidiary and a country were to choose to subject that return to CFC taxation" the situation would be in tune with BEPS counter measures proposed.[1899]

(iii) *Balancing effectiveness and reducing administrative/compliance burdens.* As previously mentioned, CFC rules have a more mechanical application, ultimately reducing the margin for interpretation. Although the restrictveness of interpretation may reduce uncertainty, and ultimately reduce compliance costs, it may not be as effective were such rule more flexible, or even *tailored* to the relevant situation. The balance between its mechanical characteristic and its capacity to produce appropriate results can nevertheless be increased by the inclusion of provisions intended to reduce certain compliance burdens, for instance, jurisdictions may include "suitable target CFC exemptions such as an exemption for companies that are not subjected to a lower tax rate".[1900]

(iv) *Balancing effectiveness and preventing or eliminating DT.* CFC rules can result in double taxation instances to the extent that the subsidiary has already taxed on the CFC's income in the other jurisdiction. Double taxation could ultimately be avoided by the inclusion of certain tax exemptions, foreign tax credits etc.

Before we begin covering the *ins and outs* of CFC rules, it is important not to loose sight to the fact that CFC rules were not created only to prevent the shifting of profits from the parent company to associated companies (resident-to-foreign stripping), but also to prevent ***inversions*** conducted between other CFCs (foreign-to-foreign stripping), that is, now profits accrued by other undertakings will be subjected to CFC taxation.[1901] Another important factor on the application of CFC rules, concerns the tax system used by the relevant State. Countries that apply a worldwide system may impose a more strict (broad) set of

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[1898] Designing Effective Controlled Foreign Company Rules (n 1896) 14.

[1899] Ibid 14.

[1900] Ibid 14.

[1900] "That difference in treatment creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable. Even taking into account (…) the fact referred to by the national court that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which have been payable on those profits if they had been made by a subsidiary in the United Kingdom, the fact remains that under such legislation the resident company is taxed on profits of another legal person. ***That is not the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is not subjected to a lower level of taxation***." (*emphasis added*). Cadbury Schweppes plc and Cadbury Scweppes Oversees Ldt v. Commissioners of Inland Revenue, C-196-04. Para 45.

[1901] Designing Effective Controlled Foreign Company Rules (n 1896) 16.

rules in respect to foreign income, on the other hand territorial systems may apply CFC rules in a more narrowly manner (only income that should be taxed in the parent jurisdiction may be liable to taxation),[1902] therefore creating distortions on the competitive process (broader application of CFC rules means higher taxation imposed on the parent company). The competitive process may also be influenced by differences in the application of CFC rules, for instance a subsidiary company owned by a resident company located in a *broad CFC State* may be taxed more heavily than the companies in that same foreign State. According to the *OECD CFC Report*, such instances may influence investment decisions, for example "it may impact on where groups choose to locate their head office or increase the ***risk of inversions***, and it may also impact on ownership or capital structures where groups attempt to avoid the impact of CFC rules".[1903] To conclude, one has to keep in mind that ***CFC rules exempt active income.*** The matter of active income has already been largely discussed throughout this investigation, that is, the State where the economic activity originated ultimately has taxing rights over that income. Companies have obligations not only to their shareholders *per se,* but also with the society in which they operate, from where the undertaking extracted its benefits.[1904] ("Tax should be collected in those countries where the economic activity takes place that drives those profits, where the operation takes place.").

CFC Rules Definition. One should apply CFC rules directly to each and every foreign owned subsidiary, before ascertaining whether that company is "of a type that would be considered a CFC" and whether it's parent company has sufficient control over that company.[1905] In sum, in order to establish whether CFC are applicable, two matters must be consider (i) whether the foreign entity can be considered a CFC and (ii) whether the PC has enough control over the foreign entity so that the foreign entity can be classified as a CFC.[1906]

Transparent entities should not be treated as CFC for the income is already taxed in the parent jurisdiction. However, CFC rules may apply if the income is not taxed in the parent jurisdiction, for instance, if the partnership is considered transparent in the foreign jurisdiction and as taxable at the parent's jurisdiction (transparent partnership taxation). [1907]

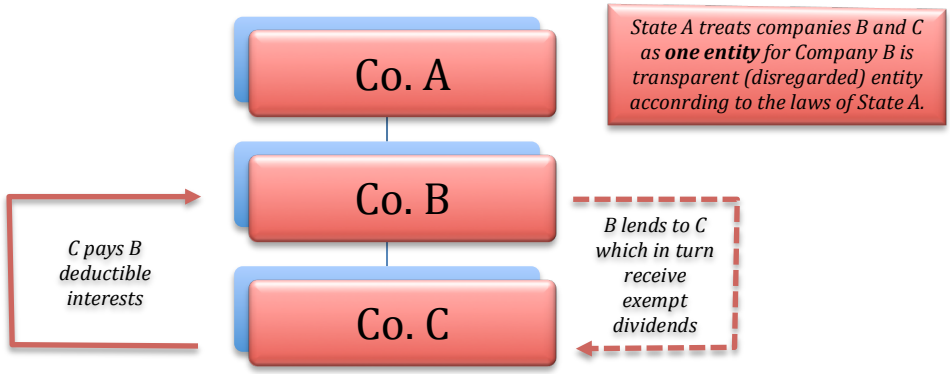
PEs may be taxed in the parent's jurisdiction under CFC rules insofar the foreign PE is tax exempt. According to the profit allocation rules, the profits generated by a PE should be taxed in the other State (Article 7 (1) OECD Model). Nonetheless, if the there is doubt as toover whether the PE's income was taxed in that other State, the PC's State tax administration may either deny the exeption provisioned by the OECD Model or apply CFC rules that would allow the profits be included in the parent company's books, therefore taxable.[1908]

Hybrid mismatches are also a matter of great concern for differences in the treatment of entities in different jurisdictions may eventually lead to D/NI outcomes to the extent that a payment made by a third CFC considered as a

[1902] Ibid 15.
[1903] Ibid 15.
[1904] Ibid 16.
[1905] Designing Effective Controlled Foreign Company Rules (n 1896)
[1906] Ibid 21.
[1907] Ibid 22.
[1908] Designing Effective Controlled Foreign Company Rules (n 1896) 22.

transparent entity, made to another CFC deemed non-transparent. The following example will put things into a better perspective. Co. A resident of jurisdiction A (***high tax jurisdiction***) owns all shares of Co. B located in Country B (***low tax jurisdiction***), which in turn owns the shares of Co. C resident in State C (***high tax jurisdiction***). Co. C contracts with Co. B an intra-group loan. Co. C pays Co. B deductible interests, which are ultimately convented into exempt dividends according to the laws of State B. Co. B is transparent under State A's legislation.

Figure 31



The group was able to create a D/NI outcome as well as stripping the tax base of State A (*resident–to-foreign stripping*) as well as of States B and C (*foreign-to-foreign stripping*). Tax jurisdiction could tackle the scheme by (***i***) including as taxable income at the parent companys level the income received by the transparent company (insofar the income was not included in the CFC) and

Control. Rules of control are at the heart of the CFC institute, nonetheless, one must approach control according to two main determinations: (***i***) the type of control (*legal control*, *economic control*, *de fact control* and *consolidation control*) and the (***ii***) level of control (minimum thresholds).[1909]

aa. Types of control

Legal control is taken as a more superficial and mechanical test for it determines the amount of voting shares held by the parent company. Nevertheless, tax authoritities will assess other caracteristics of the company's by-laws (Articles of Association), for instance the number of voting rights enabling "residents to elect the board of directors or an equivalent body responsible for the affairs of the foreign entity and thus to ensure that the CFC acts in accordance with their instructuons".[1910] However, the OECD *Report* on CFCs pont out the possibility of companies creating "artificial share terms and structures to circumvent the control requirement".[1911]

Economic control concerns the rights to the company's profits, assets and capital in case of liquidaton or dissolution.[1912] The resident shareholder may, for example, not hold the majority of the shares of the relevant CFC, and be entitled

[1909] Ibid 24.
[1910] Designing Effective Controlled Foreign Company Rules (n 1896) 24.
[1911] Ibid 24.
[1912] Ibid 24.

to the an underlying company's in case the shares are diposed, rights upon a profit distribution etc. Economic control assessment is also considered superficial and substantially meachanical and can also be easily circumvent by "group reosganizations involving the insertion of a new group holding company. In such situations, both legal and economic control may change even though there is little or no change in the underlying business or the level of decision-making and business control exercised by the previous parent".[1913]

De facto control functions mainly as a *TP cross-examination,* that is to say, tax authorities will analyse if the legal control and economic control test are in tune with the actual company's risk management, for example, is the majority shareholder (established after a legal analysis of the company's by-laws) is *de facto* exerting a dominance influence over the company's decisions? If yes, is the company entitled to the majority of the economic benefits of that company? As in a TP cross-examination analysis, tax administrations will ascertain the actual contribution to the entity's day-to-day operations, in order to verify whether the party assuming the risk, exercises control over such risk. *De facto* examination requires a more in depth analysis in order to ascertain whether company's controller is *in fact* what was first suggested, therefore, assessing all cases under this approach certainly increases "costs, complexity and uncertainty to taxpayers."[1914]

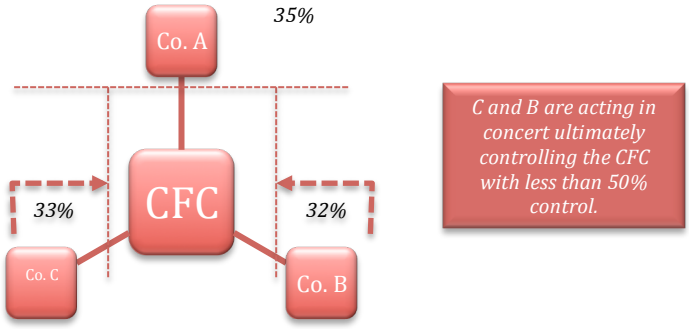
Control based on consolidation will analyse parent company's control according to accounting principle (IFRS, GAAP, IAS). For instance, under IRS 10 the parent company's must prepare a consolidate financial statement when the parent controls more than one company. In that statement, the parent will establish the principle of control as a basis for consolidation, for example, whether or not it has powers to make decisions on behalf of the subsidiary that ultimately could influence the subsidiary's return.[1915]

ab. Level of control

Minimum threshold. After ts was established thar the parent exert control over the CFC, it is important to ascertain the level of control to which the parent are able to "shift the profits to a foreign company, then, as a minimum, CFC rules would need to capture situations where resident taxpayers have a legal or economic interest in the foreign entity of more than 50%",[1916] that is, 50% or more. Nonetheless it is at the jurisdiction's discretion to apply lower thresholds. However, undertakings can easily circumvent the minimum threshold rule by "***acting in concert***" with other group undertakings. Consider the following example, Co. A resident of State A has 35% control over CFC resident of another State. Company B, resident of State B has 32% of control of the CFC and finally, Co. C, resident ot State C has 33% control of the same CFC located in a third country. ***All undertaking are unrelated parties***. If the the minimum CFC threshold rule applied in State A establishes a 50% minimum level, Co. A would not be caught under CFC rules, and ultimately income shifted to the CFC would not be liable to taxation within CFC legislation.

[1913] Ibid 24.
[1914] Ibid 24.
[1915] Ibid 25.
[1916] Designing Effective Controlled Foreign Company Rules (n 1896) 25.

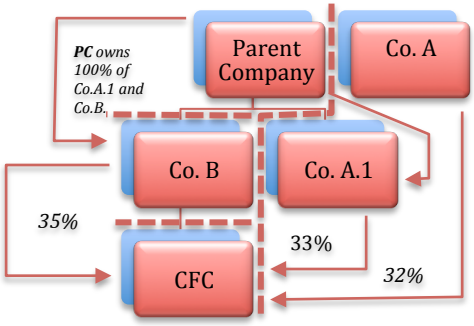
Figure 32



In order to deter such scheme, jurisdicitions could apply the "***acting in concert rule***" that would ultimately add to Company A's control, the "interests of both non-residents. Although the application of the rule may impose a greater amount of complexity to the assessment process, it certainly provides a counter measure against such conducts, ultimately reducing the possibility of base stripping.[1917]

A similar example is also applied ***to related parties***. A parent company resident of State P owns all shares of Co. B, resident of State B and all shares of Co. A.1 resident of State A. Co. B owns 35% of a CFC resident of State D. Co. A.1 owns 33% of the same CFC. The remanescent holdinds (32%) are held by an unrelated party resident of State A (Co. A).

Figure 33



Company A and Co A.1 have no relation to each other, nonetheless they are residents of State A. In order for the "***acting in concert rule***" to apply, the added sum of the control holdings in State A must meet the 50% threshold control. Note that the Parent Company splits the control between Co. B and Co. A.1 in such a way that is able to avoid the CFC control rule in its jurisdiction and consequently being taxed over the CFC profits. If State A applied the "***acting concert rule"*** to both related (Co. A.1) and unrelated (Co. A) companies, Co. A.1 would be deemed as a CFC's controller and taxed 33% on the CFC's profits, would be included as taxable income on Co. A.1's books. Co. A however would not be ascribed to the CFC's income. In Co. B's case, the inclusion of the CFC's in its books would depend on CFC rules of that State, that is, the type and level of control would have to be ascertained.[1918]

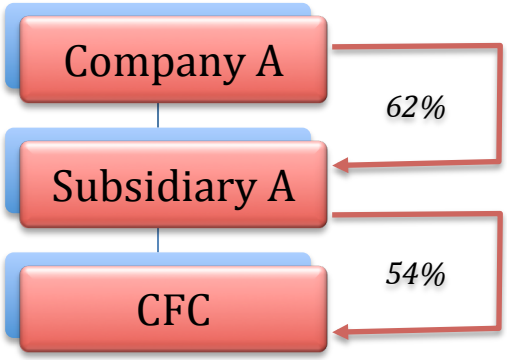
[1917] Ibid 26.

[1918] Designing Effective Controlled Foreign Company Rules (n 1896) 26.

Another way to circumvent the 50% minimum threshold rule is dividing the control among vaious shareholders within a certain State, in such a way that ultimately, those companies end up acting in concert and therefore controlling the CFC. A possible solution woulb be to add all minority shareholders that hold a minimum of mount of shares of the CFC. The United States aggregate minority shareholders to the extent that "each interest is higher than 10%".[1919]

Controlled foreign company rules must apply not only to direct holdings by also to ***indirect holdings***, that is, the parent company through a series of corporations located either domestically or not, control other corporations that subsequently control CFCs. For that matter, not including indirect holdings into CFC legislation would ultimately lead to a complete uneffective set of rules. Consider the following example. Parent company A resident of State A, owns 62% of the shares of a subsidiary B resident of State B, which in turn owns 54% os the shares of a CFC resident in State C. [1920]

Figure 34



Note that, were Subsidiary A a CFC, Company A would have 62% of its shares, and if it was established after a legal and aeconomic analysis that Company A have in fact control of the CFC, Company A would be taxed on 62% of the CFC profits. However, this is not the case, for Company A ows 62% of Subsidiary A which in turn owns 54% of the CFC. Company A, through ***indirect holdings*** is controls the CFC, for it has more than 50% of Subsidiary A (therefore, resumably controls Subsidiary A, that, consequently, controls CFC 54%). In this case, lets suppose that it was established that Company A has enough economic control, to influence the CFC through its Subsidiary, Company A would be limited to a n actual economic control of 33% (0,62 x 0,54), therefore Company A would be taxed 33% on the CFC's income.

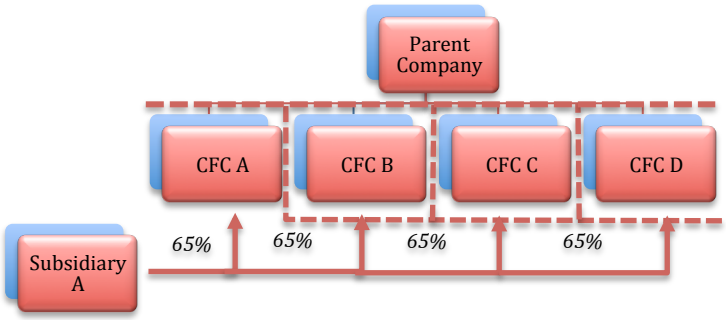
CFC exemptions limits the scope of CFC rules while maintaining the same level of protection to jurisdictions that apply CFC legislation. Exemptions are important tools in maintatining the effectiveness of CFC rules letting jurisdictions concentrate their efforts to cases that must be necessarily be scrutinized due to a large potential in creating economic distortions due to profit shifting, while reducing compliance and administrative costs.[1921]

Minimis rules. Some States apply an "entity based exemption where the entity's attributable income is less than either a certain percentage of the CFC's

[1919] Ibid 27.
[1920] Ibid 29.
[1921] Designing Effective Controlled Foreign Company Rules (n 1896) 33.

income of a fixed amount of the CFC's income or where the taxable profits are less than a fixed amount. Some rules also include a separate cap for certain types of profits that present a higher risk of being diverted. The UK rules, for example, use two different thresholds with a muche higher de minimis threshold applying to CFCs that can show that they do not earn mush income that is likely to be highly mobile."[1922] Consider for example a parent company resident of State A owns four CFCs located in other States (CFC A, CFC B, CFC C and CFC D). Each CFC derives income from Subsidiary D located in State D.

Figure 35



Subsidiary A generates income that are attributable to the CFCs' operations (65% is attributable to the CFCs' operations), and non-atributable income (income generated with independent activities). Now, consider for example, that the Parent Company's jurisdiction operates under a minimis rule which provides that income attributable to a CFC totaling less than 5% of the Parent's gross income or less than 1.000.000 is exempt from taxation in its jurisdiction. The parent company has an annual GI of 15 000 000.

	CFC A	CFC B	CFC C	CFC D
Gross Income	5 000 000	8 000 000	12 000 000	9 000 000
5% of GI	250 000	400 000	600 000	450 000
Atributable I.	162 500	260 000	390 000	292 500

Considering that the parent company owns all shares of all four CFCs, and that has an annual GI of 15 000 000, the parent company will not be liable to taxation over the CFCs' income (5% x 15 000 000 = 750 000). However, when adding the GI of all CFCs, the GI surpasses the pre-established 1 000 000 ceiling (1 105 000), therefore the PC will be liable to taxation over the CFCs' GI in its jurisdiction. Nevertheless, the outcome would be different if the parent company owned, for instance, 50% of all CFCs' holdings, which would result in the entitlement of half the GI generated by the CFCs, which would consequently exempt the parent company from being taxed over the CFCs' income under the minimis rule.

Anti-avoidance requirement threshold would only limit the application of CFC rules to structures that were build to avoid taxation. Although such approach could "narrow the effectiveness of CFC rules as preventive measures"[1923] and increase administrative burden and compliance, it can be an important tool in tackling BEPS.

[1922] Ibid 34.
[1923] Designing Effective Controlled Foreign Company Rules (n 1896) 36.

Tax rate exemption grant parent companies the benefit of not being taxed on the income generated under its CFC if the tax rate reaches a certain threshold. Tax jurisdictions grant such benefit for it suggests that the PC is not shifting income to low tax jurisdictions. Nonetheless, one muss not loose sight of the fact that medium-high tax jurisdictions may also be used as a possible capital ddestination, consequently eroding the parent company's jurisdiction tax base.[1924] Generally, there are two ways in which jurisdictions are able to ascertain whether the tax rate applied in the other jurisdiction is high enough to provide an exemption under the benefit, namely, (***i***) comparative rate approach and (***ii***) list approach.

(***i***) *Comparative approach* requires a case-by-case analysis where rate in which the CFC was taxed will be compared to a specific benchmark (either comparing "the tax rate in the CFC jurisdiction to a particular fixed rate that is considered low-tax or (…) compare the tax rate in the CFC jurisdiction to a portion or percentage of the parent country's own rate".[1925] The manner in which jurisdictions apply the acomparative approach may differ, for example, in Finland, CFC rules may be triggered if it is established that the parent company pays in the foreign jurisdiction three-fiths (3/5) of what the company would pay in Finland. Germany, for instance considers a level bellow 25% as low taxation. Under UK legislation, "there is no low taxation if the 'local tax amount' is at aleast 75% of the corresponding UK tax".[1926] Generally, States apply a 75% threshold.[1927] Now that the threshold has been established, "CFC rules must determine the tax rate in the CFC jurisdiction in order to compare this to the benchmark". There are two methods: (***1***) the nominal (statutory) tax rate in the CFC jurisdiction method and (***2***) the effective tax rate of the CFC method. Using the ***(1)*** nominal tax rate is simpler and reduces compliance. However, using the effective tax rate, jurisdictions are able to ascertain with more accuracy the CFC's tax base and other provisions that may influence the final ETR. In order to calculate ETR jurisdictions must determinie" how much the tax the CFC paid and how much income the CFC earned"[1928] (generally based on the ratio of the actual ETR paid in the CFC jurisdiction to the total income assessed according to the relevant accounting statdard - GAAP or IFRS), and second, compare the ETF to the benchmark.

(***ii***) *List approach.* The list approach (black and white list) can facilitae to jurisdictions whether or not to raise a red flag when dealing with listed jurisdictions. Many State apply a list approach, for instance the UK has a list "that excludes CFCs located in listed jurisdictions which are sufficiently similar in terms of base and tax rate to the United Kingdom", Finland has also a list with low-tax jurisdictions based on nominal rates "but only reagrds a company in those countries as a CFC company itself pays less than three-fiths of the taxes that would have been paid in Finland",[1929] and

[1924] Ibid 36.
[1925] Ibid 37.
[1926] Ibid 37.
[1927] Ibid 37.
[1928] Designing Effective Controlled Foreign Company Rules (n 1896) 37.
[1929] Ibid 37.

recently the EU adopted its first black list, therefore, companies operating in listed States will be more thoroughly monitored (black list).

Definition of CFC income. Now that we have defined CFCs and established types and levels of control, we move on to CFC income. Jurisdictions a free their rules regarding income, nonetheless, it is important the relevant rule to "capture the funding return allocated under transfer pricing rules to low-functioning cash box in that cach box meets the requirements"[1930] till now discussed (rules of control over CFCs resident in low-tax jurisdictions, exemption thresholds etc). Income may be classified according to three amin categories, namely, ***(i)*** legal classification, ***(ii)*** relatedness of the parties and ***(iii)*** source of income.

ac. Legal classification of CFC income:

i. *Dividends* can be used to shift ***passive income*** into a CFC. Nonetheless, if ***1.*** dividends were paid out of active income derived by an associated company, or if ***2.*** the dividends have been exempt from taxation in the PC jurisdiction "had they been earned by the parent company", and if the CFC is in "active trade of business of dealing securities",[1931] then such dividends may not raise great BEPS concerns.

ii. *Interest.* Interest may raise more concerns as to whether the income was earned from an active financing business. Therefore rules "designed to attribute this income should recognize that regulated entities are subjected to capitalisation and other requirements, so any rules on overcapitalisation should take account of such requirements and should not attribute income just because an entity is required to maintain a certain level of capital for non-tax purposes."[1932]

iii. *Insurance income* is likely to raise concerns if: ***(i)*** the CFC was over capitalised in relations to comparable companies operating in the same sector (insurance companies), ***(ii)*** if the policy holder, annuitant, beneficiary or location of the risks insured were outside the jurisdiction and (iii) the insurance income derived from contracts or policies with a related party, specially is the related party benefited from a deduction for the "payment of the insurance premium". The OECD report on CFC, however, argues that "income earned by a regulated wentity in an insurance group may not raise the same concerns because the regulatory enrironment sets restrictions in terms of risks and capital."[1933]

iv. *Royalties and IP income.* The mobility of intangible assets raises several challenges to tax jurisdiction in general, particularly because intangibles, such as IP, are easily manipulated for it can be "exploited and distributed in many different forms, all of which may have different formalistic classifications under CFC rules of different countries. For instance, income from IP could be embedded in income from sales and therefore treated as active sales income under the CFC rules of some coutries".[1934] Moreover,

[1930] Designing Effective Controlled Foreign Company Rules (n 1896) 44.
[1931] Ibid 44.
[1932] Ibid 45.
[1933] Designing Effective Controlled Foreign Company Rules (n 1896) 45.
[1934] Ibid 45.

the problem with HTVI due to the scarcity of comparables, makes the cost base of this assets highly inaccurate added to the fact that income "directly earned from the underlying IP asset is often difficult to separate from the income that is earned from associated services or products", [1935] poses great concerns and challenges for CFC rules. The OECD report on CFC stresses the fact of jurisdictions applying CFC rules using a "categorical analysis based on legal classification often to attempt to address the concerns raised by IP by separating out royalties and treating them as attributable (…), however, dividing accord to legal classification on its own is not enough to attribute all income that does in fact arise out of IP and that raises BEPS concerns." [1936]

v. *Sales and services income* arising from (i) invoicing companies and (ii) IP income, raise BEPS concerns to the extent that "sales and services income for goods and services (…) purchased from related parties (…) to which they have added little or no value", [1937] have the potential to shift profits from high to low tax jursdictions (CFCs), therefore a categorical "analysis based on legal classification (…) may not attribute income that raises BEPS aconcerns if they exclude all sales and services income without taking account of these two situations" [1938] (invoicing companies and IP income).

ad. Relatedness of parties

Some jurisdictions concentrate the importance on the "party from whom income was earned rather than (or along with) the legal classification of the income", [1939] due to the fact that income is more easily, and more likely to be shifted.

ae. Source of income

Income earned from CFC's activities are less likely to raise concerns in repect to base-stripping whereas income generated from third jurisdictions and transferred to the CFC, are likely to raise doubts as to whether the MNE uses the CFC as a shifting profit destination.

af. CFC Regimes (Controlled Foreign Corporation) and de-offshorization [1940] Base Erosion and Profit Shifting (BEPS) / Protecting the revenue base

Offshore-Amnesty in Russia. Russia's Law of Repatriation recognized as a criterion the effective management of the foreign company ("*The right of*

[1935] Ibid 45.
[1936] Ibid 45.
[1937] Ibid 45.
[1938] Ibid 46.
[1939] Ibid 46.
[1940] Dimitar Hristov, Anna Zeitlinger. *Russia's CFC Rules: The Latest developments and issues with foundations of a legal character*. Trusts & Trustees, Vol. 22, No. 6, (2016) pp. 616-620. http://tandt.oxfordjournals.org.uaccess.univie.ac.at/content/22/6/616.full.pdf+html.

released from tax residents for the organizations established in countries, which parties to an international tax treaty, was tightened and now requires the roof that the company employs qualified personnel and performs its day-to-day decision-making in the respective country").[1941]

Russia's CFC rules apply to foreign companies controlled by Russian tax resident individuals or corporations. Russian CFCs may be foreign organizations, in relation to the legal person, that is to say, possess legal character, examples of such corporations would be, regular corporations, stock companies etc.[1943] Nevertheless, CFC can also have no legal personality. An example of such corporate structure would be contractual relationships without legal personality, fiduciary contracts etc.[1944]

> "*The Russian CFC Rules may be avoided by using an Austrian or Liechtenstein foundation. However, in their nature an isolate, opaque asset, inaccessible from the influence of its founders and donators, and thanks to this exact quality they are capable of responding to the Russian anti-avoidance measures.*"[1942]

After the institution of CFC Regime in Russia in 2015, the country was able to collect taxes over CFCs under three main pillars, namely, (1) profits of foreign companies controlled by Russian beneficiaries can be taxed in the country as income of beneficiaries themselves; (2) foreign companies can be recognized as Russian tax residents and are subject to Russian tax residents and are subject to Russian tax on profits, if they are manage within Russia; (3) passive income received from Russia (interests, dividends and royalties) and the company is not the true recipient of the income, but a intermediary for the final destination of the capital.[1945] Important to mention that the "transit" factor is presumed if the capital is transferred from Russia to an Offshore.[1946]

ag. CFC Rules within the EU[1947]

The OECD CFC report presents an interesting argument regarding the relationship between the CFC rules applied to members and to non-members of the EU. This is particularly important, for eventually differences in CFC rules may lead to certain disadvantages for those companies that are within a group with stricter rules.[1948] Nonetheless, whether or not CFC rules employed by the EU compared to CFC rules are more advantageous, will depend on the rules applied by the non-members.

At a European level, the ECJ have ruled that CFC legislation may be applied in order to prevent tax avoidance insofar the CFC rules have "specifically targeted ***wholly artificial arrangements*** which do not reflect economic reality

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[1941] Dimitar Hristov, Anna Zeitlinger (n 1940) 617.
[1942] Ibid 620.
[1943] Ibid 618.
[1944] Ibid 617.
[1945] Ibid 616.
[1946] Ibid 616.
[1947] Designing Effective Controlled Foreign Company Rules (n 1896) 17.
[1948] Ibid 17.

and whose only purpose would be to obtain a tax advantage",[1949] that is to say, although the manner in which each MS will comply with the Treaty's provisions is at each MSs' discretion, the manner in which the measure is applied must not be performed as to hinder, directly or indirectly, actually or potentially, intra-Community Trade. In *Haribo*[1950] the Court ruled that the "mere absence of a certain type on international agreement does not *ipso act* amount to a justification of a difference in tax treatment of domestic and foreign income. Member States have to give evidence that the requirement of a bilateral convention that they impose is ***proportional to the objective that they pursue***".[1951]

In *Haribo* the court operated under the premise that only discriminatory measures intended to counteract ***wholly artificial arrangements*** are justifiable. Nonetheless in *Thin Cap Group Litigation*, the ECJ ruled that, the Court should determine "whether the transaction in question represents, in ***whole or in part***, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of the State",[1952]therefore acknowledging that not only *wholly* but also *partially artificial arrangements* may be subjected to measures of a discriminatory nature, in other words, "Member States tax provisions ***may not*** be restricted to wholly artificial arrangements ***if they are justified by a reason other than the need to prevent tax avoidance***".[1953]

In both *SGI*[1954] and *Oy AA*[1955] cases, the court ruled that an undertaking's conduct characterized other than to produce wholly artificial arrangements, may also fall under the ***balanced allocation of taxation rights defense*** (discriminatory measures may be applied on grounds of public interest, that is, to guarantee: the effectiveness of fiscal supervision; the maintenance on the integrity of the tax system (fiscal coherence); the prevention of treaty abuse; territoriality; ***balanced allocation of taxation right***s; tax neutralization in other States – *rule of reason*).

e. Hybrid mismatch arrangements (Article 9 ATAD)

Article 9 (1) ATAD reads "To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source". The referred Article provides for the DD outcome (double deduction) As will be studied in other parts of this investigation, the European legislator followed the same approach suggested by the OECD

[1949] Cadbury Schweppes plc and Cadbury Scweppes Oversees Ldt v. Commissioners of Inland Revenue, C-196-04.
[1950] Haribo Lakritzen Hans Riegel Betreibsgmbh and Österreichische Salinen AG v. Finanz Linz, Joint cases C-436/08 and C-437/08. Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 45.
[1951] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 99.
[1952] *Test Claiments in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, C-524, para. 81.
[1953] Designing Effective Controlled Foreign Company Rules (n 1896) Pag.18.
[1954] The court stated that "justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardizingthe right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory". Para 60. Société de Gestion Industrielle (SGI) v. Belgian State, C-311/08.
[1955] Oy AA, C-231/05.

recommendations on HMAs, that is to say, a State should deny deductions to the extent that the same item is deductible both at the source and resident jurisdictions. Article 9 (2) provides for D/NI outcome (deduction/non-inclusion). In other words, if a "hybrid mismatch results in a deduction withouinclusions, the Member State of the payer shall deny the deduction of such payment". The matter will subjected to extensive analysis when HMAs are covered.

f. Switchover Rule

The switch-over rule or switch-over clause is a response to undertakings that transfer foreign income to low tax[1956] (or exempt) jurisdictions, that is, instead of granting the relevant company a tax exemption, the company would have to pay CIT and gain a credit of the tax paid in the third-country (if any). In other words, jurisdictions switch the applicable rule (exemption) to other rule (taxation). Article 6 of the Council's Directive Proposal 2016/011 provided for such rule.[1957] Nontheless, the rule was excluded from the wording of the new Council Directive 2016/1164.[1958]

6. Avoidance (optimization) Schemes

This part of the study is intended to shed some light on methods used by MNE in order to organize their tax schemes. All concepts that we are about to go through have already been previously discussed on Chapter 6. Such methods include avoidance[1959] and evasion schemes.

[1956] According to Article 6 of the Directive, a low tax should be considered as a statutory tax below 40% of the tax rate relevant MS.

[1957] "Article 6. 1. Member States shall not exempt a taxpayer from tax on foreign income which the taxpayer received as a profit distribution from an entity in a third country or as proceeds from the disposal of shares held in an entity in a third country or as income from a permanent establishment situated in a third country where the entity or the permanent establishment is subject, in the entity's country of residence or the country in which the permanent establishment is situated, to a tax on profits at a statutory corporate tax rate lower than ***40 percent of the statutory tax rate that would have been charged under the applicable corporate tax system in the Member State of the taxpayer***. In those circumstances, the taxpayer shall be subject to tax on the foreign income with a deduction of the tax paid in the third country from its tax liability in its state of residence for tax purposes. The deduction shall not exceed the amount of tax, as computed before the deduction, which is attributable to the income that may be taxed." (emphasis added). Council's Directive Proposal 2016/011.

[1958] Council Directive 2016/1164 of 12 July 2016 laying down rules against avoidance practices that directly affect the functioning of the internal market.

[1959] In 2012, Google, Starbucks and Amazon were called upon the Public Accounts Committee in order to explain their operations within the Union, that is, how, for example, an international company as Google, claim that its sales derived only from Ireland. Starbucks was questioned on how the Company maintained a deficitary operation for so many years and still be fully functional. In other words, the morality of their tax schemes was in fact "*put to the question*". The Committee's president posed two important questions to the persons representing the MNEs at the hearings: *"(1) Do the Companies, alongside to the duties of its shareholders, have obligations in the society in which you operate, from which huge benefits are derived, and those obligations include paying taxes? (2) Do you accept the principle that profits should be taxed in the country in which they're made, and where generally economic activity is concentrated?*" Both MNEs agreed to the statements, with the exception of Google, that stated that "[T]ax should be collected in those countries where the economic activity takes place that drives those profits, where the operation takes place." Bermuda?

Now that we have properly discussed how jurisdictions approach tax avoidance and evasion, regard will be given to the ***arrangements*** *per se*. For that matter, we will study the details of some of the most used tax avoiding arrangements used by undertakings in order reduce, or even neutralize their tax liability. Nonetheless, a brief classification of some of the objects we intent to study will certainly enhance an intuitive understanding of the topics that follow. As previouly studied in other parts of this investigation, whenever tax authorities suspect that a tax scheme is able to reduce tax liability, postpone or delay the payment of that tax, and after conducting such analysis it is concluded that the arrangement had no *economic substance or lacks a business purpose*[1960] tax authorities will classify such conduct as abusive and consequently impose fines, penalties or even deemd the scheme as un-recognizable. According to the HMRC, there are about 1.140 possible tax schemes, ranging from pensions to machinery and plant schemes,[1961] therefore, the schemes presented below are just a small fraction of possible relief arrangements that campanies may structure. In other words, listing and studying all possible taxation schemes would be a too herculean certainly falling outside tis investigation's scope.[1962]

a. Transfer Pricings Exploitation

In order for a transaction to be considered under AL, a comparability analysis is applied so that an estimate of what the charged price between two independent undertakings would have been were such undertakings not related, that is to say, were they uncontrolled undertakings. [1963] It should be noted that tax authorities will investigate companies that, on a regular basis, present the following characteristics: ***(i)*** significant amounts or numerous types of related party transactions; ***(ii)*** long-term losses or low profitability or fluctuating patterns of profit and loss;[1964] ***(iii)*** below average profitability than industry standards or profits that do not match the companies functions; ***(iv)*** business dealings [1965] with companies established in tax havens; [1966] ***(v)*** absent or

[1960] § 7701 (o) United States Internal Revenue Code.

[1961] Phillip Inman. *There are now more than 1.000 tax relief schemes. Give us a break*. https://www.theguardian.com/business/2017/aug/20/tax-relief-more-than-1000-schemes-give-us-a-break. Accessed in 18 Mar 2018.

[1962] The Internal Revenue Service (IRS - USA) publishes on its website a number of actual abusive tax schemes examples. Such schemes range from the use offshore companies to avoid taxes to the fraudulent sell of inexistent tax credits (an indidividual was sentenced to 2 years in prison for falsely purporting landfill methane tax credits and selling such credits to a network of individual taxpayers even though knowing that such credits were non-existent). *Examples of Abusive Tax Schemes – Fiscal year 2017*. https://www.irs.gov/compliance/criminal-investigation/examples-of-abusive-tax-schemes-fiscal-year-2017. Accessed in 18 Mar 2018.

[1963] John Vella (n 614) 16.

[1964] Starbucks case and the Public Accounts Select Committee Proceedings, where the company was questioned why it would maintain its operations in the UK, since it realized losses for the 10th year in a roll.

[1965] Check-The-Box Regulation: Parent Companies established in the USA must collect their taxes in that country (US applies both source and residency tax liability). The relevant Parent Company, the wholly owner on an intangible (a computer software or a patented technology), confers to its subsidiary, located in a tax haven, the rights to the relevant intangible, consequently, allowing a second subsidiary to use of the software, for which it will pay royalties. The subsidiary located in the high tax jurisdiction, deducts its royalty payments and the transferee, located in a tax haven, collect no taxes.

incomplete transfer pricing documentation; and ***(vi)*** obvious violations of the arm's length principle.

b. Debt and Profit Shifting[1967]

The fact that enterprises benefit from tax reliefs derived from commercial losses should not be a matter of great concern as far as avoidance/evasion is concerned. However, when tax jurisdictions detect possible abusive behaviours (aggressive tax planning), tax administrations are likely conduct a formal investigation in order to ascertain if the relevant undertaking implemented an abusive or even illegal tax scheme.

The OECD research on "*Corporate Loss Utilization through Aggressive Tax Planning*" provides a detailed and comprehensible study on the loss shifting tax schemes used by undertakings in order to *optimize* their taxable income. Such schemes consists mainly on: (i) *loss-shifting schemes*; (ii) *shifting profits to a loss-making company*; (iii) *time restrictions on the carry-over of losses*; (iv) *change of ownership/activity when carrying-over losses*; (v) *schemes on the rules relating to what is to be considered or treated as a loss*; (vi) *creation of artificial losses* and (vii) *the use of the same loss in two or more situations*. Details of such operations are properly analysed bellow.

aa. Loss-shifting schemes

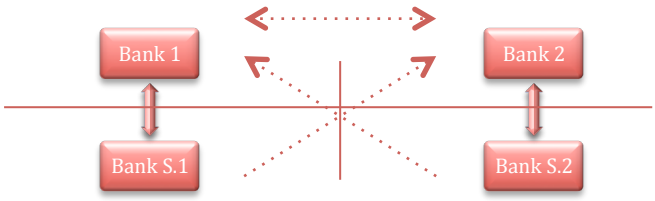
In order to apply such schemes, enterprises make use of a complex array of financial instruments such as CDS, after-tax hedges, non-arm's length TP as well as acquiring loss-making companies with no assets whatsoever other than the losses. It is by implementing such methods, that financial institutions manage to allocate losses without modifying its consolidated risk exposure. For that matter, we will present a number of loss-shiting schemes that clearly depict the abusiveness of such conducts.

Scheme 1. Bank 1, a resident in a high-tax jurisdiction (State A) and Bank 2 resident of another high-tax jurisdiction (State B). Both Banks have loss-making subsidiaries in a low-tax jurisdiction (State C). Bank S.1 enters into a Credit Default Swap (CDS) with Bank 2, resident of State B, thus transferring its risk exposure to Bank 2. Bank S.2 transfers its exposure to Bank 1 through the use of the same financial instrument, namely, CDS (Credit Default Swap). To conclude, both Banks A and B, exchange their exposure in order to neutralize their risk.

Figure 36

[1966] The 1998 OECD *Report on Harmful Tax Competition*, provided four main factors when ***defining a tax haven***, namely: ***(i)*** no or nominal tax on the relevant income; ***(ii)*** lack of effective exchange of information; ***(iii)*** lack of transparency; ***(iv)*** no substantial activity. *Harmful Tax Competition: An Emerging Global Issue.* OECD Publishing, Paris (1998). 17.

[1967] Ibid 17.



Note that, although the group's exposure remains unaltered, both Banks were able to allocate losses for taxation purposes.[1968]

Scheme 2. A group composed by two companies. One company resident of MS A acquires a *long maturity security* (index-linked notes/securities - ILS) linked to a certain index (S&P 500, for instance) issued by an AAA-rated financial institution. On the other hand, the associated company, say its subsidiary located in MS B also acquires ILS (under the same index), but at a short position.[1969] Note that, although it is difficult to forecast the index's actual variation, the eventual gains of the loss making company could be carried forward to be offset against against its profits in the future, on the other hand losses of the profitable company will be set off against its income, thus eventually neutralizing tax liability. [1970]

Scheme 3. In order to lower borrowing costs, institutional investors, banks and MNEs make use of a financial instruments called currency swaps. [1971] Such

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[1968] *Addressing Tax Risks Involving Bank Losses*. OECD Publications (2010) 55. https://www.oecd.org/tax/aggressive/46023583.pdf.

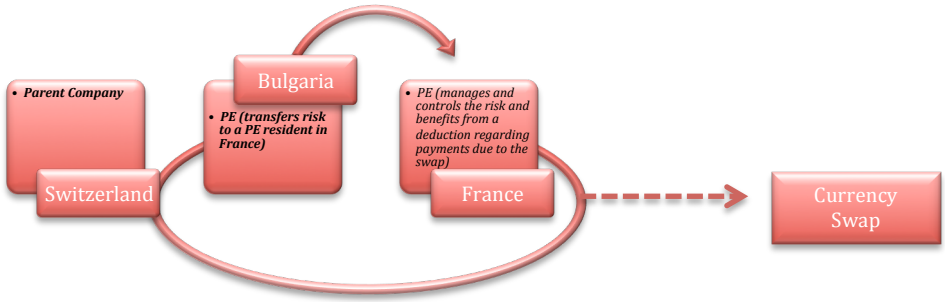
[1969] ***Short position*** is an investment strategy that allows the investor to sell borrowed shares in the market. For example, after conducting a market analysis in relation to a certain industry, investor A concludes that the share price of a certain company will fall (from 10 to 6 euros), therefore investor A instead of purchasing the share, proceeds to borrow a certain amount of shares from another shareholder in the open market, to which he will pay an interest rate (5%). After borrowing such shares, investor A proceeds to sell the shares in the open market. At the loan's maturity, investor A will have to buy back the stock he sold at present price to give it back to the lender. Therefore, if investor's A predictions are correct, he will sell the shares and profit from the difference between the selling and the buying price (if investor A bought the shares at 10 and sold at 6 plus 5%, he would have gained a total of 3,5). On the other hand, if investor's A predictions are wrong, he will have to buy the shares at a higher price of that that he paid, therefore realizing losses. In practice, investment banks do not offer such services on an unlimited basis, for in theory, the investor could put himself into a unlimited risk position, therefore, banks generally limit such operation to the investor's ability to pay (deposits etc).

[1970] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 51.

[1971] ***Currency swaps*** are financial instruments used by banks, MNEs and investors alike in order to reduce borrowing costs. For instance, in order to increase revenue, a certain American MNE concludes that it will expand its operations to China. Considering that such enterprise will finance part of its operation through debt, it proceeds to borrow funds from a Chinese Bank. Nevertheless, the interest rate chaged by that bank is considerably higher than that the MNE would have paid had it borrow the capital domestically (the MNE could also borrow funds domestically and wire such funds to China, nonetheless, such operation would certainly incur in other costs, such as taxation, currency variations etc, thus a deal breaker). Now, another company resident in China makes the decision to start its operations in the USA, nonetheless the Chinese company encouters the same difficulties in order to raise capital as the American company did. Considering that the American company needs 100 million U$ (equivalent to 664.280.000,00 CNY – 04.10.2017 conversion date), and the Chinese company also needs the same amount but in USD, both MNEs decide to enter into a *currency swap*, where the American company borrows the capital from an American bank and the Chinese company borrows the capital from a Chinese banks at lower rates. Then, both companies agree to ***swap*** the ***notional***

instruments allow the parties involved to the operation to exchange the interest rate applicable to the relevant loan, to the currency of the other country. For instance, a Swiss company has a PE in Bulgaria and in France. The Bulgarian PE enters into a currency swap[1972] with its associated company (PE in France) through the same financial institution resident in both countries and proceeds to transfer its risk management activities to its PE in France.

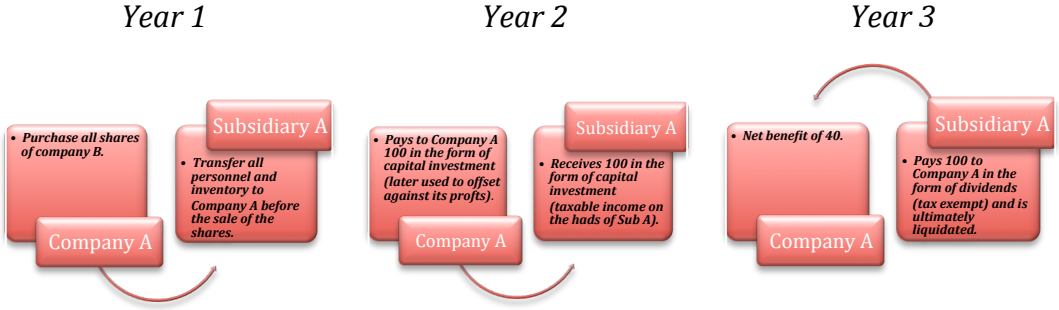
Figure 37



Note that, although the accounting function remains in the Bulgarian branch, the PE in France is considered the risk owner/manager, therefore it benefits from deductions in relation to payments made to the swap entered into by its associated company, namely the PE located in Bulgaria.

Scheme 4. This scheme involves the purchase of a parent company of a subsidiary. Company A buys all shares of subsidiary A in year 1. Before the shares are transferred, subsidiary A transfers all its inventory and personnel to company A, so that the only asset left in the subsdiriary A is a certain amount of loss of 100. According to the contract, Company A have agreed to purchase Subsidiary A for 10% of its losses, therefore for 10. Before the end of year 2, Subsidiary A receives from Company A a capital of 100 in the form of group contribution. Ultimately such payment may also be offset against the profits of company A (deductible expenses). At the end of year 3, Subsidiary A pays 100 of exempt dividends to Company A and consequently, the subsidiary is liquidated.

Figure 38



value of the loans, and to repay each party on the loans currency (the American company proceeds to pay Chinese loan in CNY and the Chinese company proceeds to pay the American loan in USD). Both companies are exposed to possible currency variations of the period as well as to the business risks of entering a new market.

[1972] Lev x Euro.

Considering that the tax value of the inicial capital contribution was 30% of 100 = 30, Company A concluded such operation with a net benefit of 40, minus the price paid for the shares, namely 10.[1973]

Scheme 5. A fith and final example relates to the transfer of losses from a parent company to a subsidiary. A MNE has full control of a number of other subsidiaries in other jurisdictions. Such subsidiaries have derived recent losses due to external factors (economic crises, for instance). Therefore, the parent company proceeds to transfer large sums of capital to those companies and claim such payments as market support payments (MSPs) or capital support payments (CSPs),[1974] which later may be offset against the parent company's profits. Note that although tax authoritities should not deem the payment as abusive (the payment may have been conduted in light of a recent maketing strategy in the relevant country in order to boost sales) the relevant tax requests the taxpayer to provide financial reasoning to such operation in order to ascertain whether the motivation constitutes an abusive behaviour.[1975] In possession of the relevant information, the relevant authority concluded that such transfer of capital served ony to transfer the losses from the subsidiaries to the parent company, due to the fact that no market investment-planning was identified, therefore the conduct was classified as abusive and liable to penalties.

[1973] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 52.

[1974] ***Market Support Payments*** (MSP) *or* ***Capital Support Payments*** (CSP) are generally characterized as a transfer of capital from the parent company to struggling subsidiaries resident in other jurisdictions. Such payments may at latter date be offset against the parent company's profits. Due to possible abusive behaviors the Australian Tax Office has recently published a *draft* stating that such payments should be considered as non-deductible for tax purposes. For that matter, we will present a short example where the MSP was not considered as a deductible expense according to the example set in the draft. A parent company establishes a fully owned subsidiary in a foreign jurisdiction. According to the contract entered into by both companies, the parent company will grant its subsidiary all necessary business support and fully implement the business strategy that will be followed by the subsidiary. Moreover, all necessary business systems, trademarks etc will be licence to the subsidiary in which it will pay a licence fee by the end of each fiscal year. The relevant contract also states that the parent company will, in case the subsidiary realize losses related to its operations in that country, liquidate such losses with a single payment. Such payment was described in the respective contract as market support payment (MSP). In the coming year, the parent company's subsidiary realizes losses on 1 million, thus, the parent company proceeds to pay the associated company. Note that, although the parent company classified such payment as **MSP** or **CSP**, the cost generated by the subsidiary that gave rise to such payment did not relate to the price of a certain asset or service, that is to say, they did not "reflect, the quality and quantity of the things supplied." In other words, such payment had "the objective purpose and effect of enabling the parent to underwrite the activities of the subsidiary, and, in so doing, to protect the value of their investment and to secure it as a future source of income." Here, the ALP plays also an important role in ascertaining the economic purpose of the transaction, that is, whether the payment's purpose related to the actual cost of production or whether the payment simply intended to secure the operation in that market. In sum, the important question one must ask is, would independent parties have conducted such payments in comparable circumstances? In the case just described, the answer to this question should be no, therefore, the payment may not be offset against its profits. Draft Taxation Determination. TD 2014/D7. *Australian Taxation Office. Legal Database*. http://law.ato.gov.au/atolaw/view.htm?docid=DXT/TD2014D7/NAT/ATO/00001. Accessed in 18 Mar 2018.

[1975] Addressing Tax Risks Involving Bank Losses (n 1968) 55.

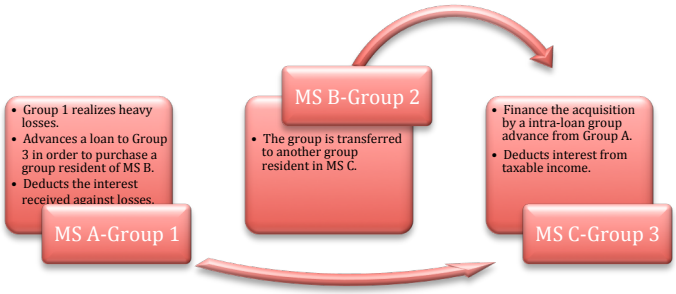
ab. Shifting profits to a loss-making company

Multi-national enterprises may realize losses in one jurisdiction or more jurisdictions, that is, loss is a common enough fact of business. Moreover, although realizing losses on a regular basis may trigger concern due to evasion, this may well be explained by the business strategy that the relevant MNE conducts, that is to say, the MNE may be structured in such a manner that those losses may be necessary in light of the group's business model (for instance, a MNE concentrate its distribution center within a certain State of the EU where only costs are generated, nonetheless, the income generated when selling such products compensates the undertaking's overall losses). As previously studied, losses may be offset against future profits (*carry-forward*) or against past profits (*carry-back*), although the latter is generally not permitted by the vast majority of tax jurisdictions due to a number of reasons (prescription, administrative, budgetary matters).

The OECD study on aggressive tax planning has identified a number of schemes where undertakings shift profits to loss making enterprises in order to use those losses. The schemes bellow were identified by the OECD participating countries.

Scheme 1. Due to a severe economic crisis in MS A, Group 1 has realized considerable losses in a certain year. In order to use the losses suferred by Group 1, the Group decides to reorganize its corporate structure by transferring its companies located in MS B to another Group located in MS C (Group 3). Group 3 financed this operation by an intra-group loan operated by Group 1, resident of MS A.[1976]

Figure 39

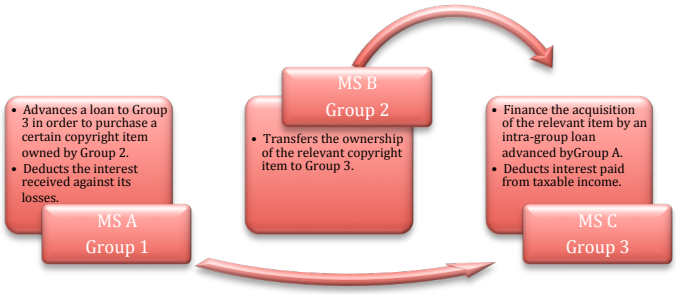


The income received as interest of such intra-group loan will be offset against its losses by Group 1, alternatively, Group 3 will also deducted the interest payments made out to Group 1 against its profits.

A possible variation of the present scheme (see bellow) was also encountered by tax administrations in respect to licence payments, where Group 3 purchases a certain copyright item from Group 2 for example, financed by an intra-group loan advanced by Group 1.[1977]

Figure 40

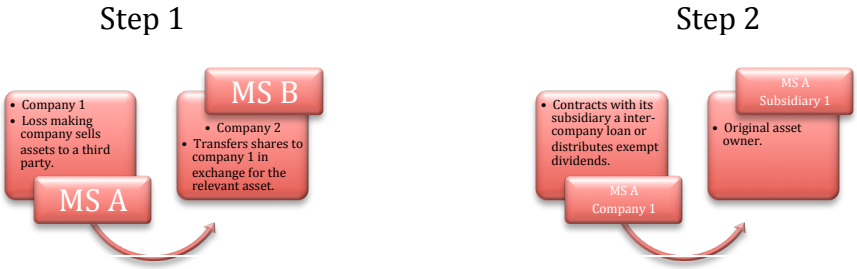
[1976] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 52.
[1977] Ibid 52.



It is important to keep in mind that not all jurisdictions allow a *ad aeternun* carry-forward of losses, therefore in certain cases, had Group 1 not been able to offset its losses against its taxable income within a certain period of time, such loss "*credit*" would be ultimately lost.

Scheme 2. This scheme is particular interesting for it allows the relevant group to avoid taxation on the appreciation value of a certain asset as well allows the transfer of loss to other companies of the same group. A company participant of a certain group realizes losses in a certain fiscal year (company 1). The company then proceeds to sell assets to a third unrelated party from which it derives profit over the original asset's value compared to its present value (goodwill), which ultimately is offset against its losses.

Figure 41



In *step 1*, company 1 resident of MS A received shares of company 2 resident of MS B. In *step 2*, company 1 resident of MS A contracts with its subsidiary (original owner of the sold asset), also a resident of MS A an intra-group loan in which it ultimately offsets the received interest against its losses. Alternatively, company 1 may also distribute exempt dividends to subsidiary 1.[1978]

ac. Time restrictions on the carry-over of losses

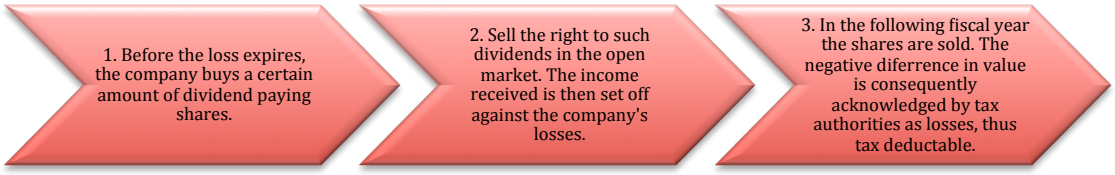
As previously studied, tax jurisdictions allow undertakings either to carry-forward losses (general rule), and only a few jurisdictions allow the carry-back of losses, both approaches are prone to time limitations, that is to say, carry–forward is in some jurisdictions limited to 30 years (or indefinetly), and carry-back generally allowed to one or three years. Nontheless, some undertakings

[1978] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 52.

manage to *work their way around* such time limitations in such a way that they are able to renew losses that should have been expired. The OECD Report on the utilization of losses through aggressive tax planning has identified two schemes of such nature, namely, in corporate restructurings and by creating taxable income on the last fiscal year before loss expires. Both schemes are described bellow.

Scheme 1. A certain taxpayer resident of a country that imposes a time limitation to carry-forward losses, proceeds to buy shares of a company that is expected to pay dividends in the same fiscal year in which the relevant loss expires. Then the company sells the right to receive such dividends, thus generating taxable income, which is offset against the company's already "*stocked*" losses. In the next year the shares are sold and the reduction on share's value is recognized as deductible losses.

Figure 42



Note that the company was able to use the profits derived from dividends by selling its rights ultimately *refreshing* losses (substantiated by the difference in value of the purachase and the selling prices) that at a latter date could be used to deduct future profits. In other words, the company will enjoy the benefits of such operation even though the market share value increases before the shares are sold (dividend stripping).

Scheme 2. Some countries (Canada and France, for instance) allow the carry-back of losses to the preceding year the loss was realized. Nevertheless, in case the business operation is discontinued permanently, the relevant undertaking may be granted a carry-back extension period of three years. However, the OECD Report on the treatment of losses through the use aggressive tax planning, has identified a number of cases where companies were able to benefit from such extension period without ceasing its operation, by creating a partnership controlled and managed by the group itself and including as a partner "an individual, trust or person which is not a company within the charge to corporation tax".[1979] In other words, a group may transfer the loss-making company to a newly created partnership, where a "small partnership interest (*e.g.* 1%) is held by an individual".[1980] By introducing a third-person to such corporate structure the trade is ceased for the rule's purposes, therefore enabling the company to carry-back losses within the extended period.

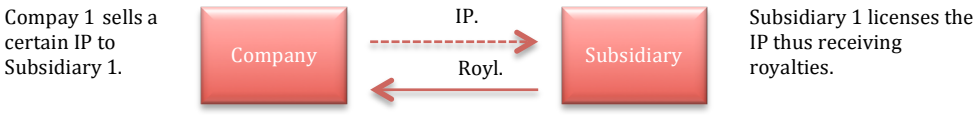
[1979] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 53.
[1980] Ibid 53.

ad. Change of ownership/activity and carrying-over losses

As previously studied, most tax jurisdictions deny the carry-over of losses in instances such as *change of activity*, *mergers* or in *change of ownership*. Nontheless, each country has a different approach to the matter, for example, Norway allow the carry-forward of losses after a group restructuring (change of ownership or activity) as long as the main purpose of the operation was not to avoid taxation (the burden of proof falls under the relevant taxpayer). Other countries such as Germany, Austria and Italy, do not restrict the use of such losses after corporate restructurings if the main purpose of the restructure is proven to be of a ***rescuing nature***.[1981] Nevertheless, in respect to pos-restructuring ownership thresholds, tax administrations also apply diferent methodologies, that is, some States focus on the amount of shares pos-reorganization, others on voting rights or both (percentages thresholds[1982] may also differ).[1983] France, for example, applies such rule in a more restrictive manner by denying the carry-over of losses if the company's activity is changed, regardless of whether the company changed ownership, or not. In order to avoid rules on change of ownership restricting carry-over losses, MNEs may inject large sums of capital into a company that is about to be restructured in such a way that the company is able to surrender its carry-forward losses. Such injections may occur through he use of financial instruments. Some of the schemes bellow were identified by the OECD report on corporate loss utilization through the use of aggressive tax planning.

Scheme 1. A certain Company resident of a certain State requires a minimum holding thereshold after the change of ownership, either by a merger or other form of corporate restructure, otherwise losses may be lost. Considering that Company 1 was unable to maintain the minimum threshold required. Thus, in order to avoid losing such losses, Company 1 sells an IP to its associated company which is licensed back to company 1. Company 1 then proceeds to pay a certain amount of royalties to Subsidiary 1 which will offset the royalty income against its losses.

Figure 43



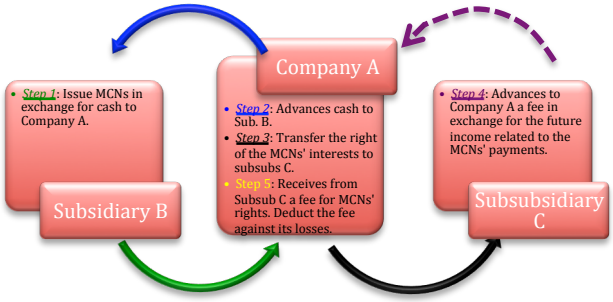
Note that by paying royalties to its subsidiary, the group was able to transfer the subsidiary's losses to Company 1, in the form of royalties. In other words, had the scheme not been implemented such losses would ultimately be lost.

Scheme 2. The present scheme involves two new established subsidiaries and a parent company, that is, Company A has a new wholly-owned subsidiary

[1981] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 36.
[1982] The Netherlands applies a 30% threshold control whereas Austria 75% threshold control.
[1983] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 36.

(Subsidiary B), which in turn has also a new wholly-owned subsubsidiary (Subsubsidiary C). As previously mentioned, tax jurisdictions generally apply a minimum control threshold after a change of ownership (some jurisdictions apply the ring-fenced approach – the UK, the Netherlands, France etc - whereas others allow the use of losses upon joining the group – Norway, Sweden etc). Some countries allow the inclusion of previous losses under certain conditions (continuity of voting rights and commonalities between previous and current operations – New Zealand).[1984] The example below depicts a scheme identified by the OECD Report on use of losse through the use of aggressive tax planning where the group, was able to use losses before "the shareholder's continuity breach (…) and after". Subsidiary B (recently acquired by Company A) issues mandatory convertible notes (MCNs) to Company A (step 1), in exchange for capital (step 2). Company A then proceeds to transfer the convertible's interest rights to Subsubsidiary C (step 3) which in turn, pays Company A a fee at present value (step 4).

Figure 44



Note that the fee received by Company A in exchange for the interest payments (MCNs) may be offset against Company A's losses before Subsubsidiary C breaches the minimum threshold (step 5). After the control is finally changed, the group will also benefit from a deduction on the interest paid by Subsidiary B.

Scheme 3. Under another scheme identified by the OECD a certain company made use of different voting shares[1985] in order to circumvent the limitations imposed by the relevant State concerning unused losses of the acquired company, therefore avoiding the ***change of control*** which would eventually impose limitations over the use of such losses. The renewal of tax holidays offered by developing States through changes of control is also an example on abuses conducted by MNEs in order to reduce tax liability.

ae. Schemes on rules relating to what is to be considered or treated as a loss

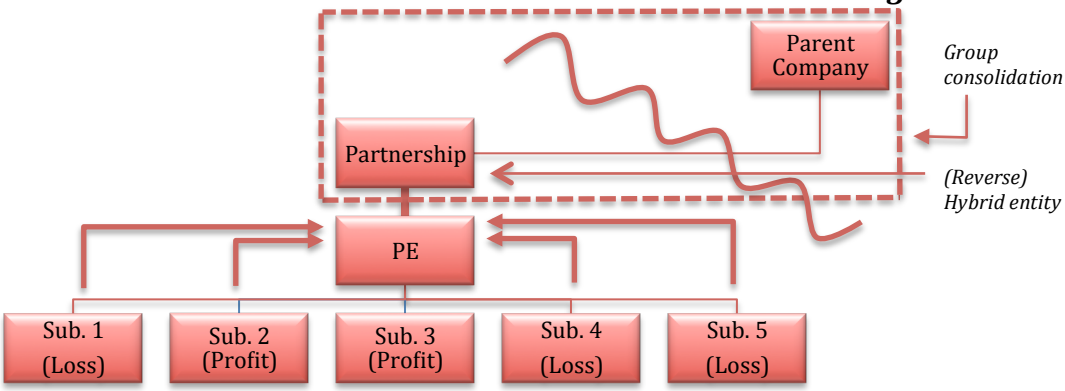
The OECD Report on aggressive tax planning through the use of losses identified also a number of schemes aimed at "circumventing the rules on the use

[1984] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 37.
[1985] See citations 1653, 1654, 1655, 1656, 1657, 1658, 1659, 1660, 1661 and 1662.

of losses for group taxation, the deductibility of foreign losses, or the carry-over of losses".[1986] See bellow.

Scheme 1. A Parent company resident of State A, operates through a number of wholly owned subsidiaries in State B. The group realized in a certain year losses due to the failure of a business strategy in that State. Before the end of the fiscal year the parent company incorporates a partnership in the same State its subsidiaries operate. According to the legislation of that State, the partnership is transparent for tax purposes (*reverse hybrid entity*). The partnership in turn creates a PE in that State. The subsidiaries then proceed to include in the books of the recent created PE profits and losses. The parent company includes the transparent partnership in a cross-border consolidation regime.

Figure 45



Even though the PE did not control the subsidiaries during the loss period, the parent company claims the PE's losses through its transparent partnership (reverse hybrid entity).

Scheme 2. The OECD has indentified a great number of loss-making undertakings acquisitions before the end of the fiscal year. If the State where the acquired company do not apply rules limiting the use of losses after changes of control, "the acquiring company can then make use of the available group taxation regime to offtet the acquired company's losses against the profits of the group companies".[1987]

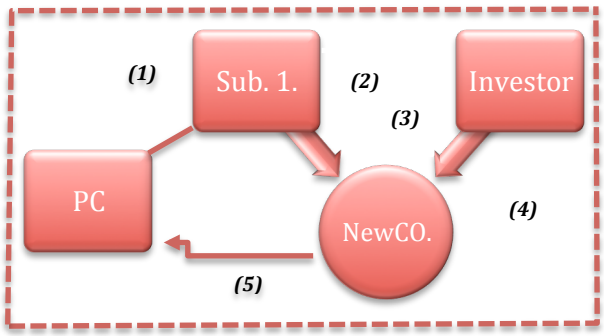
Scheme 3. According to the rules of a certain consolidation regime, losses realized by a company that had just recently joined te group are not deductible against the groups losses, that is, losses of the newly joint company are ring-fenced, therefore those losses can only "be set off against profits made by the consolidated group up to the amount of profits made by the subsidiary which carries the losses forward".[1988] In this particular scheme, a certain group

[1986] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 54.
[1987] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 54.
[1988] Intra-group transactions, balances, expenses and income are not taken into consideration when determining tax liability. Corporate Loss Utilization through Aggressive Tax Planning (n 1091) Ibid 55.

distributed dividends to the company which had just recently joint the group. The taxpayer claimed that the losses could be deducted up to the amount of the received dividends, "even if the dividends were not ultimately taken into account to determine the group taxable income". [1989]

Scheme 4. A parent company anticipates that its subsidiary will realize losses in the foreseeable future. The parent company then sells the company to a recent created undertaking (NewCo.). NewCo issues two types of shares (ordinary and preference shares), which are consequently bought by a third party investor (30% of voting shares). After the losses are realized, the parent company claims a loss relief under a consortium scheme, which "enables losses to be surrended to companies outside the original group".[1990]

Figure 46



1) *Sub.1 anticipate losses.* ☑
2) *PC sell all shares of Sub. 1 and create NewCo.* ☑
3) *PC issues two classes of shares (ordinary and preference shares).* ☑
4) *Investor purchases 30% of the voting shares.* ☑
5) *Upon realization of NewCo.'s Losses, PC claims a group relief under* ***consonsortium rules.*** ☑

Scheme 5. In this scheme, a loss making PE resident of a certain MS is liquidated by its parent company resident of another MS ultimately turning the PE into a partnership. After the PE's liquidation, the company's losses are deemed as realized and any "resulting income is offset against the loss-carry forward of the PE". The parent company then proceed to claim the losses carry-forward of the newly establish partnership using the *Lidl case* "to which the country of the head office must allow the deduction of the foreign PE losses when they become definitive and cannot be used anywhere else". In the next year following the convention from the PE into a partnership, the partnership "amortizes goodwill and sets up a reserve, causing a significant loss and thus shifting the loss carry-forward from the terminated to the re-established business".[1991]

af. Creation of artificial losses

Artificial losses are, in sum, losses lacking economical substance, that is to say, losses that were ultimatey incurred without the company conducting any real activity which would give rise to such outcome. Artificial losses are highly dependable on financial instruments such as "securities lending, equity swaps, sale and repurchase agreements ("repos") on shares"[1992] (*repo*). Artificial losses

[1989] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 55.
[1990] Ibid 55.
[1991] Ibid 55.
[1992] Ibid 55.

may also be created by conducting company reorganizations or by exploting domestic merger rules. [1993]

Scheme 1. Under ***repo*** arrangements, a certain undertaking, Company A transfers a number of shares to its associated Company B that will sell (short) such shares. Company B (borrower) anticipated (expectation of profits) that it will purchase back the shares from the third-party at a lower price. During the time of the ***repo***, if Company A pay dividends on its shares, Company B will transfer such dividends to Company A on the form of ***manufactured dividends*** (manufactured payments),[1994] which are exempt from tax under the relevant DTC. In order to implement the transaction, the Company lending the shares may require some sort of secutity. Upon the operation's maturity, Company A will pay "both the collateral and the interest earned on such collateral" to Company B minus a fee.[1995] Company B's intention is to sell the borrowed shares at a higher price, and at a later date, buy those shares back at a lower price, therefore realizing (taxable) profits. The ***manufactured payment*** (*substitute payment*) made by Company B is *deductible* at the source MS, and *exempt* at the resident MS (Company A). This scheme will be discussed in the next topic in hybrid mismatches.

Scheme 2. In order to "reduce the taxable base through intra-group debt" a company may create a circular financing scheme through a cross-border zero coupon where the parent company finances its subsidiary resident of another State through equity, which at a later date proceeds to contract with the parent company a loan with a zero coupon note.[1996] The scheme generates an artificial deduction for the "interest on a zero coupon note is deductible on an accrual basis[1997] in the participating country, whereas for foreign tax purposes it is taxable on a cash basis,[1998] and that cash in never actually paid".[1999]

Scheme 3. The following scheme was also identified where a group artificially creates deductible goodwill in order to offset against the parent company's profits in another State. PC creates a limited partnership in State B and proceeds to sell all shares of its subsidiary resident of that State (Sub. 1). After transferring all assets to P Ltd 1, it converts Sub.1 into another limited

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[1993] Ibid 55.

[1994] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 56.

[1995] *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, OECD (2015). 262. http://dx.doi.org/10.1787/9789264241138-en.

[1996] ***Zero-coupon notes*** come with no recurring coupon payments whatsoever, which makes their yield to maturity equal to the normal rate of return on the note.

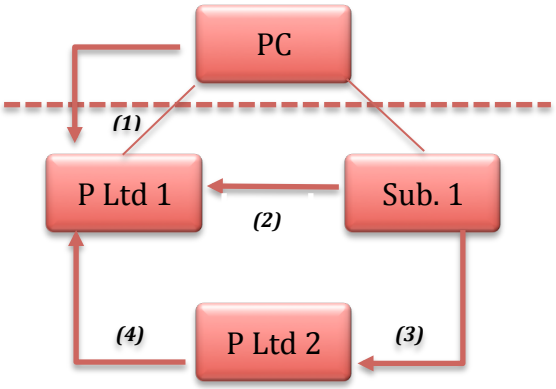
[1997] ***Accrual basis accounting***, contrary to cash basis accounting, accrual basis accounting has a more propelled into the future method of reporting revenue. For instance, a certain company sells a product to a client, nonetheless, the company will only receive payment in 10 days. Even through the company did was not paid, the revenueis already included in the company's books. The same mechanincs applys to expenses, that is, they are recorded bofore money is spent. (most commonly method used by undertakings).

[1998] ***Cash basis accounting*** uses a more immediate recognition of revenue and expenses, that is, revenue in reported in the company's income statement when when cash is actually received, and expenses will only be recorded when cash is actually spent.

[1999] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 56.

partnership (P Ltd 2). Ultimately, the P Ltd 2 is merged with P Ltd 1. The sale of Sub. 1 to P Ltd 1 and the convertion into P Ltd 2 had the ultimate purpose of creating goodwill, which will be used by the PC in order to reduce its tax liability.[2000] In other words, by acquiring the target company (Sub.1) at a higher price than the fair value of the net identifiable assets (goodwill), the PC is able to offset the premium against its profits.

Figure 47



(1) *PC creates P Ltd 1 in State A.*
(2) *PC sells Sub. 1's shares to P Ltd 1.*
(3) *Sub. 1 is converted into P Ltd 2.*
(4) *P Ltd 1 merges with P Ltd 2.*

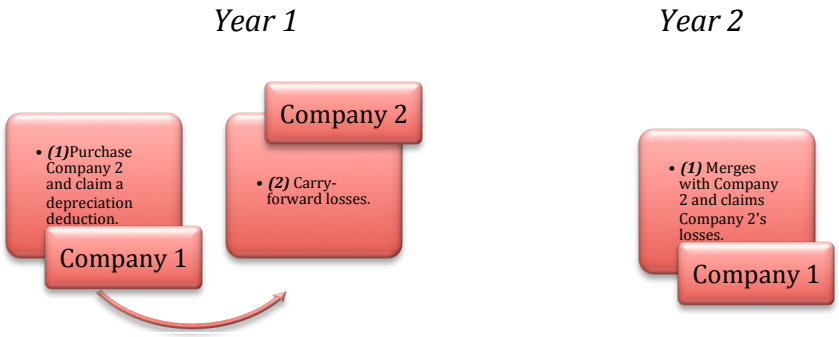
Scheme 4. The OECD identified another scheme where a company proceeded with a short-form amalgamation merger, which "requires the shares in the merging entity to be cancelled for no considerations. In oher words, the merger is considered to be a disposal of shares, which results in a loss for the repective shareholder. The loss is artificial because the taxpayers still holds the participation, although in the acquiring company and not in the acquired one. This scheme has been successfully challenged in court."[2001]

ag. Use of multiple deductions created by the same loss in two or more jurisdictions

Scheme 1. Company 1 buys 90% of Company 2 shares, which in the same year, realized losses. Those losses are claimed by the purchaser as a depreciation deduction on the shares' value, and Company B carry its losses forward. In the next year, Company 1 and Company 2 merge and the carried-forward losses of Company 2 are claimed by Company B in order to reduced its tax liability. Note that Company 1 used the losses once as a depreciation deduction upon buying Company 2's shares, and used the losses in the following after the merger.

[2000] Ibid 56.
[2001] Ibid 56.

Figure 48



Scheme 2. In order to use the losses of an associated company, the parent company injects capital in that company or enters into a loan contract with the associated company which at a later date will be waived, "thus increasing the tax value of the shares accordingly". Note that the companies were able to create fluctuations over the share prices with an artificial contract, for the "contribution has no influence over the lower fair market value of the shares". The company then at a later date proceeds to sell such shares at a lower price due to the outstanding debt contracted with the parent company and "beacause the fair market value is lower than the acquisition costs of the shares, which includes the contributions (or waived shareholder loan)"[2002] the company is able to reduce tax liability by creating an artificial loss.

Scheme 3. The OECD report referred to other scheme where a company operating under a cross-border group consolidation scheme, used two dedutions to the same loss. Loss generated by the group's subsidiaries may ultimately be deducted against the group's profits under a consolidation scheme, however, if the group conducts any adjustments after closing the assessment, the consolidation must be reversed (de-consolidation). The taxpayer therefore includes that same loss ***before*** and ***after*** de-consolidating its results.[2003]

As we shall properly study on the next section MNEs make use of the so-called ***hybrid mismatch arrangements*** (exploitation of inconsistencies between the tax treatment of certain corporate forms and financial operations), which are operated through the following entities:

Dual-resident companies are generally achieved when a certain State considers the place of incorporation as an allocation factor for tax purposes, whereas the other State considers the place of effective management or control. In order to solve problems regarding the allocation of taxing rights, the OECD model provides the tie-breaker rule in case the company is considered resident for tax purposes on both States. Nevertheless, a dual-resident company "deduct its losses twice –once against the taxable profits of one group, and once against the taxable profits of another, thus resulting in a double benefit for the worldwide group in respect of the same initial loss".[2004]

[2002] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 57.
[2003] Ibid 57.
[2004] Ibid 57.

Hybrid entities relates to entities that are treated differently by jurisdictions for taxation purposes, that is, a certain State treat the entity as transparent, while the other State treats the same entity as opaque. For instance, a group operates in a certain State through a "debt-funded acquisition vehicle (either a partnership or a corporation) (…) treated as non-transparent in the coutry in which it is organized and as transparent in the country of residence its members". Operating under such circumstances, the company may be able to create multiple deductions for a single loss (the loss is deducted against the profits of the non-transparent entity in State B and once again in State A on the hands of the parent company which operates under a cross-border group consolidation scheme. The same result may also be achieved by the use of hybrid instruments as we shall study in the next topic.[2005]

Branch models. Companies operating in various States through branches (PE), may be tempted offsetting the branch's expenses against its profits, and once more in the hands of the parent company resident of another State. According to the OECD report on corporate loss utilization through ATP (Aggressive Tax Planning) "[T]his is because in many cases losses attributable to a foreign branch are available to offset income of a resident corporation. At the same time the branch may also deduct the interest expense agaist its income of other companies resident in the country where the branch is located through the relevant group taxation regime ".[2006]

Double-dip leases concern depreciation rules, where MNEs abuse the differences on the laws of different jurisdictions regarding the property's owner. Under the legislation of State A, the property of an asset is established to the "person who has economic ownership of the asset", whereas in State B the person "who holds the legal title to the asset" shall be considered its owner. Undertakings are able, therefore, to appy depreciation formulas in order to reduce their tax liability in both States, that is, "[W]here accelerated depreciation is available on the assets for tax purposes, this may give additional upfront tax benefits to the taxpayers involved"[2007] (depreciation)

c. Hybrid Mismatch Arrangements (HMAs)

Hybrid mismatch arrangements are a perverse and aggressive tax planning mechanism used by multinational companies in order to achieve *tax neutrality*. It is through the use of such schemes that undertakings are able to apply a number of deductions with a single expense, generate various foreign tax credits etc.[2008] As we have previously studied, ***the European legislator allow MSs to exclude from the benefits of the Interest and Royalty Directive company groups that make use of HMAs***. Article 4(1) provides the so called *exclusion catalogue* mainly referring to such arrangements. The previous chapter dealt exclusively with some of the schemes used by MNEs to reduce their tax liability in respect to profit and loss shifting. In order to tackle both profit-shifting and HMAs schemes,

[2005] Ibid 57.
[2006] Corporate Loss Utilization through Aggressive Tax Planning (n 1091) 58.
[2007] Ibid 58.
[2008] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 11.

the *Junker Commission*[2009] will in 2019 present an amendment to the *Directive for Administration Cooperation* (DAC) imposing upon tax advisors, namely, accountants, banks, lawyers etc, who assist undertakings with their tax schemes, the obligation to disclose such structures to the extent that such schemes include: (***i***) the use of losses able to reduce tax liability, (***ii***) special tax regimes or (***iii***) structures that make use of tax havens, that is, intermediaries not based in the EU or bound by professional privilege or secrecy rules.[2010]

According to the OECD final report on the matter,[2011] HMAs reduce not only the tax revenue of the relevant State, but also creates a negative impact on "competition,[2012] efficiency,[2013] transparency[2014] and fairness."[2015] This part of the study proposes to present some of such schemes structured by MNEs in order to create double deductions or deduction/non-inclusion outcomes. But before that, in order to provide a full and more rigorous study of the institute, we will first dissect the main elements of the term. In the following pages much will be discussed about how MNEs structure their tax structures, and how ultimately such structures are used to reduce or neutralize tax liability.

"Hybrid". The term ***hybrid*** refers to the differencial treatment given by two jurisdictions in respect to entities that are treated as transparent or disregarded for tax purposes (opacity approach). Here also lies the concept of ***tax arbitrage***, generally "described as the taxpayer's purposeful use of two countries' conflicting treatment of a single transaction or entity with the effect of the reduction of that taxpayer's overall tax burden compared with the situation in which the same transaction or entity existed exclusively within one or the other jurisdiction."[2016] In other words, MNEs exploit such differences to produce the

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[2009] Jean-Claude Junker, current European Commission's President (Ex-prime minister of Luxembourg).

[2010] *Commission forges ahead on new transparency rules for tax planning intermediaries*. European Commission – Press release. http://europa.eu/rapid/press-release_IP-17-1663_en.htm. Accessed in 18 Mar 2018.

[2011] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 18.

[2012] Multi-national emterprises have access to financial instruments and know-how not available to small-and medium-size enterprises, placing MNEs in considerable advantanged in relation to small and medium-size companies, therefore distorting the ***competitive environment***. Hybrid Mismatch Arrangements (n 1893) 11.

[2013] Market ***efficiency*** may also be compromised to the extent that the relevant hybrid may influence the investment decisions of enterprises. In case of the avalibility of a hybrid (different treatment of a certain entity for tax purposes – transparent and non-transparent partnerships, for instance), cross-border investment may result in possible tax benefits, thus infringing CEN. Alternatively, CIN may also be negatively influenced, for cross-border investment may be more attractive than a "local inverstor's investment in the target country". Hybrid Mismatch Arrangements (n 1893) 11.

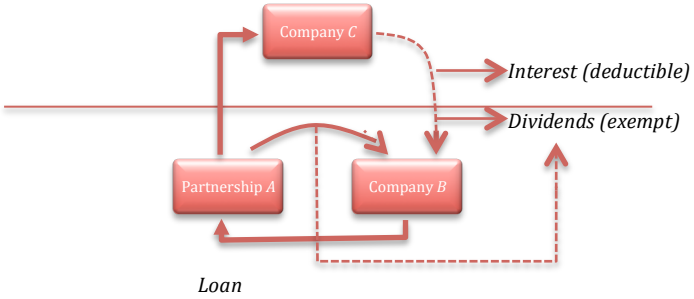
[2014] The higher the ***transparency***, the higher the public awareness in respect to tax policies conducted in a relevant country. Alternatively, the lower the transparency, the more difficult taxpayers will be able to properly establish a more sound financial and budgetary forecast. Hybrid Mismatch Arrangements (n 1893) 11.

[2015] Hybrid Mismatch Arrangements may compromise the ***fairness*** of the tax system, that is to say, undertakings that have the possibility of deriving income from capital instead of labour, have a competitive advantage in relation to companies that exclusively derive income from labour. Hybrid Mismatch Arrangements (n 1893) 12.

[2016] Kenan Mullis. *Check-the-box and Hybrids: A Second Look at elective U. S. Tax Classification for Foreign Entities*. Taxanaliysts. (2011). Accessed in 18 Mar 2018. http://www.taxhistory.org/www/features.nsf/Articles/58D8A3375C8ECCD18525793E0055EB9B?OpenDocument.

desired tax outcome, namely, tax neutrality, double deductions and the creation of artificial tax credits. The transaction's hybrid element, allow undertakings to generate deduction/non-inclusion of income (D/NI) or a double deduction (DD) outcome, at the resident and source State. Such arrangements seek to exploit differences in tax treatment in respect to debt instruments (loans), equity instruments or derivative contracts. [2017] Consider the following example, Company B and partnership A are wholly-onwned by Company C, resident of another MS. Company C, in order to finance its operation in the another MS structures the following scheme. Company B lends to partnership A a certain amount of capital. Under the laws of that MS, the loan is regarded as equity, therefore partnership A, instead to paying deductible interest back to Company B, pays exempt dividends. Partnership A then enters into a loan contract with its parent company (Company C) resident in another MS. According to the contract, the interest should be paid to Company B.

Figure 49



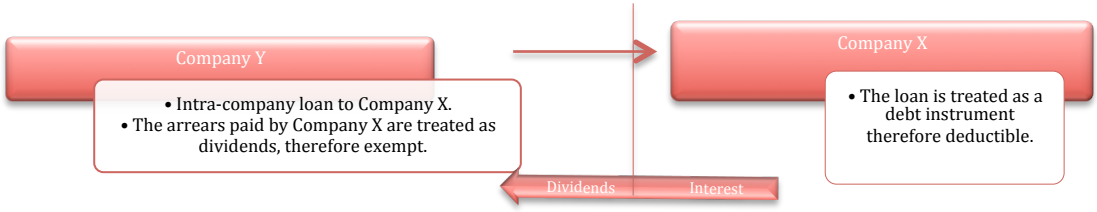
Under the law of source country (Company C), the loan is, of course, a debt instrument generating *interest*, therefore the interest paid to Company B is ultimately offset against Company C's profits. Alternatively, under the rules of the resident MS (Company B), the payment is treated as dividends, therefore exempt in the hands of Company B (note that the ***interest*** paid by *Company C* was converted into exempt ***dividends*** in the hands of *Company B*). Under the laws of the source MS, partnership A is disregarded for tax purposes (***transparent***), whereas in the resident MS, is treated as a ***non-transparent*** entity, thus liable o tax. Note that the group was able to exploit opacity differences in respect to the partnership's corporate form, that is to say, were partnership A treated as *non-transparent* by the source State, the payment would have been classified as dividends, *therefore taxed upon distribution* (under the Interest and Royalties Directive, MSs are allowed to deny the benefits of the directive if the relevant tax structure generates a D/NI, DD or indirect D/NI outcomes – HMAs). Such arrangement falls under the category of ***Hybrid Mismatch***, for it produces tax benefits due to differential opacity treatments, creating thus a D/NI outcome. Moreover, the arrangement is also "caught by the ***hybrid financial instrument*** rule" [2018] due to the fact that the financial instrument is treated as an equity instrument at the resident MS and as a debt instrument under the laws of the Source MS.[2019]In order to neutralize such arrangement, the Source MS should deny the interest deduction to Company C

[2017] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 25.
[2018] Ibid 236.
[2019] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 236.

since the instrument resulted in a D/NI outcome. Alternatively, the resident MS could also apply the ***defensive rule***, that is, treat the payment as ordinary income, thus liable to taxation.[2020]

"Mismacht". The term ***mismatch*** (interaction between tax jurisdictions' legal frameworks)[2021] stands for differences of tax treatment in respect to the relevant cross-border payment, for instance, a certain company may deduct a payment at the source, according to the laws of that jurisdiction, and not include the same payment as income at the recipient State (D/NI).[2022] Alternatively, the same company may explore the deduction laws of multiple jurisdictions by deducting the same payment in both jurisdiction (source and resident). Nonetheless, differences in value in respect to certain payments do not fall under the *mismatch* categorization, for example, currency variations related to loan instalments may influence the total amount paid by a certain enterprise over a certain time period.[2023] If the transaction's character is unaltered, that is to say, there is no double deduction (source State and resident State) and alternatively, no differencial treatment in respect to the inclusion of the relevant payment as income (deductible at the source and included as regular taxable income at the resident State), such payment consequently will not be deemed as mismatched, and no adjustment will be required by the relevant tax authority.[2024] Consider the following example, an undertaking (*C X*) established in MS B contracts with an associated company resident of MS A (*C Y*) an intra-group loan that will be paid on an annual basis in arrears. The conditions set out on the contract allow *C X* to default on such payment in case the undertaking has cash flow problems. Under MS B, the interest payments are offset against the undertaking's profits and exempt in MS A under the Parent-Subsidiary Directive (*C Y* ows over 10%[2025] of *C X* voting rights for a longer uninterrupted holding period of two years).[2026] Note that the company was able to avoid taxation in both State

Figure 50



Note that, if Company Y benefits from a dividend exemption, the payment will characterized a ***hybrid mismatch arrangement***, that is, a ***hybrid financial instrument***. Such example would fall under the D/NI outcome (deduction/non-inclusion). The OECD recommend jurisdictions to deny exemption in case the associated company deducted the interest paid.[2027]

[2020] Ibid 236.
[2021] Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal Market. COM/2016/026 final – 2016/011 (CNS).
[2022] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 17.
[2023] See citation 267 (Bretton Woods – currency devaluation).
[2024] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 18.
[2025] Parent-Subsidiary Directive Article 3 (1) (a)(i).
[2026] Parent-Subsidiary Directive Article 3(2)(b).
[2027] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 176.

"Arrangement". An ***arrangement*** is any contract, plan or scheme, whether or not enforceable at law, entered into two or more related or unrelated parties. According to the OECD definition, an "arrangement may be part of a wider arrangement, it may be a single arrangement, or it may be comprised of a number of arrangements." [2028] One must not loose sight of the fact that "regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes" [2029] under an objective test,[2030] if the mismatch has been ***priced on arrangement's terms*** [2031] so that it can be established that it was designed to achieve tax optimization (when properly identified as a possible *mismatch generator*) than it may be classified as an mismatched arrangement. Nonetheless, the OECD *Study* on the matter suggests the transaction be adjusted so that the relevant abusive outcome is properly neutralized. The *arrangement test* is an objective one, that is to say, tax authorities are not precluded from classifying a contract as an arrangement even though it has concluded that the parties involved had no intention whatsoever to generated such outcomes. Paraphrasing Lord Denning's ruling in *Newton v Commissione* on tax avoidance arrangements: "*In order to bring the arrangement within the section you must be able to* ***predicate*** *– by looking at the overt acts which it was implemented – that it was implemented in that particular way so as to avoid tax*. (…) *the first question is – "Was there an arrangement? The answer is "Yes". The whole complicated series of transactions must have been the result of the concerted plan; and the nature of the plan is to be ascertained by the overt acts done in pursuance of it*." In sum, by ***predicating*** tax administrations, arbiters or taxpayers should leave all the arrangement's details aside and ask: "Do the facts amount to an arrangement for tax avoidance?"(***Predication Test***). Lord Denning's predication test and the OECD recommendations on structured arrangements are considerably similar, that is to say, both operate under the premise that if a reasonable person can come to the conclusion, given the ***terms, facts and circumstances of the arrangement***, [2032] that a mismatch was

[2028] Ibid 121.
[2029] Ibid 106.
[2030] ibid 106.
[2031] ***Pricing the hybrid mismatch into the terms of the arrangement*** will indicate if parties to an agreement factored into the calculation of the arrangement's economic return an eventual tax benefit. Tax authorities will "dertermine whether the pricing of the arrangement of the transaction is different from what would have been agreed had the mismatch no arisen. This is a legal and factual test" it has as its main purpose the analysis of the arrangement's terms *per se*, risk allocation and ROI under a *contractual analysis*. Under a contractual analysis, tax authorities will assess the parties' assumed risks on the relevant agreement, that is, what was the exact contribution of each party to the operation's risk, and if the pricing under the hybrid is in tune with the arrangement's terms.
[2032] By analysisng the ***terms, facts and circumstances of the arrangement*****, tax authorities** will generally assess the arrangement's terms and risk distribution in order to ascertain each party's contribution and economical liabilities to the operation. Assets, risks and business strategy used by undertakings, the relationship between group members will also be evaluated, in order to determine whether the arrangement was "designed to produce a hybrid mismatch". Moreover, the fact that the arrangement generates commercial benefits should not be deemed as a viable defense to avoid the application of the OECD recommendations, that is, if the arrangement (recognizable to an well informed observer) produces a hybrid mismatch, tax authorities will eventually request some sort of adjustment. Similar to the *functional analysis* employed to ***transfer pricing instances***, tax authorities will assess the exact contribution of company

engineered to produce a certain tax benefit, the arrangement "should be caught by definition regardless of the actual intention or understanding of the taxpayer when entering into an arrangement".[2033]

Nevertheless, tax authorities may not deem a party to an arrangement if that entity has ***no sufficient involvement in the design of the arrangement*** and could ***not, beyond reasonable doubt*** [2034] "***understand how it has been structure and what its tax effects might be***".[2035] The OECD recommendations on neutralizing hybrid mismatch arrangements provides a list of six (non-exaustive) factors "that would lead an objective observer to concluded that the arrangement has been designed to produced a mismatch in tax outcomes" [2036], namely: (***i***) an arrangement designed, or is part of a wider plan to generate a hybrid mismatch; (***ii***) an arrangement that incorporates a term, step or transaction used to create a hybrid mismatch; (***iii***) an arrangement that is marketed as a tax advantage product; (***iv***) an arrangement marketed to taxpayers where the hybrid mismatch occurs; (***v***) an arrangement that alters the terms of the arrangement, namely, return, in case the hybrid is no longer available and finally (***vi***) an arrangement that produces a negative return absent hybrid mismatch.

(i) ***An arrangement designed, or is part of a wider plan to generate a hybrid mismatch.*** The person responsable for engineering the undertaking's tax structure is an essential figure when determining the extent to which the arrangement is part of a wider plan to optimize tax liability. Contracts entered between tax advisors, such as accountants, tax lawyers etc and undertakings, or even oral advices provided by such entities, can be fundamental in determining the awareness of the persons invoved as to the hybrid mismatch (documents, e-mails, contracts, working papers etc are likely to indicate the outcome of a tax structure).

(ii) ***An arrangement that incorporates a term, step or transaction used to create a hybrid mismatch.*** If a taxpayer inserts a term, step, or transaction within its tax structure, and due to the inclusion of such term, step or transaction the outcome of the tax position is optimized by a mismatch, tax authorities are likely to characterized the transaction as an arrangement. Tax administrations will also classify as an arrangement under the scope of OECD recommendation on neutralizing hybrid mismatches, operations that could otherwise be avoided, insofar other "reasonable alternatives that would have achieved the same effect without triggering a mismatch tax outcomes"

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members in relation to applied assets and ROI concerning risk allocation. In other words, a thorough analysis of the terms, facts and circumstances of the arrangement will be conducted. (contractual and factual risk cross-examination in transfer pricing).

[2033] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 106.

[2034] The matter of ***reasonable doubt*** is fundamental not only to litigation but also in administrative procedures, especially in tax law. As previously discussed in several parts of this study, it falls under the taxpayer the burden of proof to convince the relevant authority that no abusive behaviour has been conducted.

[2035] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 106.

[2036] Ibid 107.

were available.[2037] Again, the *arrangement test* is objectively applied, therefore, the fact that the relevant group generated a hybrid mismatch, impose upon tax authorities the duty of requesting the relevant company the transaction be adjusted, so that the mismatch is neutralized.

(iii) ***An arrangement that is marketed as a tax advantage product.*** An arrangement will be considered as a tax advantage product to the extent that the engineer of the scheme signalled the investor the tax benefits that such scheme would produce, for example a DD or a D/NI outcome. Nevertheless, a written (prospect, letter etc), electronic (e-mail) or oral agreement is necessary for such *liaison* be drawn. In sum, the OECD recommendations on the matter expressively refute that tax benefits generated by hybrid mismatch be sold as tax alternative structures.[2038]

(iv) ***An arrangement marketed to taxpayers where the hybrid mismatch occurs.*** Prospects, letters, electronic (e-mail) or oral agreements that offers tax advantage products to investors are discouraged by the OECD recommendations, and eventually will be subjected to some adjustment, nonetheless, the lack of such documentation does not necessarily prevent the application of the structure arrangement rule. Moreover, *the fact that certain agreements create mismatches in some jurisdictions and not in others, do not inhibit the relevant tax authority on acting upon the arrangement*, that is to say, the structured arrangement will fall under the rule regardeless of a written contract, prospect etc, if it produces a tax advantage that would otherwise not be achieved on the absence of such agreement.[2039]

(v) ***An arrangement that alters the terms of the arrangement, namely, economic return, in case the hybrid is no longer available.*** When undertakings enter into cross-border financing arrangements with related or unrelated parties, it is not uncommon that clauses regarding the risk of a possible change on the Country's legal framework in respect to tax law, be included. Such clauses are intented to mitigate the effects of a possible cost increase both from a lender's as well as from a borrower's (bond issuer) perspective. On the one hand, cost adjustable provisions, due to specific risks in relation to taxation, are not necessarily conclusive, that is, they do not irrefutably confirm the parties' intention to achive some sort of tax benefit through the use of a hybrid mismatch structure. On the other hand, if it is established that such clauses were draft to tackle the possible application of a hybrid mismatch rule, tax authories are likely to apply the structure arrangement rule, thus requiring adjustment.

(vi) ***An arrangement that produces a negative return.*** The aim of business enterprises is to generate profits for the benefit of its shareholders, therefore arrangements that lack economic substance, are approached by tax authorities with scepticism to the extent that

[2037] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 108.
[2038] Ibid 109.
[2039] Ibid 109.

undertakings in general, would not enter into agreements that generate "*pre-tax negative returns*".[2040] The main question here is, would an independent enterprise enter into an agreement that is expected to generate loss? As previously mentioned, the fact that a group maintain losses in a certain State for a lond period of time, does not necessarily point out to an abusive behaviour, nevertheless such situations will inevitably "raise a red flag" and eventually be carefully analysed by the relevant authority.

Now that we have briely classified HMAs, it is important to delineate its practical effects. Hybrid Mismatch Arrangements may generate the following outcomes: (***i***) deduction/non-inclusion outcome (D/NI); (***ii***) double-deduction outcome (D/D) and (***iii***) indirect-deduction/non-inclusion outcome (D/NI).

aa. Deduction/non-inclusion income outcome (D/NI)

In order to create such outcomes, namely D/NI, groups generally structure their financial operations [2041] in such a way that differences between the tax treatment in respect to such transaction's, financed with debt and equity, are exploited, that is to say, the most "tax-efficient mixture of debt and equity in borrowing countries" is achieved, therefore, enabling such untertakings to optimize tax liability of all parties involved. [2042] In sum, such outcome may result in ***tax exemption*** (not including the received payment as <u>*ordinary income*</u> produces tax neutrality as far as hybrid financial instruments are concerned - ***NI***), ***low taxation*** (the tax authoritye where the payee resides may grant a partial exemption or reduced tax rate in respect of payments made under hybrid financial instruments)[2043] or alternatively a ***deduction*** (treating the payment made out by the relevant undertaking as an expense allows such undertaking to "take the payment into account when calculating its taxable income" - ***D***).[2044]

Substitute Payments (SP). Such class of payments have the purpose, as the name suggests, to "substitute payments" that would otherwise be due under the relevant transaction, for example, if during a *share lending agreement*, the

[2040] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 110.
[2041] Arrangements for supply of services such as lease or licencing agreements, non-financial risk assumptions – insurance – or asset transfers that do not incorporate the received payments of a ***financial return*** (agreement structured to provide the relevant entity a return for the time value of money – anything that has exchangeable price/value) ***or equity return*** (calculating the amount of the entitiy's return on equity investment, in order to ascertain whether the entities are in the same control group, ultimately influencing the the operation's tax liability, for instance, dividend distribution within companies of the same group may be tax exempt if rule of control is satisfied), <u>***do not fall under the hybrid financial instrument rule***</u>. ***Transfer of assets*** that do not result in a financial or equity return, do not fall under the category of Hybrid, even though it produces a D/NI outcome, for instance, an asset sale's agreement itself (where the share transfer occurs on the same day of payment), although it results in D/NI outcome (the purchaser may calculate losses or gains at the disposal of such shares against its income), the operation itself does not "provide for a financing or equity return", that is to say, it "does not produce a return that is economically equivalent to interest, as the *exchange of the value occurs on the same day*, and it does not provide any party with an entitlement to an equity return". Ibid 244.
[2042] Thin Capitalization Legislation (n 673) 3.
[2043] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 31.
[2044] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 27.

borrower of the shares receives dividends, such company is expected to pay the lender of those shares a ***substitute payment*** (manufacture dividends), which ultimately will be deducted against the borrower's profits. Substitute payments are likely to give rise to D/NI outcomes, that is to say, the payment is not included as ordinary income by the lender (exempt dividends), and will be used by the other company as a deductible expense. Recommendation 1.2 of the OECD's Final Report on the effects of Hybrid Missmatch Arrangement, suggests tax authorities to implement in such events, the so called "***Substitutive Payment Rule***" (*defensive rule*) which has the ultimate purpose to neutralize D/NI outcomes by imposing upon the payee the obligation to adjust such payment by including it as ordinary income, thus liable to taxation.[2045]

Hybrid Transfers (HT). Hybrid transfers explore differences on the treatment of ownership of two or more jurisdiction in respect to a certain asset, for instance, two undertakings may enter into an agreement where one undertaking will transfer a number of shares to the other undertaking in exchange for cash (finance) under a sale and repurchase agreement (repo), that is, the transferor will re-buy the shares at a future date. Under the transferor's jurisdiction, the ownership of such shares remain with that company, that is, the shares serves only as collateral for the loan, on the other hand, the transferee's jurisdiction treats such arrangement as a "payment under a financial instrument". In other words, payments made by that company under the financial instrument will be considered as "interest", therefore deductible.[2046] Note that the company party to the transaction, was able to deducted the payment made to the other company in its jurisdiction, and the amount received was not comprised as income, therefore not taxed. Such arrangement was engineered to generate a mismatch for taxation purposes. We will present two schemes ultimately resulting in HT, namely, ***loan agreement under repo*** and ***share lending arrangements***.

Loan agreement under share repo. Company A whishes to expand its operations and therefore needs capital. In order to raise capital it enters into a loan structured repo with an independent undertaking resident of another MS (Company B). Company A then proceeds to establish a Special Purpose Vehicle (SPV) (*Zweckgesellschaft*) by transferring assests to such entity. The assests are still managed by Company A. [2047] Company A transfers an amount of its shares to Company B (***repo agreement***) in exchange for cash (finance). At a later date, Company B, the temporary holder of such shares will receive dividends paid by the SPV (the income earned by the SPV – interest on bonds, for instance – which

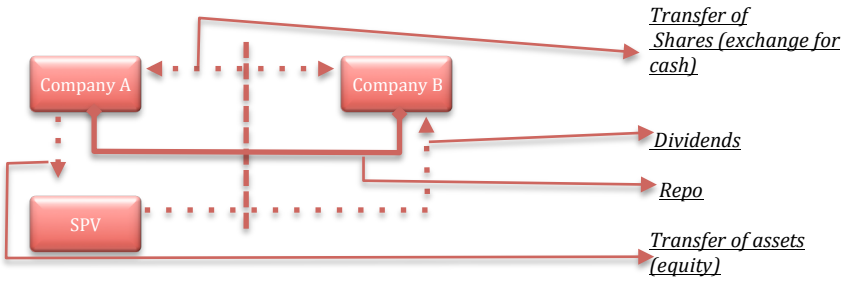
[2045] Ibid 38.

[2046] Ibid 38.

[2047] ***Special Purpose Entities*** or ***Special Purpose Vehicles (SPV)*** are generally used by MNEs in order to isolate risk due to the operation's complexity, for instance, undertakings that require certain licences or permits (construction industry), may opt to separate from the parent company such risks by creating a SPV (managing assets related to the construction industry – builders – are substantially complex, and separating those assets accounting from the parent company makes it easier for MNEs to keep track of income and expenses related to such undertaking). Moreover, if the relevant MNE opts for selling the assets at a future date, there would be no need to transfer the permit (if any) from the parent company to the purchaser, that is, the fact that the permit was already granted to the SPV simplifies a potentially difficult sale. Nontheless, SPV have also been used by MNEs to hide debt, therefore maintaining a healthier financial statement (Enron).

will be retained as payment and reduced from Company A's agreement with Company B). Under the ***repo*** (repurchase agreement), Company B agrees to sell back those shares back to Company A at a future date for an agreed price that represents a financing return *minus* any dividend distribution received during the ***repo***.[2048] The scheme bellow demonstrates in a more bluntly manner a ***loan structure under repo share.***

Figure 51



Under the laws of the resident MS, such arrangement is treated as a sale and purchase agreement (*Kaufvertrag*) therefore the shares are deemed as Company B's property. When the SPV transfers dividends to Company B, the source MS will tax such dividend distribution. Nevertheles, the resident MS operates under an integration/imputation system of taxation and will grant Company B the benefit of an underlying (indirect) foreign tax credit (FTC), which will be offset against Company B's *CIT* (alternatively it could also exempt such dividends from tax). However, under the laws of the source MS the arrangement is treated as a loan agreement, therefore the SPV shares are still considered Company A's property and the dividends paid to Company B will be treated as a "deductible financing expense" at the source MS.[2049] Again, during the time of the *repo*, the resident MS may either exempt the dividends received from the SPV, or, alternatively grant an underlying (indirect) tax credit for the tax paid by the SPV upon distribution.

Now consider the same example numerically, Company B paid 10.000 euros for such shares at a rate of 5% for a period of one year. Under the *repo* agreement, Company A would have to re-buy such shares 10.500 euros at the end of the first year. However, Company B received anticipated dividends as monetary compensation for the transaction on the amount of 500 euros (therefore matching the contractual remuneration under the repo). Under the *integration/imputation system*,[2050] the profits that gave rise to such dividends were taxed at the source, and credited. At the contract's maturity, Company A willl re-purchase such shares (10.000 euros – ***net paying repo***). Considering that the *CIT* at the source MS is 25%, the transaction's accounting would be the following:

[2048] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 256.
[2049] Ibid 257.
[2050] Under the present example, the resident MS operates under an imputation system of taxation. As we have previously studied, the CIT paid by Company A may be either deducted or credited, due to taxation upon distribution. One must not loose sight of the fact that integration systems of taxation generally have higher withholding taxes upon profit distribution in order to avoid loosing revenue (shareholders may not fully inform the received dividends) and to prevent loosing revenue on dividends paid internationally.

Company A				Company B		
		Tax	Book		Tax	Book
Income				**Income**		
Dividend		500	500	Dividend	0	500
Gross up Tax		200	0			
Expenditure				**Expenditure**		
repo		(500)	(500)			
Net Return			0	**Net Return**		500
Taxable income		200[2051]		Taxable income	0	
	Tax (25%) net income	(50)				
	Tax credit	200				
Tax benefit			150	Tax liability		0
After-tax return			150	**After-tax return**		500

The gross up tax credit of 200 euros relates to the SPV's CIT (tax credit), that is to say, the source MS will grant a tax credit over such profits in order to avoid double taxation (remember, the SPV is a profitable and fully-owned SPV of Company A, and is also taxed on its profits, transferred at a later date to its parent company, considering that the MS operates under an integration/imputation system of taxation). In order to enhace the possibility of a more intuitive understanding of such operation, we have organized in the table bellow the operation steps as well as the tax benefits of both parties involved to the *Loan share repo agreement*.

Loan agreement under share repo (net paying repo)	
Company A (MS A) – Source MS	***Company B (MS B) – Resident MS***
vi. Establishes a SPV and proceeds to transfer assests to that new formed entity (assets remain under management of Company A); vii. Transfers a number of shares to Company B in exchange for cash (finance) under ***repo*** (repurchase agreement); viii. Transfer dividends from the SPV to Company B as part of remuneration for the transaction; ix. Dividend retained by Company B is treated as a deductible expense for Company A's tax	xiii. Receives shares of Company A in exchange for cash (finance) under ***repo*** (repurchase agreement); xiv. Receives dividends from the SPV as well as a FTC in respect to the tax paid upon dividend distribution at the *resident MS*, deductible against its CIT; ***xv. Transation treated as a sales and purchase agreement;*** *xvi. Dividends not included as income (thus not taxed);*

[2051] SPV earned income, and transferred to its parent company, for instance.

liability; x. Shares treated as loan's collateral; ***xi. Transaction characterized as a loan agreement (debt);*** ***xii.*** *Dividends treated as a deductible expense;*	

According to the OECD study on the matter, such scheme is characterized as a ***hybrid transfer*** **(HT)** due to the differences between the treatment of the share transfer, that is to say, under the laws of MS A, the shares are treated as collateral for the loan (property of Company A), whereas the other jurisdiction of treats Company B as the owner of such shares, even though it will at a late date transfer the shars back to Company A (***repo***). The *payment under the repo* agreement falls under the definition of a hybrid financial instrument within the meaning of the rule. The scheme gave rise to a D/NI outcome, for the payment made by Company A is a ***deductible*** expense whereas ***not taxed*** at the resident MS, that is, not included as ordinary income (exempted or credited). It is important to point out that, even though the parties to such agreement are independent undertakings, ***the arrangement was able to reduce Company A's financing costs (lower financing rate) by exploring mismatch possibilities in tax treatments on both MS.***

Recommended OECD solution to ***net paying repo****.* Deny deduction in respect to such financing expenses (dividends) at the source MS ***or*** include the received payment as ordinary income therefore liable to tax at the resident MS.[2052]

*Share lending arrangement*s are also structured under ***repo*** arrangements, that is, Company A transfers a number of shares to its associated Company B that will proceed to sell (short) such shares in the open market. Company B (borrower) anticipated that it will purchase back the shares from the third-party for a lower price, therefore profiting from the operation. During the time of the ***repo***, if Company A (lender) pay dividends on its shares, Company B will proceed transfer such dividends to Company A (manufacturing dividends), which ultimately, are exempt from tax. However, since Company B will proceed to sell Company A's shares (even though it has the contractual obligation to re-sell such shares at a later date to Company A – ***repo***), Company A is likely to require Company B to provide some sort of "investment grade debt securities."[2053] Upon the operation's maturity, Company A will pay "both the collateral and the interest earned on such collateral" to Company B minus a fee.[2054] Company B's intention is to sell the borrowed shares at a higher price, and at a later date, buy those shares back at a lower price, therefore realizing (taxable) profits. The ***manufactured payment*** (*substitute payment*) made by Company B is *deductible* at the source MS, and *exempt* at the resident MS (Company A). As in the *loan agreement under repo* (previous example), the resident MS treats Company A as

[2052] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 260.
[2053] ***Investment Grade Debt Securities*** are debt instruments (bonds, MCNs, debentures etc) rated by credit rating agencies such as Moody's, Standard & Poors's and Fitch which assess the financial health of undertakings and governments, and consequently their ability to pay its debt.
[2054] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 262.

the holder of such shares, therefore disregarding such transfer, and ultimately exempting the *manufactured dividends* (non-inclusion *NI* outcome). On the other hand, Company B will offset the manufacture dividends paid out to Company B against its profits (at the source, the manufactured payment is treated as losses, thus deductible). Such scheme falls under the category of a ***hybrid transfer*** (under Company A's jurisdiction, the shares are treated as property of Company A, whereas in Company B's jurisdiction treated as a financial instrument). Moreover, the scheme also produces a ***D/NI outcome***, for the manufacture dividends received by Company A are not included as ordinary income, and Company B is able to offset the manufactured dividends against its profits. In instances such as these, tax authorities are likely to subject the arrangement to some sort of adjustment, either by including the dividends as ordinary income or deny denying deduction.

Recommended OECD solution to ***share lending arrangements****.* Deny deduction in respect to the *manufactured dividends* (substitute payments) at the source MS ***or*** include the received dividends as ordinary income therefore liable to tax at the resident MS.[2055]

Denying deduction or applying the "***defensive rule***" by including such income as ordinary income in the payee jurisdiction, are both possible hybrid neutralization solutions suggested by the OECD report on the matter.[2056]

ab. Double-deduction outcome (DD)

Double deductions instances may occur when cross-border payments conducted by hybrid entities, foreign branches or dual residens are included as an expense in more than one jurisdiction, that is to say, the same payment (service payments, rents, royalties, interest etc)[2057] used by an undertaking resident of a certain MS is also used by another undertaking of the same group resident of another MS. According to the OECD report on Hybrid Missmatch Arrangements, payments may generate D/D outcomes when: (a) the expense is taken into account when calculating the relevant taxpayer's tax liability under two or more jurisdictions, ***or*** when (b) payments conducted by hybrid entities are treated as deductible expenses in transparent undertakings, such as partnerships (opacity exploitation).[2058]

DD against dual included income. If a deduction surpasses the amount of dual inclusion income, the excess may be set off against dual includion income in another period. The OECD report of hybrid mismatches suggests that "in order to prevent stranded losses, the excess deduction may be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the excess deduction in the other jurisdiction cannot be set-off against any income of any person under the laws of the other jurisdiction that is not dual inclusion income".[2059] ***The item should be treated as dual inclusion income if there is a***

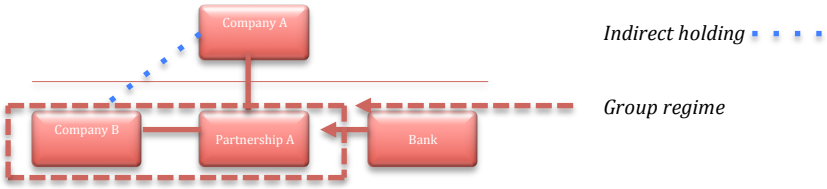
[2055] Ibid 265.
[2056] Ibid 17.
[2057] Ibid 69.
[2058] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 68.
[2059] Ibid 67.

difference in treatment under the laws of both jurisdictions. It is important to note that DT relief "such as a domestic dividens exemption granted by the payer jurisdiction or a foreign tax credit granted by the payee / parent jurisdiction should not prevent an item from being treated as dual inclusion income where the effect of such relief to avoid subjecting that item to an additional layer of taxation in either jurisdiction". In other words, while the payment can be acknowledged as ordinary income under the laws of both States "before it can be treated as dual inclusion income and equity return should still qualify as dual inclusion income if the payment is subject to an exemption, exclusion, credit of other type of double taxation relief in the taxpayer or parent jurisdiction that relieves the payment from economic double taxation".[2060]

Double deductions may also be used by undertakings in order to neutralize tax liability in different jurisdictions by deducting from profits the same expense in different countries. Bellow we will present two examples of DD instances, namely, *double deductions with a hybrid entity*[2061] and *double deductions with dual resident entities*.[2062]

DD with hybrid entities. Double deductions of expenses with hybrid entities are tax schemes used by MNEs where companies of the same group are able to reduce their tax liability by allocating a certain expense in more than one undertaking. Such result is reached through the use of hybrid entities. For that matter, we will present a short example. Company A owns all shares Partnership A resident in another MS, which in turn own all shares of Company B also resident of the same MS. Therefore, Company A holds and manages indirectly Company B. Company B is in need of capital in order to expand its operations in that country, and instead of contracting a loan with a financial institution itself, the company's board contacts such loan through Partnership A.

Figure 52



Under the laws of the source MS, the partnership is treated as a non-transparent entity, therefore liable to tax, whereas in the resident MS, the entity is treated as a transparent, thus not liable to taxation. If Partnership A ***has other sources of income***, the interest paid to the third party (bank), will be offset against its profits. If the Partnership ***has no other source of income***, the deduction will be offset against the group's tax liability in that country. Either way, since Company A fully-owns Partnership A, Company A will also offset the interest paid by its partnership against its tax liability (considering that under the laws of the resident MS, Partnership A is a transparent entity for tax purposes), therefore, generating a DD outcome. The *OECD report* on the matter suggests the resident country to "prevent A Co from claiming any net loss from

[2060] ibid 71.
[2061] Hybrid Mismatch Arrangements (n 1893) 8.
[2062] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 336.

the partnership" (interest), alternatively, the source MS could also "restrict the ability of the partnership to surrender the benefit of any resulting net loss under Country's B tax grouping regime".[2063] Under Union Law, Article 4(1) Interest and Royalty Directive provides the so called *exclusion catalogue*, which excludes from the benefits of the directive hybrid tax structures. Nonetheless, if the relevant MS denies the deduction of the expense (interest) based on Article's 4(1) (*exclusion catalogue*), undertakings could still be covered by the Parent-Subsidiary Directive. According to *Gijsbert Karel Fibbe*, the diferencial treatment given by two or more MSs in respect transparent entities, should not influence or prevent the Directive's applicability *per se*. In fact, the author argues that either for ***outbound*** as well as for ***inbound payments***, the Directive should irrespectively be applied.[2064] Nevertheless, one must not loose sight of the fact that the last amendemend to the Directive expressively forbids Member States granting its benefits to "an arrangement or a series of arrangements, which having put into place for the main purposes of obtaining a tax advantage that defeats the objective or purpose of this Directive, are not genuine having regard to ***all relevant facts and circumstances***" (emphasis added). In sum, tax jurisdictions must be attentive and act to tackle tax structures and arrangements "which are not genuine, that is, which do not reflect the economic reality" of the transaction.[2065] Nevertheless, the non-extension of the Directive's benefits must match fundamental principles of EU Law (proportionality, non-discrimination, legal certainty etc).

DD with double or dual residency entities. Double or dual residency entities are companies that are treated as residends in more than one jurisdiction. Double residency entities may structure their tax schemes in order to reach DD outcomes. Consider the following example. A certain undertaking (C *A*), holds all shares of a Subsidiary located in another MS. Such Subsidiary wishes to buy the shares of another Company resident of the same MS (C *B*). It is important to remember that, subsidiaries maintain a status of independency in relation to its parent company (contraty to PEs which are intimately connected to its parent company, making the parent company legally and fiscally exposed in that MS). The relevant company operates under a cross-border group consolidation regime. Within the Common Market only a limited number of MS allow group consolidation regimes, namely, Austria, Denmark, France and Italy. Moreover, cross-border group consolidation is an one-way road, that is, a subsidiary resident in a MS may surrender losses to its parent company resident of another MS, but not the other way around. Subsidiary *A* then proceeds to enter into a loan contract with a third party, a bank resident of the same MS. The amount is

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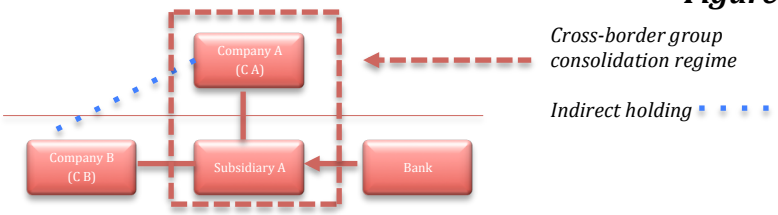
[2063] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 335.

[2064] "For ***outbound*** situations, Article 4, paragraph 1a, of the amended Parent-Subsidiary Directive specifies that Members States should refrain from taxing profits distributed by a hybrid subsidiary. Furthermore, the Member State where the parent company is situated should either exempt the profits of its subsidiary as they arise or authorize the parent company to deduct from the amount of tax due that fraction of the corporate tax related to those profits and paid by its subsidiary (and lower-tier subsidiary)." The author recognizes that the Directive should also be applied to ***inbound payments***, according to the Article 1 and 5 of the Parent-subsidiary Directive. Gijsbert Karel Fibbe. *EC Law Aspects of Hybrid Entities*. Doctoral Series. IBDF (2009). 302.

[2065] Council Directive (EU) 2015/121 of 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.

subsequently injected in the form of equity into C *B.* In other words, Subsidiary A purchases all of C *B*'s shares. The interest of such loan is deducted at resident MS (C *A*) as well as the source MS (C *B*). Subsidiary A generates no income.[2066] By purchasing C *B*'s shares (profitable undertaking) Subsidiary A gains full control of C *B's* operation ***directly***. Company A (C *A*) now ***holds indirectly*** (for indirect holding calculations see CFC) all shares of Company B (C *B*). Company B is ***opaque*** under the laws of MS A but ***disregarded*** under MS B's legislation.

Figure 53



In this case, the concept of a "***hybrid payer***"[2067] or "***hybrid payments***" emerges, that is to say, C *A* the holder of Subsidiary *A*'s shares, deducts against its profits the interest paid by its Subsidiary, and since Subsidiary *A* has no income or expenses, the interest is deducted against Company *B*'s profits. Here, the figure of the "***reverse hybrid entity***" is also arises. At the beginning of this chapter we classified hybrid entities as entities that are treated differently in respect to its opacity. In other words, if an entity is disregarded or transparent for tax purposes according to the law of the resident MS (MS *A*), but nevertheless subjected CIT in the other MS (MS *B*), such entity is classified as a *hybrid entity* (transparent in the ***numerator*** and non-transparent in the ***denominator***).

$$\frac{Transparent}{Non-transparent} = Hybrid\ Entity$$

On the other hand, if the entity is treated as non-transparent under to the law of the resident MS (MS *A*), thus liable to tax, and disregarded under the law of the source MS (MS *B*), thus not liable to tax, such entity is classified by the doctrine as a "*reverse hybrid entity*" (non-transparent in the ***numerator*** and transparent in the ***denominator***).

$$\frac{Non-transparent}{Transparent} = Reverse\ Hybrid\ Entity$$

Back to our example, Company B (C *B*), bought by Subsidiary *A*, is disregarded under the law of MS B, therefore, all income generated by the

[2066] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 336.

[2067] According to the OECD final report on Hybrid Missmatch Arrangemets, a ***person*** will be classified as a hybrid payer if: "(a) not a resident of the payer jurisdiction and the payment triggers a duplicate deduction for that payer (or related person) under the laws of the jurisdiction where the payer is resident (the parent jurisdiction); or (b) the payer is resident in the payer jurisdiction and the payment triggers a duplicate deduction for an investor in that payer (or a related person) under the laws of the other jurisdiction (the parent jurisdiction)." Ibid 67.

reverse hybrid will be treated as derived by Subsidiary A.[2068] Now consider the example numerically. Within the relevant fiscal year, the operating income of Company A (C *A*) was 400 and the interest paid by Subsidiary A to the financial institution resident in the other MS amounts to 100. The operating income Company B (C *B*) is 200. Subsidiary A has no income or any other expenditure.

MS A Company A			MS B Consolidation Regime (C *A* and C *B*)		
	Tax	Book		Tax	Book
Income			**Income**		
Operating Income	400	400	Operating Income	200	200
Expenditure			**Expenditure**		
Interest paid by Sub A (consolidation regime)	(100)	-	Interest paid by Sub A (consolidation regime)	(100)	(100)
Net Return		400	**Net Return**		100
Taxable income	300		Taxable income	100	

Note that Company A was able to reduce its tax liability in both MSs with the same expense, that is to say, Company A deducted 100 from its profits, thus reducing its tax liability (taxable income) to 300, and Company B also reduced its tax liability in the other MS from 200 to 100 (DD outcome). Nevertheless, under the Interest and Royalty Directive, the scheme structured by Company A (C *A*), would prevent the Company A from benefiting from the Directive's exemption, due to the fact that Company *A* has ***indirect control***[2069] over Company B's shares, moreover, the same Directive (contrary to the Parent-Subsidiary Directive's rule of control – 10%) provides for a minimum of 25% threshold, in order to be eligible for an exemption or credit relief, although the example above provides that Subsidiary *A* has full control of Company B. If we were to substitute Subsidiary A for a ***partnership***, Company A would still not be able to benefit from the Directive's exemption, for it would still maintain an indirect control of Company B's shares. Moreover, as previously mentioned Article 4 Interest and Royalty Directive, provides for an exclusion catalogue, excluding thus HMAs from its benefits.

Recommended OECD solution to ***double residency exploitation****.* Deny the duplicated deduction by applying the "*dual resident payer rule*" either at the source State or at the resident jurisdiction.

[2068] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 337.

[2069] "Article 3. For the purposes of this Directive: (b) a company is an 'associated company' of a second company if, at least: (i) the first company has a ***direct minimum holding*** of 25% in the capital of the second company, or (ii) the second company has a ***direct minimum holding*** of 25% in the capital of the first company, or (iii) a third company has a ***direct minimum holding*** of 25% both in the capital of the first and in the capital of the second company." Interest and Royalty Directve Article 3(b) (i)(ii)(iii).

The *dual resident payer rule* may restrict deductions either at the resident MS (parent company) or at the source MS, that is, the undertaking would be stuck (*stranded*) with the expense without being able to offset such losses against its profits. ***Stranded losses*** are "expenses" that were not deducted neither at the parent company's level nor at the associated company's level. The OECD report on hybrids mismatches makes reference to instances where the operating income of Company B (source MS) was not able to absorb all expenses in respect to the loan contracted with the financial institution (due to net loss position, for example).[2070] In this case, tax administrations may allow such deductions to be carried-forward and set-off against ***non-dual income*** [2071] (or carried-back according to the relevant legislation) as long as "the taxpayer can establish that the deduction in the other jurisdiction cannot be offset against any income that is not dual inclusion income."[2072]

ac. Indirect-deduction/non-inclusion outcome (D/NI)

Indirect-D/NI outcomes are the result of tax structures operating between "two or more jurisdictions ***without effective hybrid mismatch rules***"[2073] in such a way that the group is able to ***import or shift***, the effects of the mismatch into a ***third jurisdiction***. According to the OECD report, imported mismatch payment is an imported mismatched *deductible payment* that ultimately is not included as regular income due to the fact that the other jurisdiction *do not apply hybrid mismatch rules that could eventually neutralize the arrangement*,[2074] that is, "a payment made to a payee that is not subject to hybrid mismatch rules."[2075] Such arrangements are likely to generate D/NI outcomes where the relevant undertaking resident of a third jurisdiction deducts (D) the payment against its profits (expense), and alternatively, the payment is not included (NI) as ordinary income in the other jurisdiction due to:

1) Differences of opacity (***hybrid entity*** *or* ***hybrid payer***);
2) Differences on the treatment of financing instruments consequently resulting in a hybrid mismatch (***debt x equity***),
3) Payments conducted to reverse hybrid that generate a hybrid mismatch to the extent that such payment is not included as ordinary income in the payee jurisdiction[2076] (***reverse hybrid***) and finally,
4) Payments that generate DD outcomes (***hybrid payer*** or ***dual resident payer***).

Later in this topic, we will also discuss the difficulties in ascertaining which company should be considered "***payee***" or "***payer***" within the relevant HMA (to

[2070] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 73.
[2071] When the same item is included for more than one undertaking as income, that is, both under the payee and the payer's jurisdictions, such income is classified by the OECD Report as ***dual income***. Ibid 51.
[2072] Ibid 73.
[2073] ibid 17.
[2074] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 83.
[2075] Ibid 83.
[2076] Ibid 55.

neutralize the mismatch, jursidictions necessarily will have to classify how the foreign entity is treated by the other jurisdiction in order to identify the *payer* and the *payee*). *Imported Mismatch Arrangements* (IMAs) are highly dependent on the non-implementation of the full set of recommendations provided by the OECD report,[2077] in other words, jurisdictions that fully comply with the OECD recommendations on the matter will certainly subject the arrangement to some sort of economical adjustment in order to neutralize its abusive outcomes (D/NI or DD). Under imported mismatched arrangements, deductions are generated under three main instances and ultimately neutralized according to its own applicable rule, namely***, i. structured imported mismatch arrangement (rule)***, ***ii. direct imported mismatch (rule)*** and ***iii. indirect imported mismatsch (rule)***. Tax authorities and taxpayers alike should apply such rules in the order in which they were presented.

i. *Structured Imported Mismatch Arrangements.* According to the OECD report, if a deductution is generated under a structured arrangement, juridisctions applying OECD recommendations will treat such deduction as giving rise to an imported mismatch to the extent that such deduction "*is funded out of the payments made under that structured arrangement*".[2078] As we shall study bellow, if it was established that the dedcutions was generated under a structured arrangement, it is necessary to identify all "steps and transactions that form part of the same arrangement and to identify whether the tax payer has made a deductible payment under that arrangement that has been set-off (directly or indirectly) against that hybrid deduction." [2079]

ii. *Direct Imported Hybrid Mismatch Deductions.* According to the OECD report, a direct imported mismatch deduction must be totalled under an ***apportionment approach***, that is to say, by computing the total amount of the taxpayer's hybrid deductions under the group (direct and indirect hybrid deductions) to the total amount of imported mismatch payments made to other group members in other jurisdictions. Therefore it treats each imported mismatch payment as being set-off against those hybrid deductions in accordance with that ratio.[2080] The OECD report, provide to tax authorities and tax managers alike a set of "simple" rules intended to indentify and tackle such mismatches, namely:

(i) Determine whether the group generated a *hybrid deduction*[2081] (such deductions are divided by the OECD report as "*direct hybrid deductions*" and "*indirect hybrid deductions*".[2082] If the deduction is generated through the use of hybrid entities, the deduction is classified as a "*direct hybrid deduction*."[2083] If the deduction generated

[2077] Ibid 84.
[2078] Ibid 84.
[2079] Ibid 87.
[2080] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 88.
[2081] ***Hybrid Deduction*** is a deduction generated under a hybrid structure, whether direct or indirect.
[2082] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 85.
[2083] Ibid 85.

under a hybrid is ultimately surrendered to other group members or "arise as a consequence of making taxable payments to a group member with surplus hybrid dedcutions", the deduction is classified by the OECD report as "*indirect hybrid deductions*";[2084]

(ii) If the assessment pointed out to the existence of a hybrid deduction, such deduction should be offset (whether a direct or an indirect deduction) against the hybrid mismatched deductions generated under the relevant arrangement;

(iii) Under an "*apportionment approach*" that calculates the total amount deducted under the arrangement (including any indirect hybrid deductions), the deductions "should be treated as directly (pro-rata) against imported mismatch payments" conducted by the group's undertaking;[2085]

(iv) Finally, if not neutralized, any remaining hybrid deductions that are not set-off against the relevant arrangement or "direct imported mismatch rules"[2086] will be treated as "***surplus hybrid deductions***" and placed under the *indirect imported mismatch rules*".[2087]

iii. *Indirect Imported Hybrid Mismatch Deductions* (*waterfall approach*). Indirect imported mismatches serves as an equalizer to unneutralized hybrid deductions under the relevant structured imported arrangement, to the extend that the indirect mismatch was neither *fully*[2088] neutralized under the general (1) ***structured imported mismatch rule*** nor under the (2) ***direct imported mismatch rule***. Although tax authorities may be able to eliminate some artificial deductions generated by undertakings operating within a certain group under both rules, if there is a surplus of hybrid deduction in the relevant tax structure, the complete neutralization of such abusive deductions are only achieved under the (3) ***indirect imported hybrid mismatch rule***, that is to say, by surrendering such surplus to another group member. Such rule dictates that, in order to ascertain if a "surplus hybrid deduction should be allocated to another group member under the indirect imported mismatch rule" [2089] the relevant tax authority, or taxpayer, should apply a "tracing methodology to match the taxpayer's surplus hybrid dedutions with imported mismatch payment within the group". If the ***Funded Taxable Payments***[2090] surpasses the amount of the payee's surplus hybrid deduction, the surplus must be set-off against the funded taxable payments according to a pro-rata approach.[2091]

Surplus Hybrid Deduction

Sum of the group's direct and indirect deductions ***NOT*** *neutralized under the* ***Structured Imported Mismatch Rule*** *or* ***Direct Imported Mismatch Rule****.*

Nevertheless, it is important to ensure that the same hybrid deduction is not being offset

[2084] Ibid 86.
[2085] Ibid 88.
[2086] Ibid 88.
[2087] Ibid 88.
[2088] Ibid 88.
[2089] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 88.
[2090] ***Funded Taxable Payments*** "is any taxable payment that is directly funded out of imported mismatch payments made by other group entities" Ibid 89.
[2091] Ibid 89.

against an "imported mismatch payment under the laws of more than one jurisdiction". The OECD recommendation on neutralizing hybrid mismatches, provide a set of steps intended to indentify and neutralize remaining mismatches, namely:

(i) Determine whether the group generated a *surplus hybrid deduction*. In other words, the deduction excess was not neutralized under the *structure imported mismatch rule* and alternatively, the *direct imported mismatch rule*;

(ii) Apply the so called "*waterfall approach*" under the tracing methodology "that starts with the imported mismatch payment in one jurisdiction and follows the path of payments under the structured arrangement, through the interconnected entities and payments that make up the arrangement to identify whether the imported mismatch payment has directly or indirectly funded expenditure that gives rise to a hybrid deduction"[2092] in order to surrender the deduction surplus to other group members;

(iii) Them apply the "direct imported mismatch rules and treat those hybrid deductions as set-off agasint any mportesd mismatch paymemts received from other group members",[2093] and lastly;

(iv) If the mismatch in tax outcomes is addressed, both group members will not have a hybrid deduction after the direct imported mismatch rule is applied. [2094]

To conclude, in order to neutralize intra-group mismatches without giving rise to DT, tax authorities, tax managers etc, should apply first direct and then indirect imported mismatch rules. It is important to keep in mind that not all hybrid mismatch arrangements (HMAs) entered into between two group members have as its main purpose sheltering "income of any taxpayer other than the immediate parties to the arrangement", however all HMAs have the "net effect of lowering the aggregate tax burden of the group and the combination of intra-group payment flows and the fungible nature of income and expenses for tax purposes can make it difficult, ***if not impossible***, to determine which taxpayer in the group has derived a tax advantage under a hybrid mismatch arrangement"[2095] (emphasis added).

ad. *"Follow the white rabbit".* Apportionment rule under a payments' tracing approach (nexus between hybrid deductions and imported mismatch payments)

By following the payments made throught associated companies, one is able to ascertain whether there is a "nexus between the imported mismatch payment and the hybrid deduction."[2096] Such approach must be employed in

[2092] Ibid 86.
[2093] Ibid 89.
[2094] Ibid 89.
[2095] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 87.
[2096] Ibid 86.

respect to imported mismatched instances in order to "indentify whether the imported mismatch payment has ***directly*** or ***indirectly*** funded expenditure that gives rise to a hybrid deduction" [2097] (emphasis added). By following the payments made under the arrangement, tax authorities will be able to compute the total aggregated amount of hybrid deductions within the relevant tax structure (tracing and apportioning). The payment's path should start from the imported mismatch payment, make its way through the chain of transactions till its reaches the initial hybrid financial instrument that gave rise to the first direct hybrid deduction (***funder***). The OECD report suggests that the importing jurisdiction is ultimately the more appropriate taxable jurisdiction, for it is in that particular country, where the invested capital will generate taxable income. Therefore, allowing intermediary (associated) undertakings to apply deductions generated by companies that served only as "***conduit companies***" would certainly, or at least should, fall under the category of abusive behaviour. Therefore transactions that generate such outcomes are likely to be adjusted by the relevant tax jurisdiction, provided that the OECD recommendations are implemented.

Neutralization rules (payments' economic adjustment). If after assessing the relevant payment/loan structure, it was established that the group benefited from a direct or indirect hybrid deduction under a hybrid structure (tracing approach), the OECD report suggests tax jurisdictions to neutralize its effects according to three rules, which should be applied in the following order: (***i***) *structured imported mismatch rule*, (***ii***) *direct imported mismatch rule* and lastly (***iii***) *the indirect imported mismatch rule.*

d. Imported Mismatch Arrangements (IMA)

Imported mismatch arrangements, as previously mentioned, are structures created under the laws of two or more jurisdictions with the ultimate result to shift "the effect of an offshore hybrid mismatch into the domestic jurisdiction through the use of a non-hybrid instrument such as an ordinary loan",[2098] therefore importing the effects of a mismatch into a third jurisdiction. By applying the recommendations of the OECD report on neutralizing HMAs, jurisdictions ultimately prevent the imported deduction in respect to a "broad range of payments (including interest, royalties, rents and payments for services)",[2099] nonetheless "payments that are only deemed to be made for tax purposes and that do not involve the change of any economic rights between the parties", and payments that do "not generally include amounts that are treated as consideration for the disposal of an asset"[2100] are not included on such list. In order to tackle the effects of such arrangements, the OECD report on the matter suggests the application of the "***structured imported mismatch rule***" due to its broad functionality, extending its applicability even to non-intra-group payments (third parties). The ultimate function of the rule is to neutralize the effects of the arrangement, namely, D/NI and DD outcomes. Nevertheless, as a practical note,

[2097] Ibid 87.
[2098] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 83.
[2099] Ibid 83.
[2100] Ibid 85.

it falls under the taxpayer's the burden of proving whether the imported mismatch rule has been followed.[2101]

Classifying all types of financial instruments that eventually may result in some sort of revenue loss for the State is not the main objective of this study, moreover, due to the variety of such instruments it is unfeasible as well as impractical listing all situations where payments under a certain instrument (derivative contract, for example) result in a hybrid mismatch ("the definition of a financial instrument (…) must ultimately be left to each jurisdiction").[2102] A better and more pragmatic approach would be to identify some of the possible disparities in respect to tax outcomes (DD, D/NI or indirect-D/NI) and ultimately analyse whether such mismatches were caused by differences between *source* and *resident* legal frameworks. In sum, we will cover the four categories of HMAs and, namely: (*i*) ***Hybrid Financial Instruments***; (*ii*) ***Hybrid Financial Transfers*** (repo); (*iii*) ***Hybrid Entity Payments***, and (*iv*) ***Imported Mismatches and Reverse Hybrids***. Concomitantly, we will present some examples in order to improve the "*intuitive understanding of a functional relationship*".[2103] For that matter, it is important that some hybrid structures be explained in more detail in order to avoid a too abstract approach to an already challenging subject at best. By following the ***priority rule***, beginning from the ***structured imported mismatch rule*** (first rule), ***direct imported mismatch rule*** (second rule) to the ***indirect imported mismatch rule*** (third rule), one is able to tackle the matter in a more organized manner, from the least to the more complex tax structure. Therefore we propose starting with the tower structure, under the structured imported mismatch rule (*scheme 1*), which will pave the way to the second tax structure, where we discuss the tracing approach concept under both the structured imported mismatch rule and direct imported mismatch rule (*scheme 2*). The next tax structure will discuss the direct imported mismatch rule, where the apportionment formula (an imported concept in understanding more complex hybrid structures) will be presented (*scheme 3*). After discussing the apportionement formula, we propose to *put such formula to use* when studying the direct imported mismatch rule under an apportionment approach, where the sum of all imported payments are computed and divided by the ***TARHDI*** (total amount of remaining hybrid deductions incurred). The resulting ratio will then be applied by the importing jurisdictions to neutralize abusive dedutions (*scheme 4*). The following structure will introduce the indirect imported mismatch rule, that is, since the hybrid deductions were neither neutralized under the structured imported mismatch rule nor by the direct imported mismatch rule, tax authorities will then proceed to apply the indirect rule. Such surplus must be proportionately allocated amongst group members "in accordance with taxable payment flows within the group and in a way that takes into account the extent to which such payment have been funded, directly or indirectly, out of an imported mismatch payment",[2104] and ultimately offset against the funded taxable payment, namely, imported payment[2105] (*scheme 5*).

[2101] Ibid 90.
[2102] Ibid 25.
[2103] Robert Cooter and Thomas Unlen (n 15) 16.
[2104] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 90.
[2105] "An imported mismatch payment is a deductible payment made to a payee that is not subject to bybrid mismatch rules." Ibid 83.

Tax authorities are not always able to fully neutralize surplus deductions on hybrid financial instruments. In some cases, the amount of hybrid surplus will exceed the funded taxable payment (imported payments), which ultimately will have to be distributed to other members within a group structure (*scheme 6*). Nonetheless, in other situations, surplus deduction (hybrid deduction) will surpass the amount of funded taxable payments (imported payment). In such instances, the surplus will be distributed amongst the importing jurisdiction on a "pro-rata basis" (*scheme 7*). *Scheme 8* portrays an intra-group finance structure where the group generates DDs (imported mismatch rule) and finally, in *scheme 9* we discuss a HMA sold as a tax advantage product.[2106]

Two empirical notes before we move on to hybrid schemes *per se*: (***1***) ***differences in timing*** do not necessarily result in the recognition of a hybrid mismatch by a tax authority, however tax jurisdictions may request the deduction be deferred and only accrued in the next accounting period for convenience purposes.[2107] However, the burden falls under the taxpayer's to demonstrate that the mismatch is the result of timing differences, that is, if not properly satisfied and convinced that the payment under the relevant tax structure did not have the sole purpose of generating a D/NI or DD outcomes, tax authorities are likely to impose some sort of adjustment.[2108] (***2***) ***Losses derived from hybrid deductions*** must be included to future tax positions where net loss has been carried-forward to a following fiscal (accounting) period, to the extent that such loss is a result from hybrid deductions.[2109] Nevertheless, the OECD Final Report opted to exclude hybrid deductions generated before 31 December 2016 from the indirect imported mismatch rule in order to avoid possible difficulties in identifying past hybrid deductions.[2110]

aa. Scheme 1
Structured Imported Mismatch Rule
(tower structure)

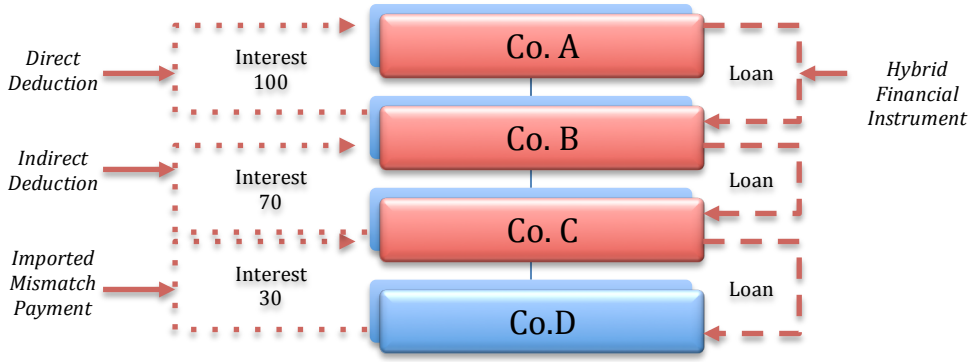
The following example, also known as the "***Tower Structure***" depicts more clearly a SIM scheme. The head's group (Co. A), resident of country A enters into a loan contract with Co. B, a wholly-owned partnership resident of another jurisdiction. Under the laws of Co. A's jurisdiction, Co. B is transparent for tax purposes (***reverse hybrid***), whereas under the laws of Co. B's jurisdiction, the undertaking is opaque for tax purposes. Therefore Co. A's jurisdiction ignores

[2106] All schemes depicted on this study were extracted from the OECD report on neutralising the effects of hybrid mismatch arrangements and adapted for the purposes of this investigation. Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995).
[2107] Ibid 71.
[2108] Ibid 34.
[2109] Ibid 90.
[2110] According to the OECD Report "In order to account for timing differences between jurisdictions and to prevent groups manipulating that timing in order to avoid the effect of the imported mismatch rule, a hybrid deduction should be taken to include any net loss that has been carried-forward to a subsequent accounting period, to the extent that loss results from a hybrid deduction. (…) In order to reduce the complexity associated with the need to identify hybrid deductions that arose prior to the publications of this report any carry-forward loss from periods ending on or before 31 December 2016, shuld be excluded from the operations of this rule." Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 90.

the loan contracted between the two associated undertakings (and by extension, also the interest on the loan) in such a way that the interest paid to Co. A is not liable to tax (NI), but nevertheless deducted in the other country (D/NI outcome). Co. B on-lends the capital to Co. C which in turn, on-lends to Co. D. Each Company is resident of a different country and ***only Co. D's jurisdiction apply the recommendations provided by the OECD report in respect to neutralizing HMAs***.[2111] In order to better understand such scheme, it is important to approach the matter strategically, therefore, such structure has the following characteristics and provide the following results:

(1) The payment gives rise to the *hybrid financial instrument* (loan contracted between Co. A and Co. B), consequently resulting in a D/NI outcome;
(2) The payment that gave rise to the hybrid deduction (Co. B's deduction) and the imported mismatch payment made by Co. D, ***are part of the same structure arrangement***;
(3) The mismatched imported payment generates a D/NI outcome.

Figure 54



Note that the loan arrangements are made under the same group in such a way that the chain of subsequent loans contracted between group members is not interrupted, *nor have any of company entered into previous loan contracts with each other*, that is to say, Co. A's loan to Co. B is passed on amogst all group members (*chain approach*), *therefore making the imported payment made by Co. D part of the same structure arrangement*.

(i) The payment under the hybrid financial instrument generates a hybrid deduction, that is, it creates a hybrid deduction (D/NI). As previously studied, by exploiting differences of the tax laws of both jurisdictions in respect to opacity treatment (hybrid entities) or hybrid financial instruments (debt x equity), groups are able to generate D/NI outcomes. Co. B's deduction under the arrangement is a "***direct hybrid deduction***" and Co. C's deduction (surrended by Co. B to Co. C through a loan contract between Co. B and Co. C), is an "***indirect***

[2111] By applying the OECD recommendations we have to assume that such country would be an OECD member, currently a group formed by 35 countries, namely, Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia Luxembourg, Mexico, The Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey the UK and the United States.

hybrid deduction". Both deductions should be properly computed under an apportioment approach.

(***ii***) ***The interest payment and the imported mismatch payment are part of the same structure arragment.*** Since the chain of loans was not interrupted throughout the scheme, the payments made under such scheme should be considered as being under the same structure arrangement.

(***iii***) ***The hybrid deduction is then imported to the third jurisdiction by Co. D, eventually, giving rise to D/NI between Co. D and Co. C.*** Under such structure, the only jurisdiction that applies the recommendations set out in the OECD report is Co. D's jurisdiction, therefore it is required jurisdiction D to deny deduction on the "*imported payment*" under the structure imported mismatch rule.[2112] In order to determine whether the "imported payment" have been "indirectly offset against a hybrid deduction", the OECD report suggests the ***tracing approach*** be applied, that is to say, since it was already established that the deductions are all part of the same structured arrangement, the relevant tax authority, or tax payer, should follow the chain of transactions starting from the imported payment, in this case, imported by Co. D to the hybrid financial instrument that gave rise to a hybrid deduction (financial instrument contracted between Co. A and Co. B). Therefore, the chain payment may be resumed as follows:

(i) Co. A enters into a loan contract with Co. B, which in turn paid 100 of interests according to the contract's terms. Such payment is ultimately offset against the profits generated in that country (hybrid deduction). Co. B enters into a new loan contract with another associated undertaking, Co. C which in turn pays Co. B an amount of 70 (also used to reduce tax liability).

(ii) Co. C enters into a ***loan contract*** with Co. D, which in turn pays a total of 30 (imported mismatch payment). Since Co. D's jurisdiction apply OECD recommendations on Hybrid Mismatch Arrangements, that country will ultimately deny Co. D's deduction therefore ***neutralizing the imported mismatch***. Note that, although the imported mismatch was neutralized, the group was able to benefit from an abusive deduction of 70.

ab. Scheme 2
Structured Imported Mismatch and Direct Imported Mismatch (tracing approach)

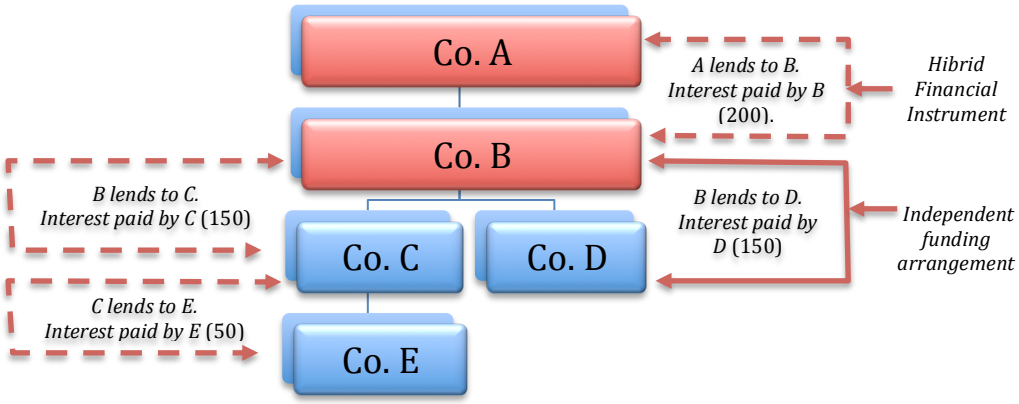
Structured imported mismatches and *direct imported mismatches* schemes are similar to structure imported mismatches, except to the fact that an associated company has beforehand an unconnected funding arrangement with another associated company resident of another State. The scheme is structured as follows. The head of the group (Co. A), contracts a loan with Co. B, a wholly-

[2112] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 342.

owned entity resident of another jurisdiction. Under the law of Co. A's jurisdiction, Co. B is transparent for tax purposes (***reverse hybrid***), whereas under the laws of Co. B's jurisdiction, the undertaking is non-transparent for tax purposes. Therefore Co. A's jurisdiction ignores the loan contracted between the two associated undertakings (and consequently the interest on the loan) in such a way that the interest received by Co. A is not liable to taxation (NI), but nonetheless deducted in the other country (D/NI outcome). Co. B on-lends the capital to Co. C which in turn, on-lends to Co. E. Each Company is resident of a different country. Co. C, Co. D and Co. E are residents of jurisdictions that ***apply the recommendations provided by the OECD report in respect to neutralizing HMAs***. When analysing such tax structure, one concludes that:

(i) The payment gives rise to the *hybrid financial instrument* contracted between Co. A and Co. B), consequently resulting in a D/NI outcome;
(ii) The payment made by Co. D to by Co. B, is ***NOT*** part of a larger structure imported mismatch arrangement, for the funding contract between Co. D and Co. B was already existent;
(iii) The payment made by Co. C to Co. B, is part of the same arrangement that gave rise to hybrid deduction, therefore Co. C's imported mismatch payment will ultimately be adjusted under the ***structured and direct imported mismatch rule***;[2113]
(iv) Given the fact that Co. E and Co. C jurisdictions apply the OECD recommendations on HMAs, the income received by Co. C from Co. E, will not be offset against any hybrid deduction, therefore the imported mismatch rule in Co. E's jurisdiction is not applied.[2114]

Figure 55



Note that, according to the tax structure depicted above, Co. B and Co. D have contracted amongst themselves independently a funding arrangement/contract, in which Co. B provides capital for Co. D's operations.

(i) The payment gives rise to the hybrid financial instrument contracted between Co. A and Co. B, consequently resulting in a D/NI outcome (hybrid

[2113] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 347.
[2114] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 346.

deduction). Co. B's deduction (200), under the arrangement is a *"direct hybrid deduction"* and Co. A's income is not taxed in the other State (reverse hybrid).

(ii) The interest payment made by Co. D to Co. B is NOT part of the same structure arrangement, for the funding contract between was already existent. The interest paid by Co. D "should be treated as outside the scope of the structured imported mismatch rule"[2115] that is to say, the chain of payments was interrupted under a tracing approach. Nevertheless, if the relevant tax authority is able to establish that the payment was made under the same scheme, that is, under the same chain of payments (on-lending payment), then the amount would necessarily be treated under the ***structured imported mismatch rule*** due to the fact that such agreement would be part of a wider arrangement. Moreover, it is important to point out that the structure imported mismatch rule should always be applied first "for it has a wider scope and applies to all payments made under a structured arrangement even if those payments are not intra-group."[2116]

(iii) The interest paid by Co. C to Co. B will necessarily be adjusted under the structured and direct imported mismatch rule, for they are part of the same structured arrangement. [2117] According to such rule, the payer jurisdiction is required to deny a deduction for an "imported mismatch payment to the extent the income from such payment is offset (directly or indirectly) against a hybrid deduction under the same structured arrangement." [2118] Numerically, Co. C's jurisdiction would deny in full the interest of 150 paid to Co. B, given the fact that such funding agreement is part of the same arrangement. Nontheless, the Hybrid Financial Instrument generated a deduction of 200. To that effect, the OECD report suggests Co. D's jurisdiction to deny, proportionally, the remaining hybrid deduction, that is to say, the ratio between the total amount of remaining hybrid deduction incurred (50), and the imported mismatch (150), namely, $\frac{50}{150}$. In other words, Co.D's jurisdiction should deny one-third (0,34%) of the remaining ratio, ultimately adjusting the operation under the direct imported mismatch rule.[2119]

(iv) Given the fact that Co. E jurisdiction apply the OECD recommendations on HMAs, the interest paid by Co. E to Co. C, will not be offset against any hybrid deduction, therefore the imported mismatch rule is not applied to Co. E's jurisdiction.[2120] Co. E's jurisdiction apply in full the recommendations provided by te OECD report on HMAs, therefore any payment made to an associated undertaking resident of such jurisdictions will not be offset against any of the group's hybrid deduction.

[2115] Ibid 346.
[2116] Ibid 87.
[2117] Ibid 347.
[2118] Ibid 347.
[2119] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 347.
[2120] Ibid 346.

ac. Scheme 3
Direct Imported Mismatch Rule
(apportionment approach)

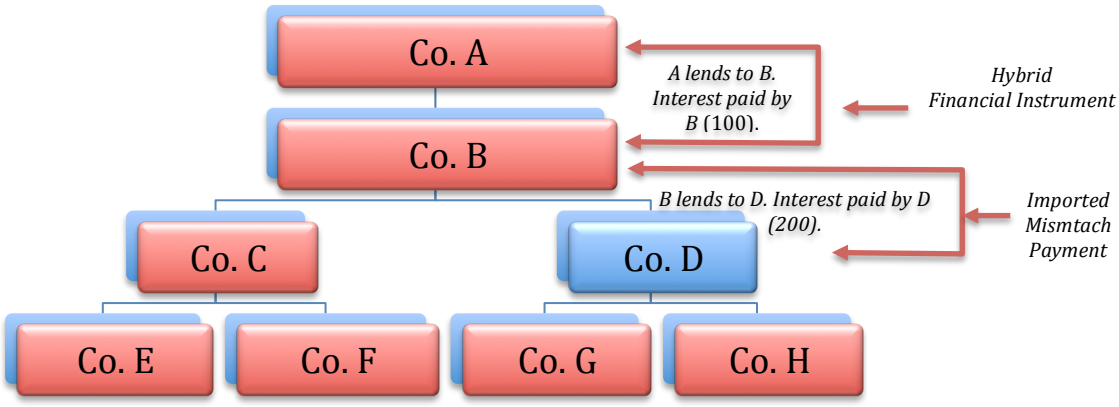
The scheme bellow depicts a finance structure where Co. A lends capital to an associated undertaking, namely Co. B. Alternatively, Co. B enters into another financing contract with Co.D independently, that is to say, the capital lent by Co. A to Co. B is ***NOT*** on-lent to Co. D. Ultimately, Co. D proceeds to contract with other associated companies other loans (all undertakings are residents of different jurisdictions). In this scheme in particular, the ***apportionment formula*** will be applied in order to ascertain if the imported mismatch payment "has been directly set-off against the hybrid deduction of a counterparty." [2121] After analysing such structured, one concludes that:

(i) The payment gives rise to the *hybrid financial instrument* – hybrid deduction between Co. A and Co. B, consequently resulting in a D/NI outcome;

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is ***NOT*** part of a larger structure, therefore the ***structured imported mismatch rule*** is ***NOT*** applicable;

(iii) The interest payment made by Co. D to Co. B will be subjected to adjustment by Co. D's jurisdiction under the ***direct imported mismatch rule (apportionment approach).***

Figure 56



The tax structure above is similar to the ones previously studied (schemes 1 and 2). The outcome is the following:

(i) The payment gives rise to the hybrid financial instrument – hybrid deduction contracted between Co. A and Co. B), consequently resulting in a D/NI outcome. Co. B's deduction (100), under the arrangement is a *"direct hybrid deduction"* and Co. A's income is not taxed in the other State (D/NI).

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is NOT part of a larger structure, therefore the imported mismatch rule is NOT

[2121] Ibid 350.

applicable. Here, the structure mismatch rule does not apply for the loan contracted between Co B and Co. A, although a hybrid financial instrument, for it generates a deduction non-inclusion outcome (paid as interest and not included as income) is not part of a wider instrument.

(iii) The interest payment made by Co. D to Co. B will be subjected to adjustment by Co. D's jurisdiction under the direct imported mismatch rule (apportionment approach). The application of the ***apportionment formula*** calculates the "extent to which an imported mismatch payment has been directly set-off against the hybrid deduction of the counterparty".[2122] Such formula compares the total amount of hybrid deductions within a certain tax structure (direct and indirect deductions) to the total amount of imported mismatch payments made between associated companies. It is by determining the ratio of such hybrid deductions against the imported payment *per se,* that tax administrations are able to partly neutralize D/NI outcomes. Nonetheless, if after comparing the total amount of hybrid deductions, it was established that the sum of such deductions surpassed the amount of the imported mismatch payment (***surplus of hybrid deductions***), the surplus will be treated by the ***indirect imported mismatch rule***.

Apportionment Formula

$$IMP \times \frac{TARHDI}{TAIPR}$$

IMP = Imported mismatch payment made by the payer
TARHDI = Total amount of remaining hybrid deductions incurred
TAIPR = Total amount of imported payment received

According to the formula above, the ***IMP*** the payment made by Co. D to Co. B equals ***200***. The ***TARHDI*** generated under the hybrid financial instrument contracted between Co. A and Co. B is ***100***. Finally, the ***TAIPR*** paid by Co. D to Co. B equals ***100***.

$$200 \times \frac{100}{200} = 100$$

By applying such formula, Co. D's jurisdiction will request an adjustment by denying a half (i.e. 100) of the interest payment made to Co. B.

ad. Scheme 4
Direct Imported Mismatch Rule under an apportionment approach

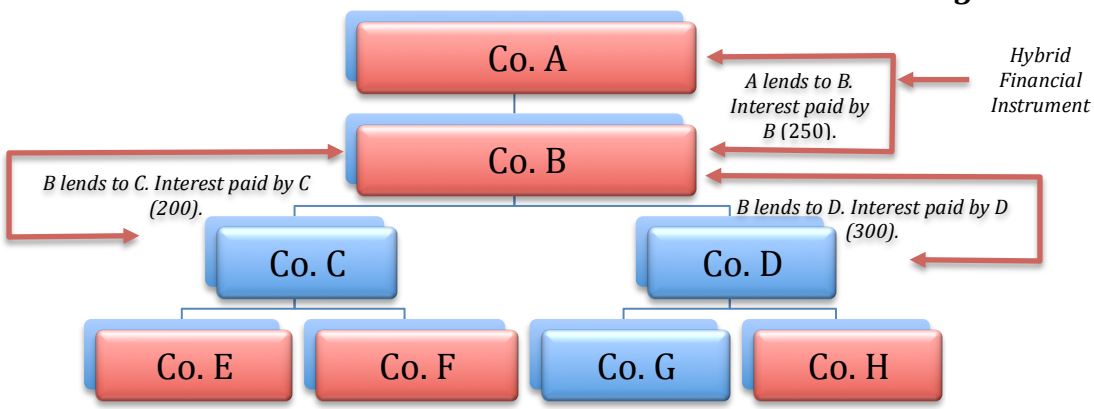
The present tax structure wil demonstrate more clearly how an ***apportionment approach*** is computed under a tax structure, that is to say, wem divide the total amount of hybrid deductions under the tax structure by the ***TARHDI*** (total amount of remaining hybrid deductions incurred). Under the

[2122] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 350.

present scheme all associated companies are part of the same group and resident of different States. Co. A contracts with Co. B an intra-company. Under the law of Co. A, the instalments of such loan are treated as dividends, therefore exempt, nevertheless, under Co. B's jurisdiction, the operation is treated as an ordinary loan (debt instrument), consequently it will be offset against its profits (deductible payments). By using such scheme the group was able to generate a D/NI outcome, therefore, the operation falls under the catgory of a ***hybrid financial instrument***. Co. C, D and G's jurisdictions apply the OECD recommendations on hybrid financial instruments. After careful analysis of the tax structure, one concludes that:

(i) The payment gives rise to the *hybrid financial instrument* – hybrid deduction contracted between Co. A and Co. B, consequently resulting in a D/NI outcome;
(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is ***NOT*** part of a larger structure, therefore the ***structured imported mismatch rule*** is ***NOT*** applicable;
(iii) The interest paid by Co. D to Co. B will be subjected to adjustment by Co. D's jurisdiction under the ***direct imported mismatch rule (apportionment approach).***
(iv) The interest paid by Co. C to Co. B will be subjected to adjustment by Co. D's jurisdiction under the ***direct imported mismatch rule (apportionment approach).***

Figure 57



(i) The payment gives rise to the hybrid financial instrument – hybrid deduction contracted between Co. A and Co. B), consequently resulting in a D/NI outcome. The interest payment made by Co. B to Co. A, generates a direct hybrid deduction of 250 (***TARHDI***), that is not included as ordinary income in Co. A's books and ultimately offset against Co. B's profits (deductible).

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is NOT part of a larger structure, therefore the structured imported mismatch rule is NOT applicable. Since the hybrid financial instrument (Co. A and Co. B) has no relation to the other loans made by Co. B to Co. C and D, the hybrid instrument may not be treated as part of a wider arrangement, and the structured imported mismatch rule may not be applied.

(iii) The deducible interest payment made by Co. D to Co. B will be subjected to adjustment in Co. D's jurisdiction under the direct imported mismatch rule (apportionment approach). Given the fact that Co. D's jurisdiction apply the OECD recommendations on hybrid mismatch arrangements, and that Co. B offsets the payment it receives against a hybrid deduction (hybrid financial instrument between Co. A and Co. B), Co. D's jurisdiction will deny Co. D deduction according to the ***apportionment formula*** bellow.

$$\frac{\boldsymbol{TARHDI}}{\boldsymbol{TAIPR}} = ratio$$

In this case, the ***TARHDI*** (250) must be divided for the ***TAIPR*** (500) of both undertakings under the scheme, that is, Co. C (200) and Co. D (300).

$$\frac{250}{200 + 300} = \frac{250}{500} = \frac{1}{2}$$

Therefore, Co. D's jurisdiction will deny ½ of Co. D's deduction that is, a total of 150.

(iv) The deductible interest payment made by Co. C to Co. B will be subjected to adjustment in Co. C's jurisdiction under the direct imported mismatch rule (apportionment approach). Co. C's jurisdiction apply the OECD recommendations on neutralizing hybrid mismatch arrangements, therefore it will deny ½ of Co. C's deduction according to the formula, that is, it will only allow a deduction of 100 instead of 200.

ae. Scheme 5
Indirect Imported Mismatch Rules

Co. H's jurisdiction is the only State that applies the OECD recommendations on neutralizing hybrid mismatches. The example follow the ones previously studied, that is, all associated companies are part of the same group and resident of different States. Co. A contracts with Co. B an intra-company loan treated as equity in Co. A's jurisdiction (exempt dividends), but as debt under Co. B's jurisdiction (deductible payment). Therefore such scheme results in a D/NI outcome, therefore, falling under the category of a ***hybrid financial instrument***. Co. C enters into another loan with Co. D, that in turn enters into another inter-company loan with Co. H. After careful analysis of the tax structured, one concludes that

(i) The payment gives rise to the *hybrid financial instrument* – hybrid deduction contracted between Co. A and Co. B, consequently resulting in a D/NI outcome;

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is ***NOT*** part of a larger structure, therefore the ***structured imported mismatch rule*** is ***NOT*** applicable;

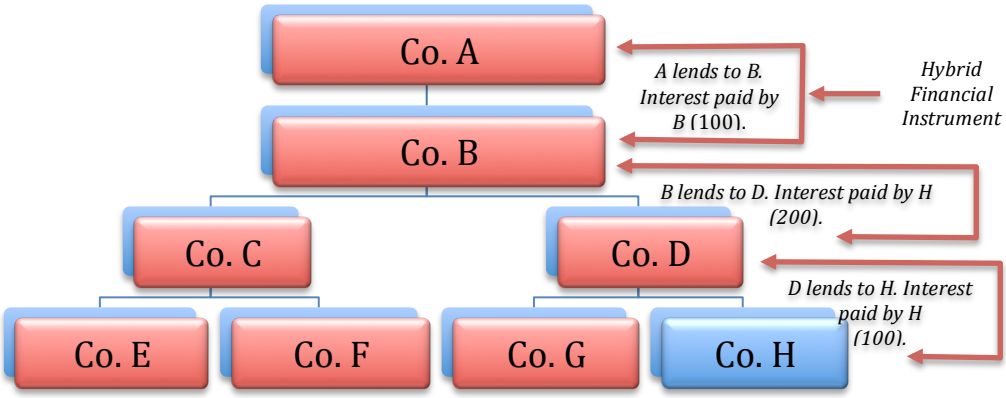
(iii) The payment made by Co. D to Co. B is ***NOT*** under the auspices of the direct imported mismatch rule, for Co. D's jurisdiction do not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the ***direct imported mismatch rule*** is ***NOT*** applicable;

(iv) Since the hybrid dedcution has neither been neutralized under the structured imported mismatch rule nor under the direct imported mismatch rule, Co. B is left with an unneutralized ***deduction surplus***;

(v) According to the OECD recommendations, the unneutralized ***deduction surplus*** must be offset against ***funded taxable payments***, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities."

(vi) This example provided for a hybrid deduction (surplus deduction) equal to the imported payment (funded taxable payment). Therefore Co. B has no remaining surplus hybrid deduction.

Figure 58



(i) The payment gives rise to the hybrid financial instrument – hybrid deduction contracted between Co. A and Co.), consequently resulting in a D/NI outcome. The interest payment made by Co. B to Co. A, generates a direct hybrid deduction of 100. Such payment is not included as ordinary income by Co. A and is ultimately offset against Co. B profits (deductible).

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is NOT part of a larger structure, therefore the structured imported mismatch rule is NOT applicable. The hybrid financial instrument (Co. A and Co. B) has no relation to the other loans made by Co. B to Co. D and H, therefore the hybrid instrument may not be treated as part of a wider arrangement, and the structured imported mismatch rule may not be applied.

(iii) The payment made by Co. D to Co. B is NOT under the auspices of the direct imported mismatch rule, for Co. D's jurisdiction no not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the direct imported mismatch rule is NOT applicable. In order to apply the *direct imported mismatch rule* it is necessary that the funder of the hybrid deduction (Co. D), be a resident of the jurisdiction that applies the OECD recommendations on neutralizing hybrid mismatches.

(iv) Since the hybrid deduction has not been neutralized neither under the structured imported mismatch rule nor under the direct imported mismatch rule, Co. B is left with an unneutralized deduction surplus. Note that Co. B's hybrid deduction (100) was not neutralized under rules both rules (SIM nor DIM), therefore the undertaking benefited so far from an abusive deduction, due to the fact that such operation lacks economic substance, ultimately eroding the tax base of that State.

(v) According to the OECD recommendations, the unneutralized deduction surplus must be offset against funded taxable payments, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities." A funded taxable payment is a payment financed by an imported mismatch payment, which in this case Co. H's payment (100) to its associated Co. D. The hybrid surplus relates to Co. B's deduction under the hybrid financial instrument (100). Note that Co.D's deduction of 200 funded the imported mismatch payment made by Co. H, even though Co. D's jurisdiction do not apply the OECD recommendations on hybrid mismatches, that is to say, although Co. D's hybrid dedcution is not neutralized under the present scheme, it directly funded the "imported mismatch payment made by other group entities", a *sine qua non* payment in order for the indirect imported mismatch rule to be applied.

(vi) This example provided for a hybrid deduction (surplus deduction) equal to the imported payment (funded taxable payment). Therefore Co. B has no remaining surplus hybrid deduction. Applying the apportionment formula to the case at hand, one concludes that the surplus deduction was fully neutralized under the indirect imported mismatch rule. The formula provides that, the ***IMP*** the payment made by Co. H to Co. D (***100***) be multiplied by the ***TARHDI*** generated under the hybrid financial instrument contracted between Co. A and Co. B (***100***) divided by the ***TAIPR*** paid by Co. H to Co. D, namely, ***100***.

$$100\times \frac{100}{100} = 100$$

Co. H's jurisdiction will deny the hybrid deduction in full, that is, a total of 100, therefore neutralizing the mismatch.

af. Scheme 6
Surplus Hybrid Deductions that exceeds funded taxable payments

This scheme portrays a situation where the funded taxable payment (imported payment) exceeds the value of the hybrid deduction under the hybrid financial instrument. Co. A contracts with Co. B a loan which ultimately generates a D/NI outcome. Such loan is not part of a larger of a wider arrangement, that is, the following operations are not funded specifically out of such financial hybrid instrument. Co. B enters into another financing agreement with Co. C and Co. D, both residents in different jurisdictions. Company D. then proceeds to enter into another financing operation with its subsidiaries Co. G and Co. H, both also residents of different jurisdictions. A scheme analysis have showed that:

(i) The payment gives rise to the *hybrid financial instrument* – hybrid deduction contracted between Co. A and Co. B), consequently resulting in a D/NI outcome;

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is ***NOT*** part of a larger structure, therefore the ***structured imported mismatch rule*** is ***NOT*** applicable;

(iii) The payment made by Co. C to Co. B is under the auspices of the ***direct imported mismatch rule***, for Co. C's jurisdiction apply the OECD recommendations on neutralizing mismatch arrangements, therefore the direct imported mismatch rule ***MUST*** be applied. By applying the direct imported rule, Co. C's jurisdiction will deny in full Co. C's deduction;

(iv) The payment made by Co. D to Co. B is ***NOT*** under the auspices of the direct imported mismatch rule, for Co. D's jurisdiction do not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the ***direct imported mismatch rule*** is ***NOT*** applicable;

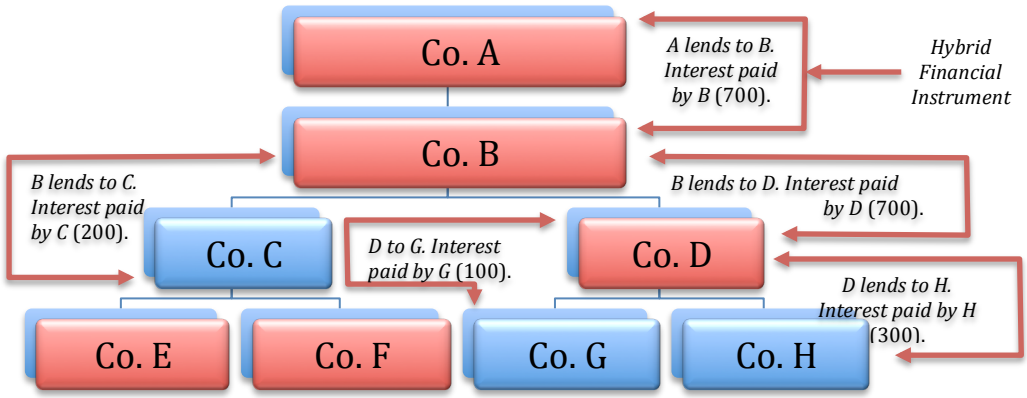
(v) Since the hybrid deduction has not been neutralized under the direct imported mismatch rule, Co. B has unneutralized ***deduction surplus*** under the scheme;

(vi) According to the OECD recommendations, the unneutralized ***deduction surplus*** must be offset against ***funded taxable payments***, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities". Therefore, Co. G and Co. H's jurisdiction will require the deducted interest paid to Co. D be adjusted under the indirect imported mismatch rule. Nonetheless, after the adjustment, Co. B still has a certain amount of unneutralized hybrid deduction;

(vii) Finally, the surplus must be offset against the residual taxable payment made by Co. D. Nevertheless, it is important not to offset the remaing surplus to an already neutralized hybrid deduction.

This example provided for a hybrid deduction (surplus deduction) equal to the imported payment (funded taxable payment). Therefore Co. B has no remaining surplus hybrid deduction.

Figure 59



(i) The payment gives rise to the hybrid financial instrument – hybrid deduction contracted between Co. A and Co. B, consequently resulting in a D/NI outcome. The interest payment conducted by Co. B to Co. A, generates a direct hybrid deduction of 700.

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is NOT part of a larger structure, therefore the structured imported mismatch rule is NOT applicable. Hybrid financial instrument (Co. A and Co. B) has no relation to the other loans made by Co. B to Co. C and D, therefore the hybrid instrument may not be treated as part of a wider arrangement and the structured imported mismatch rule may not be applied.

(iii) The payment made by Co. C to Co. B is under the auspices of the direct imported mismatch rule, for Co. C's jurisdiction apply the OECD recommendations on neutralizing mismatch arrangements, therefore the direct imported mismatch rule MUST be applied. Co. C's jurisdiction applies the OECD recommendation on hybrid mismatch arrangements, therefore the imported payment (200) will be fully neutralized under the direct imported mismatch rule in that jurisdiction.

(iv) The payment made by Co. D to Co. B is NOT under the auspices of the direct imported mismatch rule, for Co. D's jurisdiction do not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the direct imported mismatch rule is NOT applicable. In order to apply the *direct imported mismatch rule* it is necessary that the funder of the hybrid deduction (Co. D), be a resident of a jurisdiction that applies the OECD recommendations on neutralizing hybrid mismatches.

(v) Since the hybrid deduction has not been neutralized neither under the structured imported mismatch rule nor under the direct imported mismatch rule, Co. B is left with an unneutralized deduction surplus. The total amount of surplus till this point of the scheme is 500, that is to say, Co. B's hybrid deduction (700) *minus* the already neutralized Co. C's imported payment of 200.

(vi) According to the OECD recommendations, the unneutralized deduction surplus must be offset against funded taxable payments, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities". Therefore, Co. G and Co. H's jurisdiction will require the deducted interest paid to Co. D be adjusted under the indirect imported mismatch rule. The surplus hybrid deduction of 500 must, according to OECD recommendations on the matter, must be offset against the remaining funded taxable payments to the extent that such payments were "*directly funded* out of imported mismatch payments", therefore Co. G (100) and Co. H's (300) payments to Co. D will ultimately be offset against the remaining surplus (500). The total amount of neutralized payments to this point equals 600. Nontheless, the hybrid deduction generated under the hybrid financial instrument contracted between Co. A and Co. B is 700, therefore there is still a surplus of 100 of unneutralized hybrid deduction. The total amount of hybrid deduction generated under the financial hybrid instrument (700), minus the

hybrid deduction neutralized under structured imported mismatch rule (0) and the direct imported mismatch rule (200).

$$HP^{2123} - (NP\boldsymbol{SIR}^{2124} + NP\boldsymbol{DIR}^{2125}) = \text{Hybrid Surplus}$$

$$700 - (0 + 200) = 500$$

The result of such equation (500) is again deducted against the sum of both imported mismatch payments of 300 and 100 (400).

$$500 - (300 + 100) = 100$$

(vii) The surplus must be offset against the residual taxable payment made by Co. D. Nevertheless, it is important not to offset the remaing surplus to an already neutralized hybrid deduction. As we might recall, there is a remaing of 100 under the tax structured left unneutralized, according to the OECD recommendation, any surplus hybrid deduction at this point "should therefore be reflected in a corresponding adjustment to the amount" of Co. D's indirect hybrid deduction (700), ultimately neutralizing the arrangement's surplus of 100. [2126]

ag. Scheme 7
Surplus Hybrid Deductions that DO NOT exceeds the funded taxable payments

This scheme depicts a situation where the funded taxable payment (imported payment) do not exceed the value of the hybrid deduction under the hybrid financial instrument, that is to say, the amount of imported payments under the structure is greater than the hybrid deduction generated under the financial hybrid instrument. Co. A contracts with Co. B a loan which ultimately creates a D/NI outcome. Such loan is not part of a larger of a wider arrangement. Co. B enters into another financing agreement with Co. C and Co. D, both residents in different jurisdictions. Company C enters into a loan contract with its subsidiary, Co. E located in another jurisdiction. Company D., then proceeds to enter into another finacing operation with its subsidiaries Co. G and Co. H, both also residents of diferent jurisdictions. Companies E, G and H jurisdictions apply the OECD recommendation on neutralizing hybrid mismatch arrangements. Thorough analysis of such scheme have showed that:

(i) The payment gives rise to the *hybrid financial instrument* – hybrid deduction contracted between Co. A and Co. B), consequently resulting in a D/NI outcome;
(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is ***NOT*** part of a larger structure, therefore the ***structured imported mismatch rule*** is ***NOT*** applicable;

[2123] Hybrid Payment (HP)
[2124] Neutralized Payment under the Structured Imported Rule (NP***SIR***).
[2125] Neutralized Payment under the Direct Imported Rule (NP***DIR***).
[2126] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 369.

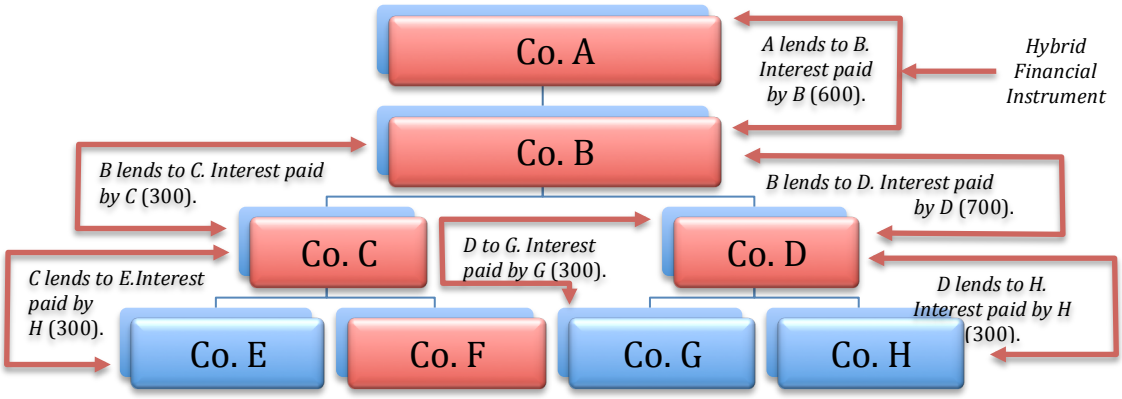
(iii) The payment made by Co. C to Co. B is ***NOT*** under the auspices of the direct imported mismatch rule, for Co. C's jurisdiction do not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the ***direct imported mismatch rule*** is ***NOT*** applicable;

(iv) The payment made by Co. D to Co. B is ***NOT*** under the auspices of the direct imported mismatch rule, for Co. D's jurisdiction do not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the ***direct imported mismatch rule*** is ***NOT*** applicable;

(v) Since the hybrid deduction has not been neutralized under the direct imported mismatch rule, Co. B has unneutralized ***deduction surplus*** under the scheme;

(vi) According to the OECD recommendations, the unneutralized ***deduction surplus*** must be offset against ***funded taxable payments***, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities". Therefore, Co. G's and Co. H's jurisdiction will require the deducted interest paid to Co. D be adjusted under the indirect imported mismatch rule. Co. E's jurisdiction will also require an adjustment under the indirect imported mismatch rule. Nevertheless, according to the structure at hand, the deduction surplus generated under the hybrid financial instrument ***DO NOT*** exceeds the total amount of funded taxable payments conducted by Companies E, G and H, therefore, the deductible adjustment will be made on a "pro-rata basis".[2127]

Figure 60



(i) The payment gives rise to the hybrid financial instrument – hybrid deduction contracted between Co. A and Co. B, consequently resulting in a D/NI outcome. The interest payment conducted by Co. B to Co. A, generates a direct hybrid deduction of 600.

(ii) The payment made by Co. B to Co. A (hybrid financial instrument) is NOT part of a larger structure, therefore the structured imported mismatch rule is NOT applicable. . Hybrid financial instrument (Co. A and Co. B) has no relation to the other loans made by Co. B to Co. C and D, therefore the hybrid

[2127] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 374.

instrument may not be treated as part of a wider arrangement and the structured imported mismatch rule may not be applied.

(iii) The payment made by Co. C to Co. B is NOT under the auspices of the direct imported mismatch rule, for Co. C's jurisdiction do not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the direct imported mismatch rule is NOT applicable. In order to apply the *direct imported mismatch rule* it is necessary that the funder of the hybrid deduction (Co. C), be a resident of a jurisdiction that applies the OECD recommendations on neutralizing hybrid mismatches.

(iv) The payment made by Co. D to Co. B is NOT under the auspices of the direct imported mismatch rule, for Co. D's jurisdiction do not apply the OECD recommendations on neutralizing mismatch arrangements, therefore the direct imported mismatch rule is NOT applicable. In order to apply the *direct imported mismatch rule* it is necessary that the funder of the hybrid deduction (Co. D), be a resident of a jurisdiction that applies the OECD recommendations on neutralizing hybrid mismatches.

(v) Since the hybrid deduction has neither been neutralized under the structured imported mismatch rule nor under the direct imported mismatch rule, Co. B has unneutralized deduction surplus under the scheme. The total amount of surplus till this point of the scheme is 600, due to the fact that neither the structured rule nor the direct rule were applied;

(vi) According to the OECD recommendations, the unneutralized deduction surplus must be offset against funded taxable payments, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities". Therefore, Co. G's and Co. H's jurisdictions will require the deducted interest paid to Co. D be adjusted under the indirect imported mismatch rule. Co. E's jurisdiction will also require an adjustment under the indirect imported mismatch rule. Nevertheless, according to the structure at hand, the deduction surplus generated under the hybrid financial instrument DO NOT exceed the total amount of funded taxable payments made by Companies E, G and H, therefore, the deductible adjustment will be assessed on a "pro-rata basis". The surplus hybrid deduction of 600 must, according to OECD recommendations on the matter, be offset against the funded taxable payments to the extent that such payments were "*directly funded* out of imported mismatch payments", therefore Co. G (300) and Co. H's (300) payments to Co. D, must ultimately be added to Co. E's interest payment of Co. C (300). It is important to note that, although Co. D paid 700 to Co. B, when calculating the funded taxable payment's total amount, only 600 out of 700 must be computed, for only 600 were "*directly funded out of imported mismatch payments made by other group entities*". The total amount of funded taxable payments received by Co. B under the scheme equals 900. Nonetheless, the hybrid deduction generated under the hybrid financial instrument contracted between Co. A and Co. B is 600 (less than the funded taxable payments).

$$Hybrid\ Deduction\ Surplus\ < Funded\ Taxable\ Payments$$

$$600 < 900$$

In such instances, Co. E, G and H's jurisdictions will deny such deductions according to the following formula:

$$\frac{\text{Payer's funded taxable payments}}{\text{Total of funded taxable payments received by Co. B}} \times \text{Co. B's surplus hybrid deduction}$$

Co. C's assessment:

$$\frac{300}{900} \text{ x } 600 = \ 200 \ or \ 0{,}33\% \text{ of } 600 \ = \frac{1}{3}$$

The payer's (Co. C) funded taxable sum (300), divided by the total amount of taxable payments received by Co. B from Companies E, G and H (900) equals 200, 0,33% or $\frac{1}{3}$ of 600.

Co. D's assessment:

$$\frac{600}{900} \text{ x } 600 = \ 400 \ or \ 0{,}66\% \text{ of } 600 \ = \frac{2}{3}$$

The payer's (Co. D) funded taxable sum of 600 (as previously mentioned, only directly funded expenses from imported payments made by other group entities can be added, therefore the 100 difference paid by Co. D to Co. B, should not be considered), divided by the total of taxable payments received by Co. B from Companies E, G and H (900) equals 400, 0,66% or $\frac{2}{3}$ of 600.

Note that there is no deduction surplus for the total amount of taxable payment exceeds Co B's hybrid deduction under the hybrid financial instrument. Therefore, under a pro-rata basis, Co. C, G and H's jurisdictions should deny 200 of each imported payment $\left(\frac{1}{3}+\frac{2}{3}=\frac{3}{3}=1\right)$, consequently neutralizing the mismatch (200 + 400 = 600).

ah. Scheme 8
Double Deduction outcome (DD) and Imported Mismatch Rule

This scheme portrays an intra-group finance structure where Co A (head-company) has two direct, fully-owed subsidiaries, namely, Sub. Co. B.1 and Co. C. In turn, Co. D is a direct and fully-owned subsidiary of Co. C. Alternatively, Co. D holds all shares of Co. E, its subsidiary. All undertakings are residents in different countries, except for Sub. Co. B. 2 which is a resident in the same country of its parent company, namely, Sub. Co. B. 1. Sub. Co. B.1 is transparent under the law of country A, but nevertheless, non-transparent in its resident country (hybrid entity), all other undertakings are separate entities for taxation purposes. Under this structure Co. A lends to Co. C, and Co. C lends to Co. D. Sub. Co. B. 1 borrows

from a local bank and enters into a loan contract with Co. A. Sub. Co. B. 1 realized losses on that year, and surrended those losses under the tax grouping regime to Sub. Co. B. 2. Finally Sub. Co. B. 2, lends capital to another group member, Co. E. A thorough analysis of such scheme have established that:

(i) The interest paid by Sub. Co. B. 1 to the bank is not part of a wider arrangement, that is, such loan is an independent contract, therefore it is independent from the other intra-group financing agreements, consequently, the structured imported mismatch rule ***IS NOT*** applicable;

(ii) The deductible hybrid payment made by Sub. Co. B. 1 to the bank results in a direct hybrid deduction both in Sub. Co. B. 1 and in Co. A's books;

(iii) The fact that Sub. Co. B. 1 surrended its losses to Sub. Co. B. 2 under a tax grouping structure prevents the direct imported mismatch rule be applied, moreover, neither the jurisdiction where the group scheme operates (Sub. Co. B. 1 and Sub. Co. B. 2) nor Co. A and Co. C's jurisdictions, apply the OECD recommendations on neutralizing hybrid mismatches, therefore the direct imported mismatch rule ***IS NOT*** applicable;

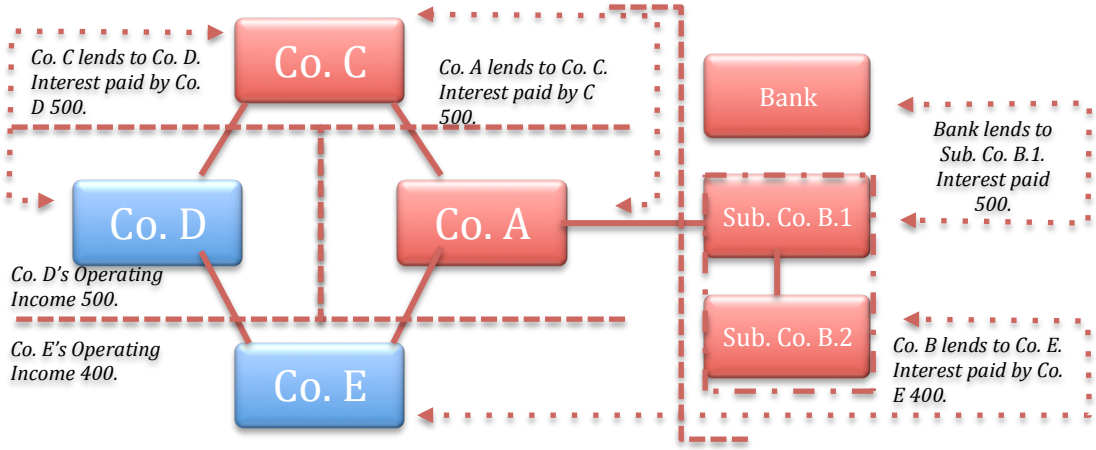
(iv) Co. A's hybrid deduction generated by Sub. Co. B. 1 a associated transparent undertaking, has not been neutralized neither under the structured nor the direct imported mismatch rules, therefore Co. A and Sub. Co. B. 1 have an unneutralized ***deduction surplus***;

(v) According to the OECD recommendations, the unneutralized ***deduction surplus*** must be offset against ***funded taxable payments***, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities". Therefore, Co. A and Sub. Co. B. 1's jurisdictions will require the hybrid deduction be adjusted under the indirect imported mismatch rule. Nevertheless, according to the structure at hand, the deduction surplus ***DO NOT*** exceeds the total amount of funded taxable payments made by Co. C and Sub. Co. B. 2, therefore the deductible adjustment will be made on a "pro-rata basis";

(vi) By adjusting the hybrid deduction under on a pro-rata basis, Co. C's surplus is fully neutralized;

(vii) Co. C and Sub. Co. B. 2 hybrid deductions are neutralized according to the direct imported mismatch rule, due to the fact that Co. E as well as Co. D's jurisdictions apply the recommendations set forth on the OECD report on neutralizing mismatch arragements.

Figure 61



Before we assess each step of the scheme, it is important to present a simplified version of the group's tax position before we apply the OECD recommendations on neutralizing hybrid mismatches. The first position depicts Co. A's tax position, as well as Sub. Co. B. 1 and Sub. Co. B. 2's consolidated group. Note that the interest paid by Sub. Co. B. 1 to the bank was included both under the consolidated group regime, as well as under Co. A's books. As previously mentioned, Sub. Co. B. 1 is transparent for tax purposes under the law of Co. A's jurisdiction. Since Sub. Co. B. 1 ***has no other forms of income***, the deduction will be offset against the group's tax liability in that country (Sub. Co. B. 1's jurisdiction). Nevertheless, Co. A fully-owns Sub. Co. B. 1, thus Co. A will also offset the interest paid by its subsidiary against its income. therefore, generating a DD outcome (Double Deduction with hybrid entities).

State A Co. A			MS B Consolidation Regime (Sub. Co. B. 1)		
	Tax	Book		Tax	Book
Income					
Interest paid by Co. C	500	500			
Expenditure			**Expenditure**		
Interest paid by Sub. Co. B. 1 to the Bank	(500)	-	Interest paid by Sub. Co. B. 1 to the Bank	(500)	(500)
Net Return		500	**Net Return**		(500)
Taxable income	0		Taxable income (loss)	(500)	
			Surrended losses to Sub. Co. B. 2	(400)	
			Loss carry forward	(100)	
			MS B Consolidation Regime (Sub. Co.		

			B. 1)		
			Income		
			Interest paid by Co. E	400	400
			Expenditure		
			Loss surrender	(400)	
			Net Return		400
			Taxable income	0	

The second position (bellow) depicts the Co. C, Co. D and Co. E's results under each Country's legislation.

State C Co. C			State D Co. D		
	Tax	Book		Tax	Book
Income			***Income***		
Interest paid by Co. D	500	500	Operating income	500	500
Expenditure			**Expenditure**		
Interest paid to Co. A	(500)	(500)	Interest paid to Co. C	(500)	(500)
Net Return		0	**Net Return**		0
Taxable income	0		Taxable income	0	
			State E Co. E		
				Tax	Book
			Income		
			Operating income	400	400
			Expenditure		
			Interest paid to Sub. Co. B. 2	(400)	(400)
			Net Return		0
			Taxable income	0	

A detailed assessment of the scheme provided that:

(i) The interest paid by Sub. Co. B. 1 to the bank is not part of a wider arrangement, that is, such loan is an independent contract, therefore it is independent from the other intra-group financing agreements, consequently, the structured imported mismatch rule IS NOT applicable. The lack of *nexus* between the interest on the loan paid by Sub. Co. B. 1 to the bank (500) and the chain of intra-group financing arrangements, results in the autonomy of such

loan in relation to the intra-group financing scheme, therefore the structured imported mismatch rule may not be applied. Nevertheless, had Sub. Co. B. 1 contracted the loan with the sole purpose of exporting the mismatch to other group members, then the structured rule would be applicable.

(ii) The deductible hybrid payment made by Sub. Co. B. 1 to the bank results in a direct hybrid deduction both in Sub. Co. B. 1 and in Co. A's books (DD). The direct hybrid deduction generated by the interest payment made to the bank is not offset against any dual inclusion income, that is to say, the same income accrued by two diferent undertakings residents of different jurisdictions.[2128] Nevertheless, according to the OECD recommendations "the question of whether a payment has given rise to a DD outcome is primarily a legal question that should be determine by an analysis of the character and the tax treatment of the payment under the laws of each residence jurisdiction. If both jurisdictions grant a deduction for the same payment (…) then the deduction can be said to give rise to a DD outcome".[2129]

(iii) The fact that Sub. Co. B. 1 surrended its losses to Sub. Co. B. 2 under a tax grouping structure prevents the direct imported mismatch rule be applied, moreover, neither the jurisdiction where the group operates (Sub. Co. B. 1 and Sub. Co. B. 2) nor Co. A and Co. C's jurisdictions, apply the OECD recommendations on neutralizing hybrid mismatches, therefore the direct imported mismatch rule IS NOT applicable. The main purpose of hybrid mismatch rules is to prevent MNEs from benefiting from multiple deductions in more than one Country (DD) and limit abusive behaviours by the use of tax sutructures that result in a D/NI outcome. Nevertheless, it is not the intention of such rules to inhibit that possible surpluses of hybrid deductions be carried-forward, for a "hybrid deduction should be taken to include any net loss that has been carried-forward to the subsequent accounting period, to the extent that loss results from a hybrid deduction". Sub. Co. B. 1, surrended to Sub. Co. B. 2 the total of 400 worth of losses and carried-forward the remaining of 100, that ultimately will be set off against future profits (next fiscal year) or alternatively, surrended to Sub. Co. B. 2 in the next accounting period.

(iv) Co. A's hybrid deduction generated by Sub. Co. B. 1, its associated transparent undertaking, has not been neutralized neither under the structured nor the direct imported mismatch rule, therefore Co. A and Sub. Co. B. 1 have an unneutralized deduction surplus. The hybrid deduction produced by the Sub. Co. B. 1's hybrid payment (500), minus the amount neutralized amount under both the structured and direct imported rules (0), equals the total of surplus of hybrid deduction generated under the scheme.

$$HP^{2130} - (NP\boldsymbol{SIR}^{2131} + NP\boldsymbol{DIR}^{2132}) = \text{Hybrid Deduction Surplus}$$

[2128] Dual inclusion income.
[2129] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 79.
[2130] Hybrid Payment (HP)
[2131] Neutralized Payment under the Structured Imported Rule (NP***SIR***).
[2132] Neutralized Payment under the Direct Imported Rule (NP***DIR***).

$$500 - (0 + 0) = 500$$

Therefore, Sub. Co. B. 1 and Co. A have 500 of hybrid deduction surplus.

(v) According to the OECD recommendations, the unneutralized deduction surplus must be offset against funded taxable payments, that is to say, against payments that are "directly funded out of imported mismatch payments made by other group entities". Therefore, Co. D and Co. E jurisdictions will require the imported hybrid deduction be adjusted under the indirect imported mismatch rule. Nevertheless, according to the structure at hand, the deduction surplus DO NOT exceeds the total amount of funded taxable payments, therefore the deductible adjustment will be made on a "pro-rata basis". A funded taxable tayment is a payment that is directly funded out of an imported mismatch payment made by other group entities. Under the scheme, the payment made by Co. C to Co. A (500) was directly funded out an imported mismatch payment (Co. D's payment to Co. C), therefore, Co. C's payment to Co. A constitutes a funded taxable payment. Sub. Co. B. 1 surrended to Sub. Co. B. 2 losses in that particular year (400), and Sub. Co. B. 2 received from Co. E interest 400 on a loan contracted between both parties (imported mismatch payment), thus making the surrended loss also a funded taxable payment. Therefore, the total ***funded taxable amount*** under the structure is 900 (500 + 400 = 900). Since the surplus deduction is less than the funded taxable amount,

$$Hybrid\ Deduction\ Surplus\ < Funded\ Taxable\ Payments$$

$$500 < 900$$

the adjustment will be concluded on a pro-rata basis. The formula that must be applied in order for the tax authority or the tax payer to reach the total deduction amount that Co. D and Co. E 's jurisdictions should deny (the only two jurisdiction that apply the OECD recommendation on hybrid arrangements), has already been introduced in the last scheme (*scheme 7*), nevertheless for the sake of a better undertading, we will present it once more.

$$\frac{\text{Payer's funded taxable payments}}{\text{Total of funded taxable payments received}} \times \text{Surplus hybrid deduction}$$

Co. C assessment under the ***indirect imported mismatch rule***:

$$\frac{500}{900} \text{ x } 500 = \ 278 \text{ or } 56\% \text{ of } 500 \ = \frac{14}{25}$$

Sub. Co. B. 2 assessment under the ***indirect imported mismatch rule***:

$$\frac{400}{900} \text{ x } 500 = 222 \text{ or } 44\ \% \text{ of } 500 \ = \frac{11}{25}$$

(vi) By adjusting the hybrid deduction under on a pro-rata basis, Co. A's surplus is fully liquidated. The deduction surplus is fully neutralized, that is to say, Co. D's jurisdiction should deny 278 and Co. E's jurisdiction 222, that is $\left(\frac{14}{25} + \frac{11}{25} = \frac{25}{25} = 1\right)$, consequently liquidating Co. A's surplus (278 + 222 = 500).

(vii) Co. C and Sub. Co. B. 2 hybrid deductions are neutralized within the direct imported mismatch rule, due to the fact that Co. D as well as Co. E's jurisdictions apply the recommendation set forth on the OECD report on neutralizing mismatch arragements. The payment made by Co. E to Sub. Co. B. 2 and by Co. D to Co. C is under the auspices of the ***direct imported mismatch rule***, for Co. E and Co. D's jurisdiction apply the OECD recommendations on neutralizing mismatch arrangements. However the adjustment must be proportionate to each company's indirect hybrid deduction. The following formula should be applied:

Co. C's assessment under the ***direct imported mismatch rule***:

$$\frac{\text{Co. C's Hybrid Deduction}}{\text{Co. C's Imported Mismatch}}$$

$$\frac{278}{500} = 0{,}56 \; or \; 56\%$$

Co. D's jurisdiction should deny 278 or 56% of Co. D's *imported mismatched payment***.**

Sub. Co. B. 2's assessment under the ***direct imported mismatch rule***:

$$\frac{\text{Sub. Co. B. 2's Hybrid Deduction}}{\text{Sub. Co. B. 2's Imported Mismatch}}$$

$$\frac{222}{400} = 0{,}44 \; or \; 44\%$$

Co. E's jurisdiction should deny 222 or 44% of Co. E's *imported mismatched payment***.**

Now the group's ABCDE tax position will be the following (no change on the first position):

State A Co. A			MS B Consolidation Regime (Sub. Co. B. 1)		
	Tax	Book		Tax	Book
Income					
Interest paid by Co. C	500	500			
Expenditure			**Expenditure**		

Interest paid by Sub. Co. B. 1 to the Bank	(500)	-	Interest paid by Sub. Co. B. 1 to the Bank	(500)	(500)
Net Return		500	**Net Return**		(500)
Taxable income	0		Taxable income (loss)	(500)	
			Surrended losses to Sub. Co. B. 2	(400)	
			Loss carry forward	(100)	
			MS B Consolidation Regime **(**Sub. Co. B. 1**)**		
			Income		
			Interest paid by Co. E	400	400
			Expenditure		
			Loss surrender	(400)	
			Net Return		400
			Taxable income	0	

The second position depicts the Co. C, Co. D and Co. E's tax liability after hybrid's neutralization.

State C Co. C			State D Co. D		
	Tax	Book		Tax	Book
Income			***Income***		
Interest paid by Co. D	500	500	Operating income	500	500
Expenditure			**Expenditure**		
Interest paid to Co. A	(500)	(500)	Interest paid to Co. C	(222)	(500)
Net Return		0	**Net Return**		500
Taxable income	0		Taxable income	278	
			State E Co. E		
				Tax	Book
			Income		
			Operating income	400	400
			Expenditure		
			Interest paid to Sub. Co. B. 2	(178)	(400)

	Net Return		0
	Taxable income	222	

By denying Co. D's abusive deduction, State D was able to tax 278 worth of income, whereas State E levied tax on 222 of Co E's income. It important to note that, although the books remained unaltered, the relevant authorities only considered a fraction of the interest expenditure of both companies for tax purposes, therefore enhancing the jurisdictions' revenue.

ai. Scheme 9
Tax advantage product

Tax advantage products are investment instruments that provide the purchaser of that product a certain tax incentive, that is, full exemption or almost no tax on future profits. It is imported to differentiate tax advantage products from a domestic perspective and from a hybrid mismatch arrangement perspective. From a ***domestic perspective***, governments may offer buyers the possibility of purchasing certain tax advantage investment products in order to achieve a specific purpose, that is, boost a particular market or to enhance revenue to fund projects and activities, for instance, *municipal bonds*[2133] or *LCI*[2134]which offers tax exempt returns or very low tax rates to that specific bond. Nonetheless, the acquisition of such products are regulated, and restrictions on its procurement may be applied. From a ***hybrid mismatch arrangement perspective***, such products are substantially deleterious to tax bases to the extent that DD or D/NI outcomes are generated. According to the OECD recommendations, "an arrangement will be treated as maketed as a tax advantage product if there is a written, electronic or oral communication provided to the parties to the arrangement or potential parties to the arrangemnt that identifies the potential tax benefits of the structure."[2135] Consider the example below. Co. A, resident of Country A receives an investment memorandum of a bond issued by Co. C, resident of Country C, with the information that such bonds generate a tax advantage (D/NI outcome) due to differences of treatment to that particular investment instrument under the laws of the issuer Country (Country C) and a third jurisdiction (Country A). Co. A then proceeds to subscribe to such bonds and ultimately sell those bonds to a willing

[2133] ***Municipal Bonds*** are government bonds (fixed income securities), sold to U.S. natural persons (inverstors) who may benefit from a reduced tax over the profits accrued when the bond reaches its maturity. This specific tax advantage is intimately related to the inverstor's tax bracket. Tax brackets in the U.S are based on the filing status of the taxpayer (single filing, married filing, head of household filing etc). *Lessons in Tax-Advantage Investing. The Municipal advantage: How much is it woth to you?* Legg Mason Global Assets Management. https://www.leggmason.com/content/dam/legg-mason/documents/en/insights-and-education/brochure/municipal-advantage-how-much-worth.pdf. Accessed in 18 Mar 2018.

[2134] ***Letra de crédito imobiliário*** (LCI) – *Real State Credit Note,* are fixed income securities sold to Brazilian investors and guaranteed by the Brazilian Government (up to R$ 250.000) in the event of the issuer's default. Such notes are backed by mortgage operations and are tax exempt. The exemption was designed to incentive banks and buyers alike in dealing such notes in order to raise capital to boost the Brazilian real state market thourgh real state loans.

[2135] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 109.

buyer resident of Country B (Co.B) at the current fair market price. All parties to the transaction are underelated parties. Moreover, the investment product was marketed also in Country B for a number of potential investors through the use of various channels of communicaton (print media, electronic – emails, propects etc). Such scheme created the following:

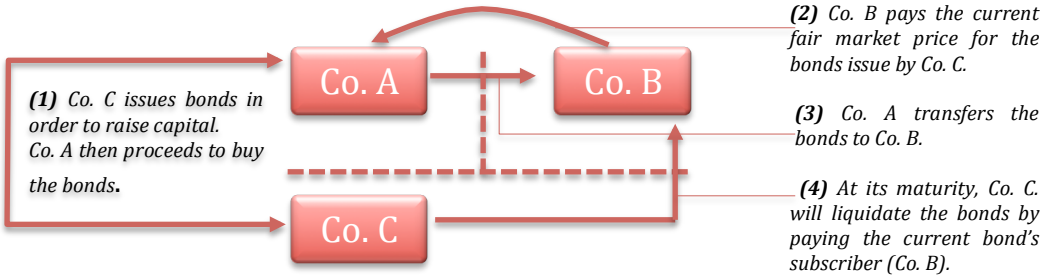
(i) According to the case at hand, Co. A received a memorandum with an investment opportunity which contained a tax advantage;

(ii) The fact that the product was marketed through a number of different communication sources is evidence that the product was not marketed to specific entities that could eventually profit from a mismatch;

(iii) Co. A was aware that entities residents of Country B could eventually benefit from a tax benefit for it had subscribed to Co. C's bonds. Therefore, it is reasonable to conclude that Co. A should be caught under the structure arrangement rule;

(iv) Co. B acquired the investment product at the current fair market price. This is a clear indication that the transaction was conducted under arm's length, therefore, according to the OECD recommendations, Co. B is not party to the structure arrangement.

Figure 62



(i) According to the case at hand, Co. A received a memorandum with an investment opportunity which contained a tax advantage. An arrangement will be considered a tax advantage product if it is commercialized through a written (prospect, letter etc), electronic (e-mail) or oral agreement which contains tax advantage benefits such as DD or a D/NI outcomes.

(ii) The fact that the product was marketed through a number of different communication sources is evidence that the product was not marketed to entities that could eventually profit from a mismatch. The fact that Co. C marketed its bonds to a number of different investors is evidence that the arrangement was not structure to a particular group of investors that could have previous knowlege of tax advantages "due to differences of treatment to that particular investment instrument under the laws of the issuer Country (Country C) and a third jurisdiction (Country A)".

(iii) Co. A was aware that entities residents of Country B could eventually benefit from a tax benefit for it had subscribed to Co. C's bonds. Therefore, it is reasonable to conclude that Co. A should be caught under the structure arrangement rule. It is fair to conclude that Co. A had knowleged of the tax benefits that entities could benefit under the laws of the other Country,

namely, Country B. Moreover, according to the OECD recommendations, if the arrangement produces a hybrid mismatch, and it is recognizable to a well informed observer, the arrangement should be caught by the rule.

(iV) Co. B acquired the investment product at the current fair market price. This is clear indication that the transaction was conducted under arm's length, therefore, according to the OECD recommendations, Co. B is not party to the structure arrangement. Since Co. B is not part of the arrangement, tax authorities ***will NOT require*** Co. B to adjust the transaction.[2136] However, it is also reasonable to expect of the bond's purchaser (Co. B) a certain degree of knowledge regarding its financial operations and tax structure, that is to say, if it is established that Co. B could have sufficient information that the operation would result in a mismatch (D/NI outcome), then Co. B would be trated as part of the arrangement and consequently would be required to adjust the transaction by including the bond's income as ordinary income therefore liable to taxation in Country B.

7. Tax Treaty Abuse

The State where the economic activity took place should be entitled to such taxing rights (substance over form).[2137] However, through the use of certain strategies, MNEs are able to avoid or reduce the group's tax liability. Multi-national companies engaging in treaty-shopping and other treaty abusive schemes "undermine tax sovereignity by claming treaty benefits in situation where these were not intended to be granted, thereby depriving countries of tax revenues".[2138] However, tax authorities will not grant the tax benefit to a company if a possible abuse is identified. According to OECD report on "*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*"[2139] there are two main groups of treaty abuse, namely, when the entity (***i***) circumvent the DTC's limits using the treay's provisions (***DTC circumvention***) and when the entity (***ii***) circumvent domestic law using the treaty's provisions (***domestic circumvention***). In respect to DTC cicumvention, it is important to point out that although after entering into force the DTC becomes part of the Contracting State's legislation, only anti-abuse provisions contained in the DTC itself and international law principles (good faith – *bona fide*, substance over form etc) may be relied upon by tax authorities in order to deny the benefits of that DTC, that is, tax authorities may not invoke domestic law on cases "where a person tries to circumvent limitations provided by the treaty".[2140] However, domestic anti-abuse rules may be relied upon to bar cases where "a person tries to circumvent the provisions of domestic tax law using treaty benefits".[2141] Both situations are described bellow.

[2136] Neutralising the Effects of Hybrid Mismatch Arrangements (n 1995) 105.
[2137] Introduction to the Law of Double Taxation Conventions. 64.
[2138] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 9.
[2139] Ibid 17.
[2140] Ibid 17.
[2141] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 17.

a. Circumventing the DTC's limitations using Treay's provisions (***DTC Circumvention***)

There are a number of schemes that an entity can use in order to circumvent the DTC's limitations, namely, (***1***) *treaty shopping* (when the person is ***NOT*** a resident of the contracting State and tries to obtain tax benefits as residents), (***2***) *splitting-up contacts*, (***3***) *hiring-out labour cases*, (***4***) *conducting transactions intended to avoid dividend characterization*, (***5***) *dividend transfer transactions*, (***6***) *conducting transactions that circumvent the application of Article 13(4)*, (***7***) manipulating *tie-breaker rules for determining the DTC's residence of dual-resident persons other than individuals* and finally (***8***) *abusing preferential tax regimes where in the PE's jurisdiction.*

aa. *Treaty shopping*. When the person is ***NOT*** a resident of the contracting State tries to obtain tax benefits as residents this person shopping for the best possible Treaty in order to optimize tax liability, that is, the taxpayer attempt to "access indirectly the benefits of a treaty between two contracting States".[2142] Numerous measures have already been taken by the OECD in order to detain the practice, such as the inclusion of the "beneficial owner" concept in order to prevent the use of conduit companies that serve as an intermediary in passing on dividends to other entities. Nonetheless, three main practices may contribute to halt such abuse: ***1.*** A clear statement in DTCs on the prevention of tax avoidance through ***treaty shopping***[2143] instances; ***2.*** Inclusion of a *LOB* rule; ***2***. Inclusion of a *PPT* rule[2144] (Article 29 OECD Model 2017).

[2142] Ibid 17.

[2143] The OECD Commentaries suggests the inclusion of the following DTC's provisions as a means to tackle treaty shopping: "(a) ***General bona fide provision*** "The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention." (b) ***Activity provision*** "The foregoing provisions shall not apply where the company is engaged insubstantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations." (c) ***Amount of tax provision "***The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident." (d) ***Stock exchange provision*** "The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned — directly or through one or more companies each of which is a resident of the first-mentioned State — by a company which is a resident of the firstmentioned State and the principal class of whose shares is so registered." (e) ***Alternative relief provision*** "In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term "shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention." OECD Commentaries on the Model Tax Convention Para. 19. 64.

[2144] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 19.

ab. *Splitting-up contacts* is a method used by undertakings in order to circumvent the application of Article 5 (3) OECD Model (twelve-month rule) that provides "A building site or construction project constitutes a permanent establishment only if it lasts more than twelve months)". Contractors or subcontractors (engaged in activities connected with the exploration and exploitation on the continental shelf)[2145] avoid taxation in the source State by dividing their contracts into several parts. Article 5 (3) (a) UN Model provides instead for a 6 month rule, therefore reducing the possibility of such abusive practices. Such measure is applied by undertakings that artificially avoid a PE status.

ac. *Hiring-out labour cases.* By now, it is clear that the State where the economic activity occurred is entitled to taxation rights. Consider the following case. Company A resident of State A, enters into a service contract with company B located in State B, for a particular software training. Company A will then provide Company B all the necessary technology as well the personal which will conduct the tranning in Company B's premises. The personal is under the direct supervision and control of Company A, moreover the services provided is an integral part of the business activities provided by Company A. All travel expenses, social contributions will be paid by Company A. In this case, it is clear that State A will be entitled to the such taxation rights, therefore, State B shall not tax the income accrued in its State (Article 15 (2) (b) OECD Model). Now, were the contract between Company A and Company B related to the outsourcing of an activity which forms an integral part of the business activities of Company B, where Company A would provide the personnel to Company B, who would work under the direct supervision and control of Company B, even if Company A retained the const center (paid all travel expenses, salary and social contribution of the the personnel in State B), State A would ***NOT*** be entitled to such taxing rights. The cost or remuneration alone (social contributions, travel expenses, employment benefits and charges) do not constitute an exception provided by Article 15(2)(a)(b)(c) OECD Model. The important factor here is the connection, the nexus, that the activity has with that State (should the funder be entitled to a higher anticipated return on account of financing the operation? ***No***, the company that had the most control over the operation's risk, will be entitled to a greater portion of retuns.

ad. *Conducting transactions intended to avoid dividend characterization*. This cimcumvention method has already been largely dicussed in hybrid mismatches, where companies abuse the differences on the of of the States involve avoid taxation, for example,a company proceeds to transfer exempt dividends to its associated company resident in another State which are ultimately not characterized as income, but as interest. In order to avoid such

[2145] Ibid 69.

instances jurisdictions should apply the suggested OECD rules of avoiding the effects of Hybrid mismatches.

ae. *Dividend transfer transactions*. As previously studied, dividends paid by a "resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State" Article 10 (1) OECD Model. However, the source State may also either exempt those dividends or levy a 5% of its gross amount if the owner of the dividends holds directly 25% of the capital of the company paying the dividends, ***or*** up to 15% in cases where the owner of the dividends holds directly ***less then 25%*** of the capital of the paying the dividends. [2146] Note that the provision does not mention the time period the company must own the company's shares in order to be eligible (the Parent-Subsidiary[2147] and Interest and Royalties[2148] Directives, for instance, requires at least a 2 year period in order to be elible to the Directive's benefits), that is, companies may be tempted to increase their holdings "shortly before the dividends become payable".[2149] The OECD suggested in the last update version of the Model (2017) the following amendment to Article 10 (2) (a) "5% per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends ***throughout a 365 day period that includes the day of the paymemnt of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganization, such as a merger or divisive reorganization, of the company that holds the shares or that pays the dividend***" (*emphasis added*).[2150] Further changes were also suggested to contain abuse behavior in relation to certain intermediary entities established in the State of source (Real Estate Investment Trusts – REIT) and on cases where dividends are paid to non-resident companies by a U.S. Regulated Investment Company (RIC) "even if that non-resident company holds more than 10 per cent of the shares of the RIC."[2151]

af. *Conducting transactions that circumvent the application of Article 13(4).* Capital gains derived of immovable property may be taxed where the immovable is located, however, Article 13(4) allows the the Contracting State to tax capital gains "realized by a resident of the other State on shares of companies that derive more tham 50 per cent of their value from such immovable property". [2152] However, in some cases, assets are "contributed to an entity shortly before the sale of the shares or other interests in that

[2146] OECD Model Article 10 (2 (a)(b).
[2147] Parent-Subsidiary Directive Article 3(2)(b).
[2148] Interest and Royalties Directive Article 1(5)(10).
[2149] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 70.
[2150] Ibid 70.
[2151] Ibid 70.
[2152] Ibid 71.

entity in order to dilute the proportion of the value of these shares or interest that is derived from immovable property".[2153] To tha effect, Article 13(4) OECD Model was altered[2154] in its last update in 2017 to "refer to situations where shares or similar interest derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only".[2155]

ag. *Manipulation of tie-breaker rules for determining the DTC's residence of dual-resident persons other than individuals*. In order to beneft from a DTC, one has to be a resident of that State for tax purposes. However, in some instances entities (individuals and persons other than individuals) may be resident's of two Contrancting States (although less commom, it is possible due to differences in allocation factors). Tie-breaker rules are provisioned in Article 4 OECD Model, and shall follow the criteria established by the Article. Nonetheless, in case a person other than an individual is a resident of both contracting State the "***competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, <u>such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States</u>***" (emphasis added) (Article changed in the last 2017 Model's update).

ah. *Abusing preferential tax regimes where in the PE's jurisdiction*. MNEs may abuse certain positions by transferring shares, claiming debts, rights or property to PE "set up solely for that purpose in countries that offer preferential treatment to the income from siuch assets. Therefore, where the "State of residence exempts, or taxes at low rates, profits of sucg permanent establishments situated in third Statesm the State of source should not be expected to grant treaty benefits with respect to that income." [2156] Here, Article 29 OECD Model 2017 (Entitlement to benefits) is applied.

[2153] Ibid 71.

[2154] "4. Gains derived by a resident of a Contracting State from the alienation of ***shares or comparable interest, such as interest in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, there shares or comparable interest derived*** ~~deriving~~ more than 50 per cent of their value directly or indirectly from immovable property, ***as defined in Article 6***, situated in ~~that~~ the other State ~~may be taxed in that other State~~." OECD Model 2017 Article 13(4).

[2155] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 71.

[2156] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 75.

b. Circumvent domestic law using the Treaty's provisions (***Domestic Circumvention).***

Cases where the taxpayer circumvent domestic law using the Treaty's provisions has already been largely discussed throughout this study, for instance, in order to avoid taxation entities may diversify how they finance their operation (debt x equity) in order to reduce ETR (thin capitalization), transfer mispricing, build tax schemes with hybrid mismatches (turning dividend into interest), transforming business profits into capital gains, take advantage of timing differences by delaying taxation or advancing deductions etc. Such forms of tax arbitrage are possible due to mismatches of domestic laws.[2157] Taxpayers may also make use other abusive tax practices, by creating of artificial foreign tax credits for deduction purposes. The neutralization of such practices are highly dependable on the correct application of the Model's provisions, that must be interpreted not only within the strict meaning of its provisions but also according to its spirit,[2158] which is to provide the functioning of a more fair international taxation system that creates no interference whatsoever on investment decisions. Investment choices should be determine by the equation *risk x return on investment*, and not by subversive tax schemes. Hybrid neutralization, a more intensified application of CFC rules, the strengthening on the correct application of arm's length principle on transfer princing instances counter attacks such practices.[2159] However, without full cooperation of the international community, this will prove to be impossible.

One of the guiding principles of the OECD Model is that "the benefits of double taxation convention should not be available where the main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position",[2160] therefore the ***imporper use of the convention*** should be vehemently prohibited. Under such reasoning, the OECD have on the last *Model*'s update (12.2017) revised the section on the "Improper use of the Convention"[2161] only to include provisions that "better articulate the relationship between anti-abuse rules and tax treaties", such as the PPT test, guidance on possible conflicts between domestic GAARs and Treaty's GAARs,[2162] etc.

Tax jurisdiction have created a number of judicial doctrines in order to interpret tax legislation, for instance the already discussed transaction's economic substance, substance over form, "sham (fraud), business purpose, step-transaction, abuse of law and fraus legis"[2163] etc. However, the OECD study on "*Preventing the granting of Treaty Benefits in Innapropriate Ciscumstances*",

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[2157] Ibid 78.

[2158] *Bach*, for example, did not indicate how its music should be played. Therefore, the only way to proceed would be to study how life socially, economically, politically and most important, religiously was conducted back then, and by compiling such information, one is able to grasp the spirit of his work. The same must be done when studying the law. The sole purpose of international tax law is to provide a neutral international system of taxation, a system that do not interfere in the competitive process, nor influence investment decisions whilst maintaining fairness and effectiveness.

[2159] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. (n 462) 78.

[2160] OECD Commentaries on the Model Tax Convention 61. Para 9.5.

[2161] OECD Commentaries on the Model Tax Convention 59. Para 7.

[2162] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. (n 462) 82.

[2163] Ibid 84.

points out that the Treaty's interaction with domestic GAARs may lead to the (***i***) contracting State's inability to tax its own residents and to the (***ii***) application of Treaties to departude or exit taxes.[2164] Both approaches are are properly analysed bellow.

aa. *Contracting State's inability to tax its own residents.* Some of the Treaty's provisions could be interpreted as to prevent a contracting State from taxing its nationals by providing them some tax benefits, for instance, in cases of readjustment of profits in the other State that lead to a correlated readjustment in that State "to the amount of tax charged on the profts of a permanent establishment of an enterprise"[2165] (para 3 Article 7 OECD Model), ***or*** by providing relief to DT "with respect to the income that the other State may tax in accordance with the Convention"[2166] (para. 2 Article 7 and Article 23 A and 23 B OECD Model) among oter cases.[2167] Contracting States are only required to provide relief to double taxation when "income was taxable in the other under treaty provisions allowing that other State to tax the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable". To that end, the OECD Model has in the last Model's update, changed the wording of Articles 23 A and 23 B.

ab. *Departure or exit taxes.* Tax liability may arise when a taxpayer ceases to be a resident of a State (*exit taxes*). In circumstances such as these the State may levy taxes on capital gains and on pensions in order to protect the balance of allocation rights. The fact is that DTCs do not provide for this exit taxes, that is, "tax treaties do not prevent the application of domestic tax rules according to which a person is considered to have realized pension income, or to have alienated property for capital gain tax purposes, immediately ***before ceasing to be a resident***"[2168] (*emphasis added*). In other words, the possibility of double taxation emerges when that person becomes a resident of the other contracting State which will eventually "tax the same income at a different time". The problem with departure or exit taxation is that the income is not yet realized (a State may levy taxes over unsold shares of a listed company – capital gains ***or*** levy taxes of yet not received pension dues). The OECD Commentaries provide a solution for resident States that are entitled to tax income from an employee's stock-option at different times through MAP.[2169] Solving DT situations through MAP is also a possible basis for solving problems not convered by DTCs. ("This would mean that the new State of residence would provide relief for the departure tax levied by the previous State of

[2164] Ibid 86.
[2165] Ibid 87.
[2166] Ibid 87.
[2167] Ibid 87.
[2168] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 89.
[2169] Para. 4.3 OECD Commentary on Articles 23 A and 23 B reads "[T]he mutual agreement procedure could be used to deal with such a case. One possible basis to solve the cases would be for the competent authorities of the two States to agree that eache State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State." Para. 4.3 OECD Commentary on Articles 23 A and 23 B.

residence on income that accrued whilst the person was a resident of that other State, except to the extent that the new State of residence would have had source taxation rights at the time that income was taxed (i.e. as a result of paragraphs 2 or 4 of Article 13)".)[2170]

One of the OECD BEPS greatest concernes is treaty abuse. Nevertheless, the Model's provisions must be adapted according to the specifications of the relevant Contracting States, takings into consideration other relations that may affect DTC applicability, for instance, some State have supra-national restrictions, that is to say, EU law that "prevent them from adopting the exact wording of the model provisions"[2171] recommended by the OECD. Adminitrative issues must also be considered for they affect directly the applicability of anti-abuse provisions. However, a number or OECD and non-OECD members already have developt its ow n set of "interpretative tools (e.g. economic substance, substance-over-form) that effectively address various fors of domestic law and treaty abuses and these countrie might not require the general treaty-abuse provision" [2172] suggested by the OECD report on the matter. Nonetheless, the suggestions made by the OECD report on "*Preventing the Granting of Treaty Benefits in Inapropriate Circumstances*", if approprietly implemented, are likely to reduce or even neutralize eventual abuses.

8. Artificial Avoidance of PE Status[2173]

The PE concept is central to international taxation, for it determines the taxing rights of a State. In 2013 the OECD published an action plan (*Report*) where it identified "15 actions to address BEPS in a comprehensive manner" as well as a deadline for the implementation of such measures. In the Report, special attencion were given towards the necessity of an update on the definition of a PE, in order to *keep up* with the "avoidance strategies related to the permanent establishment concept". According to the Report, *"[T]he definition of permanent establishment (PE) must be uploaded to prevent abuses.* In many countries, the interpretation of the treaty rules on agency-PE allows contacts for the sale of goods belonging to a foreign enterprise to be negociated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by the distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by "*commissionaire arrangements*" with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for *preparatory and ancilliary activities*" (*emphasis added*).

Should ***distributions centres*** be demmed as having a preparatory or anciliary activity for the purposes of PE classification under the OECD Model? ***No***.

[2170] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (n 462) 89.
[2171] Ibid 14.
[2172] Ibid 14.
[2173] Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (n 40) 152.

Article 7 (1) OECD Model, if an enterprise operates through a PE in another State, that State will be entitled to such taxting rights (substance approach). According the OECD 2017 Model Update, distribution centrers "[W]here, for example an enterprise (…) maintains (…) a very large warehouse in which a significant number of employees work for the main purpose of storing delivering goods owend by the enterprise that the enterprise sells online to customers (…), *paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through the warehouse, constitute an essential part of the enterprises's sale/distributions business and do not have, therefore, a preparatory or auxiliary character*" [2174] (emphasias added).

VI. *"Opting" out National Tax Systems – CC"C"TB*[2175]

A. Introduction[2176]

After this introduction to international corporate taxation and corporate taxation within the Internal Market, one is able to grasp the great challenges posed upon the EU Community in order to create a more friendly, just and fair tax system, which contributes to economic growth (increasing consumption, jobs, reducing uncertainty etc), where each company pays its fair amount of taxes according to the benefits extracted from the relevant Country where it operates. According to *Watter/Terra* "(…) it is pointless to approximate tax rates without approximating tax bases (…). In this respect, the Committee presented a long list of recommendations, ranging from matters of principle (*e.g.* commercial accounts should be the starting point for the computation of taxable income in all Member States) to very technical matters. It identified as the most urgent technical matters: (i) common rules on depreciation of assets and abolishment of all special depreciation rules with an incentive effect, (ii) uniform tax treatment of goodwill and other intangible assets and basic harmonization of the tax treatment of leasing, (iii) introduction of a free but irrevocable choice of stock valuation methods LIFO,[2177] FIFO,[2178] average cost or base stock ('stock outil'), (iv) common rules for the allocation of headquarter cost, for the invoicing for intercompany pricing of centrally provided services within groups of companies, and for definite costs born by shareholders, in order to preclude these costs to be non-refundable in any Member State, (v) adoption of the 1984 Commission proposal for a directive on the harmonization of carry-back and carry-forward period of losses, and (vi) ensuring the deductibility of pension contributions paid in respect of expatriate employees or paid to a non-resident pension fund. To date, none of this has been achieved, while most these matters are still topical." [2179] The CCCTB Directive proposal is a response to such shortcomings.

[2174] Draft Contents of the 2017 Update to the OECD Model Tax Conventiion. OECD (2017). Comentaries on Article 5 concerning the definition of Permanent Establishment. 85.
[2175] Jacques Malherbe, Philippe Malherbe, Isabelle Richelle, Edoardo Traversa (n 194) 108.
[2176] Luca Cerioni (n 418) 155.
[2177] Last In First Out. (LIFO).
[2178] First In First Out (FIFO).
[2179] Ben Terra and Peter Wattel (n 60) 186.

In 2011 when the first CCCTB draft was issued, the Commission suggested an optional regime, that is to say, undertakings could ***opt out of domestic tax bases for a supra-national one***, for a Common Corporate Consolidated Tax Base, meaning that, the group's tax liability would now be assessed according the formulary apportionment proposed by the Commisssion, and tax revenue would be distributed to MSs on the basis of that formula (a complete shift from a separate accounting to formulary appontionment). Nonetheless, the Commission concluded that a complete and immediate shift from one system to the other would not be a viable approach, therefore it propose to divide the CCCTB project in two parts, that is, first a compulsory harmonization of tax bases would occur (1th step - CCTB) and then consolidation (2nd step - CCCTB). *The song remains the same*, however is slowly played. We will discuss the most relevant parts of both Directives (apportionment formula, how it is assessed when compared to ALP, tax base elements etc). Regard will also be given to depreciation rules and losses under the Directive's rules. The anti-abuse provisions were already studied in GAARs – hybrid mismatches, CFC rules, switch over-rules etc (GAARs).

B. Opting out of the National Tax System

The verb "opt", relates to choice, selection, decision, therefore, can only be associated to the CCCTB 2011 Directive Proposal. The CCTB Directive proposal (COM(2016) 685 final) ***DO NOT*** grant groups operating over EUR 750 000 000[2180] such faculty (SMEs and start-ups may opt-in the Directive regardless the threshhold).

As previously mentioned, the "CCCTB is supposed to replace the national corporate tax law system, which have been built over decades of legislation, parliamentary explanations, resolutions and case law, and the provisions of the CCCTB should not be interpreted by each Member State from the perspective of its national corporate law system (…)".[2181] Nonetheless, it is important to keep in mind that after calculated, "the tax base (…) will be subjected to the tax rate applicable in the Member State concerned",[2182] ***for only the base is being uniformed, and not rates***.

1. Formulary Apportionment (dismissed paths)

Before accepting the formulary apportionment (three factor formula) as the basis for tax base allocation across the Union, it was proposed using the "separate accounting method", that is, profits would be distributed according to that method. Nonetheless, since such method still operates under the same TP single transaction method, the Commission "concluded that the system would be 'be rather self-defeating' and it did not analyse that option".[2183] The Commission also considered "***macro options*** based on measures such as national income or ***value added***" (emphasis added), in order to "break the link between the company and the allocation process" thus, not introducing distortions to

[2180] COM(2016) 685 final Article 2(c).
[2181] Denis Weber (n 45) Pag 42.
[2182] Ibid 10.
[2183] Ibid 267.

economic activity as the formulary apportionment does.[2184] Both methods were also rejected, for they were inconsistent "with the mutual recognition approach and (…) they seemed more appropriate for allocating the tax base rather than income (…)". In sum, "the Commission concluded that Member States tax rates would have to be identical (…)" *and* "did not consider the option of distributing income according to industry averages. Using industry averages seemed an inappropriate way to determine the tax liability of an individual company".[2185] The Commission did not accept distributing income according to the location of ***value added*** rather than the location of capital, labour and sales, for when "measured on an origin basis, value added reintroduced the transfer pricing problem, and when measure on a destination basis, it reintroduced significant complexity".[2186] To conclude, the unitary tax, or combined report method was also considered, which would have combine "all of economically related entities of a corporate group into a single taxable unit".[2187] Such method would look past the parent company's relation with its associated companies, therefore concentrating on their economic connections, for instance the level of economic integrantion between group members. On the one hand, corporate integration requires ownership tests in order to ascertain whether the associated company is part of the consolidated group (objective test). On the other hand, econonmic integration requires the analysis of companies "economic flow" to determine if the relevant company is actually part of the consolidated group (subjective test).[2188]

2. Formulary Apportionment (chosen path)

Formulary apportionment, in sum is a distribution formula, that is to say, a prescription on how the tax paid by the relevant group will be distributed to MSs within the internal market, therefore it was mandatory for the Commission to came up with a formula which would distribute income in a equitable and fair manner, moreover, the formula should be simply enough in order to avoid being manipulated. The matter of global formulary apportionment (GFA) and arm length's principle (ALP) was already subjected to discussion in other parts of this investigation (TP), where the reasons why the OECD did not choose the GFA over SA were presented (governments would want to "(…) *include different factors in the formula based on the activities or factors that predominate in its jurisdiction*" in order to enhance its revenue, which would make the GFA unlikely to be adopted at an international level).[2189] Nonetheless, at a supranational level, it may very well be the best alternative the EU can take in order to get several steps closer in creating a "true internal market within itself".[2190]

Internationally, the allocation of business profits is conducted under the so-called ***separate accounting model*** (SA). Such model relies on the principle that all intra-group transactions should be priced at arm's length, that is, the relevant

[2184] Ibid 268.
[2185] Ibid 268.
[2186] Denis Weber (n 45) 268.
[2187] Ibid 268.
[2188] Ibid 268.
[2189] Transfer Pricing Guidelines (n 503) 40.
[2190] Denis Weber (n 45) 269.

taxpayer (and tax administrations) analyse the transaction by using comparables in order to ascertain if the charged price is in fact in tune with the price that unrelated parties would contract (TP). However, as previously discussed the referred model "ignores the very nature of economically integrated multi-jurisdictional corporations by treating their operations as if they were separate and independent"[2191] ultimately offering the possivility to MNEs to manipulate controlled transactions. Furthermore the problem of valuating certain intangibles (HTVI) raises great difficulties to tax adminsitrations in finding reliable comparables, therefore determining "the tax liability in each jurisdiction by applying the arm's length pricing standard adds complexity to the working of internation business". [2192]

The Commission has ultimately chosen to portion the company's capital, labour and sales, which will be shared according to the apportionment formula consisted of three main factors: ***fixed tangible assets***, ***labour*** and ***sales***, being that each is distributed equally (same weight). It is important to note that by "attributing the tax base to group members rather than to the EU Member States, the entire tax base will be attributed to a taxpayer". Nonetheless, the Commision included in the Directive Proposal's a safeguard clause "for cases where the standard formula does not fairly represent the extent of business activity".[2193] The formula for apportionment provided in Article 28 CCCTB Directive proposal[2194] reads:

$$Share\ A = \left(\frac{1}{3}\frac{Sales^{A}}{Sales^{Group}} + \frac{1}{3}\left(\frac{1}{2}\frac{Payroll^{A}}{Payroll^{Group}} + \frac{1}{2}\frac{No.of\ employees^{A}}{No.of\ Employees^{Group}}\right) + \frac{1}{3}\frac{Assets^{A}}{Assets^{Group}}\right) * Tax\ Base$$

At first sight, one is able to identify immediately that the Commmission gave an equal weight to all variables, having divided only labour in two parts – each element weighted equally. Bellow each variable is briefly analysed.

Sales factor. Sales of goods, supplies and services are part of such factor. Sales between members of the same group ***were excluded***. ***Interest***, ***dividends***, ***royalties*** and ***capital gains*** were also excluded from the factor "unless these items of income are earned as part of the business".[2195] Sales of goods are connected to their destination, services to the place where the service was actually provided. [2196] To conclude, "[S]ales that would otherwise be assigned to a place where they would not be taxed are assigned to the sales factor of all members in proportion to their asset and labour forces".[2197]

Labour factor. The Commission chose to split the labour factor, recognizing that "labour productivity is not yet equalized across the EU".[2198] Consequently it included both employees and compensation in the labour factor (***payroll).*** One has to keep in mind the wage disparities within the Union, factor which lead the Commission to break the labour factor into two parts. According to *Joann Martens Weiner* "[P]ayroll is generally assigned to the location where

[2191] Sec (2011) 315 final (n 20) 9.
[2192] Sec (2011) 315 final (n 20) 9.
[2193] Denis Weber (n 45) 258.
[2194] COM(2016) 683 final.
[2195] Denis Weber (n 45) 259.
[2196] Ibid 259.
[2197] Ibid 259.
[2198] Ibid 259.

the services are performed, to the base of operations, or to the place from which the employee's services are perfomed. If the location cannot be determined, payroll is assigned to where the employee lives. Independend contractors are considered employees if they perform work that would normally be done by an employee."[2199]

Assets factor. Within the asset factor lies the *average value* of the rented, owned or leased *fixed tangible assets* (buildings, airplanes and machinery).[2200] Rental property should be measured at a rate of eight times its annual rent.[2201] The factor, do not include ***intangibles***, ***inventory*** and ***financial assets*** ("the reason for this exclusion mainly lies with the mobile nature of those asssets and the risks of circumventing the system").[2202] Actually, restraining the asset factor to fixed assets was a brilliant move, that is, the Commission "eliminated the possibility of artificial factor shifting for the two classes of assets that offer the greatest opportunities for such shifting: (1) *intangible property* and (2) *inventory*".[2203] Another interest fact that one has to keep in mind is that by excluding from the tax base intra-group transactions, "leases or rentals of assets between group members are not reflected in the assets factor".[2204] The value of depreciable property should be measured "at its value for tax purposes" [2205] and as for contribution to intangible assets, the factor "includes the costs incurred for research and development, marketing and advertising in the six years before the company joins the CCCTB for the period of five years after it joins the CCCTB.[2206] Assets are included in the factor of its economic owner".[2207] Nevertheless, if the "allocation apportionment provisions (…) do not fairly represent the extent of the taxpayer's business activity (…), the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity"[2208] the use of an alternative method (***safeguard-clause***).[2209]

Now that we have briefly presented how the formula should be applied, nothing better than an example in order to improve the "*intuitive understanding of a functional relationship*".[2210] Consider the following case. A Parent Company resident in Austria has four subsidiaries, one in Austria, Germany, France and

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[2199] Ibid 259.

[2200] "***Fixed assets are depreciable for tax purposes subject to certain exceptions***. Depreciable assets are distinguished between those subject to depreciation individually and those placed in a pool. Long-life tangible and intangible fixed assets are individually depreciated whilst the remaining assets go into a pool. (…) Fixed assets are divided into five groups with maximum depreciation periods of 4, 6, 12, 20, 30, 50. The fith and the sixth group includes buldings only, some items in the forth group refer to immovable as well" (emphasis added). Sec (2011) 315 final (n 20) 156.

[2201] CCCTB Directive Proposal. COM (2011) 121/4 Article 94(4).

[2202] Sec (2011) 315 final (n 20) 98.

[2203] Denis Weber (n 45) 245.

[2204] Ibid 247.

[2205] Ibid 258.

[2206] CCCTB Directive Proposal. COM (2011) 121/4 Article 92(2).

[2207] Denis Weber (n 45) 258.

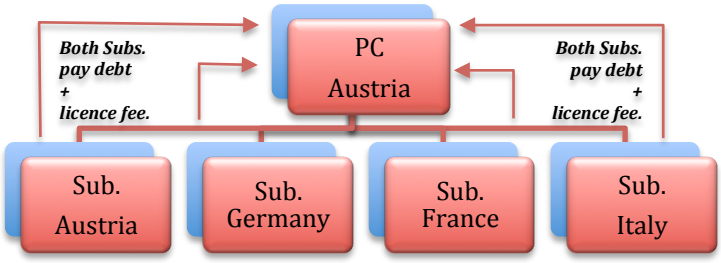
[2208] "Although the safeguard clause (…) says nothing about the alternative methods that may be used (…) the CCCTB's safeguarde clase could be invoked in cases in which abusive tax planning lead to outcomes that do not fairly represent the group member's business activity". The manner in which such clause will be applied will be established by a Committee (Articles 13(1) and 13(2) CCCTB Directive Proposal), assisted by the Commission. Denis Weber (n 45) 250.

[2209] CCCTB Directive Proposal. COM (2011) 121/4 Article 87.

[2210] Robert Cooter and Thomas Unlen (n 15) 416.

Italy. Each subsidiary produces and sell products in its respective market. The product was developed by the parent company in Austria. The product's research and development (R&D), marketing, adventisement are all paid by the parent company in Austria. In order to finance the activities of its subsidiaries, and taking advantage of a high credit score, the PC contracted a loan with a bank in Austria, which was invested into the group's operation. It is also important to note that due to the fact that the PC developed the product, marketed and advertised it, the PC charges its subsidiaries a licence fee for its use. The PC's ***costs are paid by all four subsidiaries*** and for the sake of simplicity, consider that all subsidiaries initiated its operations in the same year, say 2005.

Figure 63



Parent Company Austria contracted a loan on the amount of 450 for each each of its subsidiaries, resulting on an interest payment of 13,50 for each subsidiary made out to the PC.

	PC Austria	Sub Austria	Sub. Germany	Sub. France	Sub. Italy
Interest (intra-group) 3%	54	(13,50)	(13,50)	(13,50)	(13,50)
Licence fee (5% sales)	350	(50)	(75)	(100)	(125)
PC's costs (6% sales)	420	(60)	(90)	(120)	(150)
Number of employees	20	70	100	110	120
Payroll	2	7	10	11	12
Tax value fixed assets	0	100	400	400	400
Market Value	2.000	300	400	500	600

The current market value capitalization of PC Austria is at 2.000, 300 for Sub. Austria, 400 for Sub. Germany, 500 for Sub. France and finally 600 for Sub. Italy. Note that PC Austria has the higher market value for it detains the

ownership of the product sold by its four subsidiaries. PC Austria has no sales of its own, nonetheless, Sub Austria has a total turnover of 1000, Sub. Germany a total to 1500, Sub. France 2000 and Sub. Italy has a 2500 of sales.

Balance Sheet	PC Austria	Sub Austria	Sub. Germany	Sub. France	Sub. Italy
Fixed assets	0	100	400	400	400
Subsidiaries	450	-	-	-	-
Group receivables	900	-	-	-	-
Equity	1000	100	100	100	100
Liabilities (debt)	300	450	450	450	450
Profit & Loss items					
Sales	-	1.000	1.500	2000	2.500
Intra-group - interest 3%	54	(13,50)	(13,50)	(13,50)	(13,50)
- licence fee (5% sales)	350	(50)	(75)	(100)	(125)
- PC's costs (6% sales)	420	(60)	(90)	(120)	(150)
R&D costs	(60)	(10)	(15)	(20)	(25)
M&A costs	(100)	-	-	-	-
Payroll (and other costs)	(120)	(790)	(1.220)	(1.655)	(2.075)
EBT	524	76,50 7,65%[2211]	86,50 5,77%	91,5 4,57%	111,50 4,46%
EBT group					890

The group's earninngs before tax equals 890, being that PC Austria eaned 524, Sub Austria 76,50, Sub Germany 86,50, Sub. France 91,5 and Sub. Italy 111,50. Once again, for the sake of simplicity, no adjustment under Articles 61 to

[2211] Profit ratio.

63[2212] CCCTB Directive Proposal and 67 and 68[2213] of the same Statute are necessary. Now, applying the apporntionment formula previously studied, each MS would be entitled to tax:

$$PC\ Austria = \left(\frac{1}{3}\frac{0}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{2}{42} + \frac{1}{2}\frac{20}{420}\right) + \frac{1}{3}\frac{0}{1300}\right) \times 890 = 15$$

$$Sub.Austria = \left(\frac{1}{3}\frac{1000}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{7}{42} + \frac{1}{2}\frac{70}{420}\right) + \frac{1}{3}\frac{100}{1300}\right) \times 890 = 114$$

$$Sub.Germany = \left(\frac{1}{3}\frac{1500}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{10}{42} + \frac{1}{2}\frac{100}{420}\right) + \frac{1}{3}\frac{400}{1300}\right) \times 890 = 226$$

$$Sub.France = \left(\frac{1}{3}\frac{2000}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{11}{42} + \frac{1}{2}\frac{110}{420}\right) + \frac{1}{3}\frac{400}{1300}\right) \times 890 = 253$$

$$Sub.Italy = \left(\frac{1}{3}\frac{2500}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{12}{42} + \frac{1}{2}\frac{120}{420}\right) + \frac{1}{3}\frac{400}{1300}\right) \times 890 = 282$$

Note that the value that each MS would be entitled to tax under SA are considerably different from that of the formula. For instance, under the present system (ALP), Austria would be entitled to tax ***524*** of PC Austria's income. However, under the ***apportionment formula***, the Austrian tax authority would only be entitled to tax ***15***. The interesting fact about the formula is that it restricts the possibility of profit shifting through aggressive tax planning, for the formula shares among group members, the "average share of the group's overall sales, labour and assets, with the labour factor itself reflecting an average of the group's payroll costs and number of employees".[2214]

Now, consider that all subsidiaries have just recently joined the group, therefore, attentive to Article 34(2) CCCTB Directive proposal,[2215] the taxpayer proceeded to ajust the group's consolidated tax base to the rule of referred in that Article which states that "[I]n the five years that follow a taxpayer's entry into an existing or new group, its asset factor shall also include the total amount of costs[2216] incurred for ***research***, ***development***, ***marketing*** and ***advertising*** by the taxpayer over the ***six years that preceded its entry into the group***" (emphasis added). In order to maintain a certain simplicity to the example,

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[2212] "Article 61 ***Fixed assets on entering the group***"; "Article 62 ***Long-term contracts on entering the group***" and "Article 63 ***Provisions on entering the group***". CCCTB Directive Proposal. COM (2011) 121/4.

[2213] "Article 67 ***Fixed assets on leaving the group***"and "Article 68 ***Self-generating intangible assets***". CCCTB Directive Proposal. COM (2011) 121/4.

[2214] Denis Weber (n 45) 226.

[2215] COM(2016) 683 final.

[2216] "In accounting an asset is initially measured at its costs. The cost of an item of property, plant, equipment comprises its purchase price and any directly attributable cost of bringing the asset to the working condition for its intended use. Cost is understood as the amount of cash equivalents paid or the fair value of other consideration given to aquire an asset at the time of its acquisition or construction" TAXUD CCCTB TF/DB/OP. CCCTB/WP/004/en. European Commission. Directorate-General Taxation and Customs Union. AAnalyses and tax policies. CCCTB task force. Para 8.

consider that the costs of the previous six years in respect to RDM&A did not fluctuate.

$$PC\ Austria = \left(\frac{1}{3}\frac{0}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{2}{42} + \frac{1}{2}\frac{20}{420}\right) + \frac{1}{3}\frac{960}{2680}\right) \times 890 = 122$$

$$Sub.Austria = \left(\frac{1}{3}\frac{1000}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{7}{42} + \frac{1}{2}\frac{70}{420}\right) + \frac{1}{3}\frac{100+60}{2680}\right) \times 890 = 110$$

$$Sub.Germany = \left(\frac{1}{3}\frac{1500}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{10}{42} + \frac{1}{2}\frac{100}{420}\right) + \frac{1}{3}\frac{400+90}{2680}\right) \times 890 = 190$$

$$Sub.France = \left(\frac{1}{3}\frac{2000}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{11}{42} + \frac{1}{2}\frac{110}{420}\right) + \frac{1}{3}\frac{400+120}{2680}\right) \times 890 = 214$$

$$Sub.Italy = \left(\frac{1}{3}\frac{2500}{7000} + \frac{1}{3}\left(\frac{1}{2}\frac{12}{42} + \frac{1}{2}\frac{120}{420}\right) + \frac{1}{3}\frac{400+150}{2680}\right) \times 890 = 254$$

Note that, by changing the asset factor, the formula's allocation change substantially. Article 34(2) CCCTB Directive Proposal,[2217] was a Comission's response to the problem of measuring intangibles. It is well known that "differences between tax book value and market value may, in combination with the formulary apportionment, lead to quite a different allocation under the FA than under (...) (ALP). This may be the case particularly where 'intangibles' and intra group services/charges form an important factor for the taxpayer/group concerned",[2218] for intangibles can influence the company's productivity, altering considerably the formula's distribution. Aware of such fact, the Commission "tried to mitigate the effect of intangibles by introducing Article 92(2) Directive".[2219] One must not loose sight of the fact that the formula's intention is to simplify profit allocation, reduce compliance costs, and more importantly, reduce avoidance due to profit shifting schemes, thus it is comprehensible the Commission's intention to exclude intangibles from the formula and including a more "pragmatic approach" through Article 34(2) Directive, for even though "trade and marketing intangibles may represent a substantial market value and may not have been recorded as an asset on the national corporate balance sheet, the principle of Article 43 CCTB Directive[2220] proposal (roll-over) is applied to intangibles. If the taxpayer becomes part of a CCCTB group, Article 34(2) Directive[2221] provides for an adjustment of the asset factor in the five years that follow a taxpayer's entry into an already existent or new group. During this period, its asset factor shall include the total amount of costs incurred for research, development, marketing and advertising (RDM&A) by the taxpayer over six years that preceded its entry intro the group".[2222]

[2217] COM(2016) 683 final.
[2218] Denis Weber (n 45) 22.
[2219] Ibid 23.
[2220] COM(2016) 685 final.
[2221] COM(2016) 683 final.
[2222] Denis Weber (n 45) 23.

EBT	ALP		FA *before* 34 (2)		FA *after* 34(2)	
PC Austria	*524*	*58,84%*	*15*	*1,70%*	*122*	*13,70%*
Sub. Austria	*76,50*	*8,60%*	*114*	*12,80%*	*110*	*12,36%*
Sub. Germany	*86,50*	*9,70%*	*226*	*25,40%*	*190*	*21,35%*
Sub. France	*91,50*	*10,30%*	*253*	*28,42%*	*214*	*24,05%*
Sub. Italy	*111,50*	*12,56%*	*282*	*31,70%*	*254*	*28,54%*
Total	*890*	*100%*	*890*	*100%*	*890*	*100%*

As previously mentioned Article 43 CCTB Directive proposal[2223] provides that, "***all assets and liabilities*** shall be recognized at their value and calculated according to national tax rules immediately prior to the date on which the rules of this directive start to be applied to the taxpayer", therefore the liabilities generated by an intangible (RDM&A), must be computed. The example above depicts the impact that the cost of intangibles impose upon the formula. According to the CCCTB Working Group (WP) "[I]ntangibles (...) improve the productivity of labour (which may be reflected in labour cost) or of the capital employed (which increases the value of capital) or improve the untility and nature of the product for the consumer (which is reflected in the sales and the income that is produced). One could argue that intangibles are used both where the product is manufactured and in the market where goods are sold. If one has to try to understand the role of intangibles, would one conclude that the profit made by a famous beverage trademark is coming from sales or from some secret formula and advertising? Should those profits be attributed to intangibles or to the place where the people drink it, where the trademark has value, where advertising occurs, etc?"[2224] We conclude the topic with the WP remarks on formulary apportionment functionality "(…) one professor from a university emphasized that there is no one 'correct formula' and one should not even try to identify the location of profits. However, whichever formula one uses, it will have real economic effects"[2225]

3. Calculation of the Tax Base (Articles 6 to 14 CCTB)

According to Article 7 CCTB[2226] (10 CCCTB) [2227] the tax base shall be "calculated as revenues[2228] less exempt revenues, deductible expenses[2229] and

[2223] COM(2016) 685 final.
[2224] TAXUD CCCTB TF/DB/OP. CCCTB/WP/64/en. European Commission. Directorate-General Taxation and Customs Union. Analyses and tax policies. CCCTB task force. Para 65.
[2225] CCCTB/WP/64. Para 66.
[2226] COM(2016) 685 final.
[2227] COM (2011) 121/4.
[2228] "Revenues include proceeds of any kind, whether monetary or non-monetary. That is, not only trading income but also proceeds from disposals of assets and rights, interest, dividends and other profit distributions, royalties, subsidies and grants, gifts, compensation and ex-gratia payments." Nonetheless, revenues "shall not include equity raised by the taxpayer or debt repaid to it (Article Article 4 (5) CCTB). Sec (2011) 315 final (n 20) 92.
[2229] "Deductible expenses shall mean all expenses incurred by the taxpayer for business purposes in the production, maintenance or securing of income, including costs of research and

other deductible items. As a matter of principle, the tax base would be calculated for each tax year",[2230] that is to say, ***under a profit and loss account*** (P&L).[2231] Bellow we we list the general principles in ascertaining the tax base:

a. *P&L must be recognized only when realized (Article 9(1) CCCTB – Article 6(1)CCTB).* "Income and expenses shall be recognised on an ***accrual basis***[2232] in the tax year to which they relate. Generally speaking, the expense should be established and the amount known in order to be accrued. However, when an amount arising from a legal obligation or a likely legal obligation relating to activities or transactions carried out in the current or previous tax years, such as potential warranty claims, can be reliably estimated, the expense would be deductible in the current tax year. An appropriate deduction shall be allowed for a bad debt receivable by the taxpayer when certain conditions are met."[2233]
b. *Transactions must be measure individually (Article 9(2) CCCTB*[2234] *– Article 6(2) CCTB).* [2235] General principle expected to be found in any tax base rules.
c. *The calculation of the tax base shall be consistent unless exceptional ciscumstances validate the variation (Article 9(3) CCCTB – Article 6(3) CCTB).* The calculation of the tax base must "be consistent unless exception circumstances justify a change", [2236] that is to say, as long as the main reason for the change is obtaining a tax advantage, the system may be changed. [2237]
d. *The tax base must be calculated for each tax year (unless otherwise provided), and consist of a 12 month period, unless otherwise provided (Article 9(4) CCCTB – Article 6(4) CCTB).* Tax base, income and expenses shall be measured in EUR or translated into EUR on the last day of the tax year." [2238]
e. *Expenses, Revenues and deductible items must be recognized within the tax year that they occurred, unless otherwise provided (Articles 17, 18 and 19 CCCTB – Article 15, 16 and 17 CCTB).* Revenue and expenses shall be measured by reference to: "(a) the monetary consideration for the relevant transaction, such as the price of goods or services, (b) the market price where the consideration for the transaction is wholly or partly nonmonetary, (c) the arm's length price in the case of transactions between related parties, and (d) the fair value of financial assets and liabilities held for trading."[2239]

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development or costs for raising equity or debt for business purposes. The definition is accompanied by an exhaustive list of non-deductible expenses." Sec (2011) 315 final (n 20) 92.

[2230] Sec (2011) 315 final (n 20) 92.
[2231] Denis Weber (n 45) 68.
[2232] Accrual basis accounting ***x*** cash basis accounting.
[2233] Sec (2011) 315 final (n 20) 92.
[2234] COM (2011) 121/4.
[2235] COM(2016) 685 final.
[2236] Denis Weber (n 45) 68.
[2237] Ibid 68.
[2238] Sec (2011) 315 final (n 20) 92.
[2239] Sec (2011) 315 final (n 20) 92.

f. Related parties must be dealt on an ALP (Articles 15 and 79 CCCTB[2240] *– Articles 14 and 56 CCTB).* [2241] General principle found in any tax base rules.

4. Depreciation of fixed Assets (Articles 30 to 40 CCTB) (Articles 32 to 42 CCCTB)

Before we examine the Directive's depreciation rules, it is important to discuss the major differences between both Directives in respect to the topic at hand. When compared to the CCCTB Directive proposal (2011), the CCTB Directive proposal (2016) [2242] included two additional topics, namely, ***rules against debt-bias*** and a ***super-deduction for research and development***. The "already generous R&D regime" of the CCCTB Directive proposal (2011), [2243] continued to apply in the CCTB Directive proposal (2016), that is, "[D]eductible expenses shall include all costs of sales and expenses net of deductible value added tax incurred by the taxpayer with a view to obtaining or securing income, including costs of research and development and costs incurred in raising equity or debt for the purposes of the business".[2244] In order to enhance and accelerate "the modernization of the EU industry, the uptake of product and service innovations, use of innovative manufacturing technologies and introduction of new business models", the Commission work in developing policies to "help speed up the broad commercialization of innovation" and to that effect have engaged in "many activities that support innovation in the EU mainly through the ***Horizon 2020 programme***".[2245] The ***new super-deduction*** proposed by the Commission is in tune with the Commission's policy in promoting innovation in Europe. Note that Article 9(3) CCTB Directive proposal, in addition to deductible costs for research and development, grants the taxpayer a R&D expenditure deduction up to 50% of such costs. Costs above EUR 20 million, may be deducted up to 25% of the exceeding amount (with the exception of costs related to movable tangible fixed assets incurred during that year).[2246] Moreover, if the taxpayer is able to fulfill the conditions established by Article 9(3) (a) (b) (c) and (d),[2247] he will be able to deducted and extra 100% of its costs for R&D up to EUR

[2240] COM (2011) 121/4.
[2241] COM(2016) 685 final.
[2242] COM(2016) 685 final.
[2243] COM (2011) 121/4.
[2244] CCCTB Directive Proposal Article 12. COM (2011) 121/4 and CCTB Directive Proposal COM(2016) 685 final Article 9(2).
[2245] The horizon 2020 Program stands for a EU research and innovation program with a funding of EUR 80 billion available over 7 years (2014-2020). The programm's ultimate goal is to improve economic activity thus generating jobs, income etc. *What is Horizon 2020?* https://ec.europa.eu/programmes/horizon2020/what-horizon-2020. Accessed in 10 Jun 2018.
[2246] COM(2016) 685 final Article 9(3).
[2247] "[t]he taxpayer may deduct an extra 100% of its costs for research and development up to EUR 20 000 000 where that taxpayer meets all of the following conditions: (a) it is an unlisted enterprise with fewer than 50 employees and an annual turnover and/or annual balance sheet total that does not exceed EUR 10 000 000; (b) it has not been registered for longer than five years. If the taxpayer is not subject to registration, the period of five years may be taken to start at the moment that the enterprise either starts, or is liable to tax for, its economic activity; (c) it has not been formed through a merger; (d) it does not have any associated enterprises." COM(2016) 685 final Article 9(3) (a) (b) (c) (d).

20 000 000.

Preamble 14 CCCTB Directive proposal[2248] reads the following: "***Fixed assets should be depreciable for tax purposes***, subject to certain exceptions. Long-life tangible and intangible assets should be depreciated individually, while others should be placed in a pool. Depreciation in a pool simplifies matters for both the tax authorities and taxpayers since it avoids the need to establish and maintain a list of every single type of fixed asset and its useful life" (emphasis added). As previously studied in other parts of this investigation (*asset depreciation*), depreciation consists of the writting off "for tax purposes the costs of certain business assets".[2249] Nevertheless, the expected useful life of an asset varies according to the asset itself, and according to the relevant legal framework. To that end, the Commission through the CCCTB Directive proposal (as well as the CCTB Directive proposal), defined the its own rules for depreciation. Article 4(14) CCCTB[2250] and Article 4(19) CCTB[2251] provide the following definition for fixed assets:

> '***fixed assets***' means all ***tangible assets*** acquired for value or created by the taxpayer and all ***intangible assets*** acquired for value where they are capable of being *valued independently*[2252] and are used in the business in the production, maintenance or securing of income for more than 12 months, except where the cost of their acquisition, construction or improvement are less than EUR 1,000. Fixed assets shall also include financial assets" (emphasis added).

Under such reasoning, two main concepts can ultimately be drawn, that ***fixed assets are***: (a) tangible assets acquired for value or created by the taxpayer and (b) intangible assets acquired for value where they are capable of being *valued independently*. Moreover, both categories must be "used in the business in the production, maintenance or securing of income for more than 12 months". The second part of the Article provides that ***goods valued less than EUR 1,000 are not fixed assets***. Intangible assets ***created*** by the taxpayer ***are also not considered fixed assets***. Nevertheless, depite the fact not being fixed assets, the cost may be used as a deductible expense.[2253] Now, after this brief classification as to which asset could be considered as fixed, we pose the following question: What assets shall be ***depreciable*** under both Directives? Article 33 CCCTB proposed Directive[2254] (Article 31 CCTB Directive proposal)[2255] provides that costs directly related with the ***acquisition***, ***construction*** or ***improvement*** of a

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[2248] COM (2011) 121/4.
[2249] Absetzung für Substanzverringerung. Glossary of Tax Terms. IBDF.
[2250] COM (2011) 121/4.
[2251] COM(2016) 685 final.
[2252] According to IFRS, if an asset is contractually or legal and reliably measured, the asset may be recognized as an intangible. Nevertheless, if the relevant asset is neither contractually nor legally measured, then one must ascertain whether the asset is ***separable individually***, and if not individually, as a Group. If the asset is ***separable individually*** or as a Group, then the asset is transferable thus can be reliably measured and consequently be recognized as an intangible. (TP).
[2253] Sec (2011) 315 final (n 20) 92.
[2254] COM (2011) 121/4.
[2255] COM(2016) 685 final.

fixed asset shall be included in the depreciation base, ***although not deductible*** (except those related to R&D - Article 14(1)(i) CCCTB Directive[2256] and Article 12 (i) CCTB Directive).[2257]

Article 33 (1) CCCTB[2258] and Article 31 (1)CCTB[2259] Directive proposals, regulate asset depreciation. The CCCTB Directive proposal establishes that "[T]he depreciation base shall comprise costs directly connected with the acquisition, construction and improvement of a ***fixed asset***".[2260] Only fixed assets are depreciable under the both Directives. However, not all fixed assets may be included in the depreciation base. Article 40 CCCTB Directive[2261] (Article 38 CCTB Directive),[2262] exclude from the base assets not subjected to ***wear, tear and obsolence*** such as "***land, fine art, antiques or jewllery***"(exceptions may apply).[2263] The same provision also ***excludes financial assets***[2264] from the depreciation base.

Depreciation base. The depreciation base provided by Article 33(1) CCCTB Directive and Article 31 (1) CCTB Directive, shall "comprise any cost directly connected with the acquisition, construction or improvement of a fixed asset". Indirect costs connected to the acquisition, construction or improvement of a fixed asset should only be included to the ***depreciation*** base in case the asset is produced by the taxpayer and "in so far they are no otherwise deductible".[2265] The "***indirect costs provision***" was not included in the CCTB Directive proposal (2016). Deductible VAT shall not be included in the depreciation base, however, non-dedcutible VAT may be included in the depreciation base, for example "when a building is acquired to be rented to an entrepreneur that renders services which are exempted from VAT, such a bank. In that case, the so-called imput VAT cannot be deducted as there is no output VAT on the incoice for rental payments."[2266] Therefore, ***non-deductible VAT*** shall be included in the base for depreciation purposes. Subsidies must also be reduced if ***directly*** connected to the acquisition, construction or improvement of a fixed asset (Article 33(3) CCCTB Directive and Article 31 (3) CCTB Directive proposals). Assets may be depreciated ***individually*** or as a ***pool***.

Individually depreciable assets shall be conculated on a ***straight-line basis*** (straight-line depreciation method), that is, other methods such as declining

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[2256] COM (2011) 121/4.
[2257] COM(2016) 685 final.
[2258] COM (2011) 121/4.
[2259] COM(2016) 685 final.
[2260] COM (2011) 121/4.
[2261] COM (2011) 121/4.
[2262] COM(2016) 685 final.
[2263] "Tangible assets not subject to wear and tear and obsolescence such as land, fine art, antiques, or jewellery and intangible assets with an indefinite life and financial assets shall not be depreciated ***unless the taxpayer demonstrates that they have permanently decreased in value***; by exception, financial assets which, if disposed of, give rise to exempt gains would not be depreciable under any circumstances." Sec (2011) 315 final (n 20) 92.
[2264] *Hein Vermeulen* listed a number of assets that ultimately would should be considered as financial: shares in affiliate undertakings; loans to affiliate undertakings; participating interests; loans to undertakings with which the company is linked by virtue of participating interests; investments held as fixed assets; others lonas and own shares to the extent that national law permits their being shown in the balance sheet. Denis Weber (n 45) Pag. 82.
[2265] CCCTB Directive Article 33(1).
[2266] Denis Weber (n 45) 83.

balance depreciation method, sum of years depreciation method, unit of production depreciation method, or other depreciation incentives, such as accelerated depreciation, bonus depreciation and free depreciation are excluded. According to Article 31(3) CCTB Directive proposal the following assets are depreciable individually:

(a) Commercial, office and other ***buildings***, as well as any other type of immovable property used for business, with the exception of industrial buildings and structures;
(b) Industrial buildings and structures;
(c) ***Long-life fixed tangible assets***. Useful life[2267] of 15 years or more such as aircrafts and ships),[2268] other than the assets referred to in points (a) and (b); (Fixed assets with a useful life longer than 15 years shall be depreciated on an individual basis). [2269]
(d) ***Medium-life fixed tangible assets***. Assets that do not qualify as long lived assets and have a useful life of eight years or more – Article 4(23) CCTB Directive proposal);
(e) ***Fixed intangible assets***. Assets acquired for value that are capable of being valued independently and that are used in the business for producing, maintaining or securing income for more than 12 months[2270] (the period for which the asset enjoys legal protection or for which the right has been granted or, where that period cannot be determined).

	New Assets	**Second-hand Assets**[2271]
Commercial, office and other buildings (excepted industrial)	40 years	40 years (unless the taxpayer demonstrates a shorter useful life)
Industrial buildings *[2272]	25 years	25 years (unless the taxpayer demonstrates a shorter useful life)
Long-life fixed tangible assets (other than the above mentioned)	15 years	15 years (unless the taxpayer demonstrates a shorter useful life)
Medium-life fixed tangible assets *[2273]	8 years	8 years (unless the taxpayer demonstrates a shorter useful life)
Fixed intangible assets	Period of legal protection and 15 where it cannot be determined	15 years (unless the taxpayer demonstrates a shorter useful life)

[2267] "'***useful life***' means the period for which an asset is expected to be available for use or the number of production or similar units that a taxpayer expected to obtain from the asset". CCTB Directive proposal Article 4 (25).
[2268] CCTB Directive proposal Article 4 (22).
[2269] Sec (2011) 315 final (n 20) 92.
[2270] CCTB Directive proposal Article 4 (19).
[2271] "'***second-hand assets***' means fixed assets with a useful life that was partly exhausted when they were acquired and that are suitable for further use in their current state or after repair". CCTB Directive proposal Article 4 (24).
[2272] CCTB Directive proposal Article 33 (1) (b) (2) (b).
[2273] CCTB Directive proposal Article 33 (2) (d) (2) (d).

Before we move on to pooled assets, it is important to note that neither the CCCTB Directive nor the CCTB Directive proposals dealt with ***mixed assets***, for instance, how should a depreciable item such as a building (depreciable according to both Directives), located in a certain land (not depreciable for it is not subjected to wear and tear) be computed in the base? The fact of the matter is that the value of a certain item of a mixed asset may influence the value of the mixed asset as a whole, and apparently, the matter was not covered by both Directives. Nonetheless, the Commission aware of such inevitable shortcomings included the so-called ***delegated acts*** (Articles 127, 128 and 129 CCCTB Directive proposal and Article 66 CCTB Directive proposal) granting the Commission the power to "[a]dopt delegated acts (…) to define more precisely the categories of fixed assets"[2274] referred to in the Directive.

Asset pool. For the sake of simplicity and efficiency, certain assets are depreciable as a group, that is to say, in a pool ("short- to medium-term assets shall be pooled for depreciation purposes.").[2275] Items which may be placed in a pool are machinery (cars, parts of a building such as air-conditioning, water heating systems, escalators, moving walkways, lifts) tables, etc. Article 39 CCCTB CCTB Directive proposals provides that pooled assets shall be depreciated at a annual rate of 25%, according to the value of the assets assessed "at the end of the preceding tax year, adjusted for assets entering and leaving the pool during the relevant tax year". In order to calculated the depreciation of pooled assets, *Hein Vermeulen* recommends the following formula:

$$VEY^{2276} + AEPool^{2277} - ALPool^{2278} = DBPA^{2279}$$

If the depreciation pool equals a negative amount, "the negative amount must be added to the depreciation base, so that the depreciation base is ***nil***. In addition, the negative amount must be added to the tax base".[2280] We conclude this topic by discussing to whom should the Directive grant the benefits of depreciation. Although it seems intuitive pointing the company out, that is to say, the economic owner "who receives substantially all the benefits and bears all the risks attached to a fixed asset, ***regardless of whether that person is the legal owner***",[2281] there are cases where the "economic and legal ownership do not coincide", for instance, in lease contracts. Aware of such instances, Article 34 (3) CCCTB and Article 32 (3) CCTB Directive proposals, provides that "If the economic owner of an asset cannot be identified, the legal owner shall be entitled to deduct depreciation. In that case both the interest and capital element of the ***lease payments shall be included in the tax base of the legal owner and be deductible by the lessee***" (emphasis added).

[2274] CCCTB Directive Article 42 and CCTB Directive proposal Article 40.
[2275] Sec (2011) 315 final (n 20) 92.
[2276] Value at the end of the year. Short- to medium-term assets shall be pooled for depreciation purposes. (VEY).
[2277] Assets entering the pool, including acquisition, constructions and improvement. (AEPool).
[2278] Assets leaving the pool. (ALPool)
[2279] Depreciation base polled assets. (DBPA).
[2280] Denis Weber (n 45) 86.
[2281] CCCTB Directive Article 4(20) and CCTB Directive proposal Article 4(28).

5. Losses (Article 43 CCCTB) (Articles 41 and 42 CCTB)

The lack of a well defined regulation on cross-border loss relief is definitely one of the major obstacles in achieving a true internal market. The absence of such rules leads ultimately to over taxation. Although it is fair to conclude that "[T]he possibility to set off losses against profits in computing tax liability of a taxpayer is a basic feature of company tax systems"[2282] the manner in which corporate profits are taxed within the common market do not "reflect the overall EU-wide result of a business activity when foreign investment if the EU is involved".[2283] Domestic profit consolidation presents no problems whatoever, that is, most States allow groups to consolidate their results (upstream or downstream basis), and although "only a few Member States provide for some limited forms of cross-border loss compensation (…) loss offsetting arrangements entail a risk of over-taxation in international activities whenever cross-border losses cannot be compensated immediately. That is, since domestic losses are immediately deductible, thus reducing the current tax burden, a group operating cross-border would face a liquidity cost compared to a domestic group. For the international group, the compensation of losses incurred by foreign subsidiaries will be at best deferred if the source country allows carry-forward of the losses (which creates significant interest cost) and in some cases, where losses cannot be absorbed locally, they will never be relieved, and will become permanent".[2284] Such barriers may influence companies not to take its operations to other MSs, "thereby directly hindering the achievement of the internal market (Article 26 TFEU)[2285] and the full exploitation of the benefits of market integration".[2286] In sum, the elimination of ***over-taxation*** on cross-border activities is one of the "main objectives of the proposed Directive",[2287] aimed at eliminating and/or reducing tax-induced obstacles and inneficiencies in the Common Market.

When calculating the tax base, "profits and losses shall be recognized only when realized",[2288] moreover, the tax base shall be calculated as "revenue less exempt revenues, deductible expenses and other deductibles".[2289] Losses realized by a resident taxpayer or a permanent establishment of a non-resident taxpayer may be carried-forward indefinetly (Article 43 CCTB Directive proposal and Article 41 CCTB Directive proposal), no loss carry-back shall be allowed and the oldest losses shall be used first (Article 41(4) CCTB Directive proposal and Article 43 (3) CCCTB Directive proposal).[2290] The CCTB Directive proposal limits

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[2282] Sec (2011) 315 final (n 20) 13.
[2283] Sec (2011) 315 final (n 20) 13.
[2284] Sec (2011) 315 final (n 20) 13.
[2285] "1. The Union shall adopt measures with the aim of establishing or ensuring the functioning of the internal market, in accordance with the relvant provisions of the Treaties. 2. The Internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties". TFEU Article 26 (1) (2).
[2286] Sec (2011) 315 final (n 20) 14.
[2287] COM (2011) 121 final. Pag. 47.
[2288] CCCTB Directive Article 9(1) and CCTB Directive proposal Article 6(1).
[2289] Article 10 CCCTB Directive and Article 7 CCTB Directive proposal.
[2290] Sec (2011) 315 final (n 20) 92.

the deduction of losses of previous years of associated companies if (a) a third company acquires a participation in the taxpayer therefore becoming a qualifying subsidiary whithin the definition of Article 3 CCTB Directive proposal,[2291] and in the case of a major change of activity, meaning that the acquired company "discontinues a certain activity which accounted for more than [60%] of its turnover in the previous year or embarks on new activities which amount to more than [60%] of its turnover in the tax year of their introduction in the following year".[2292] Such provision was not a part of the CCCTB Directive proposal, and was most definitely included in order to tackle possible abuses instrumentalized through changes of activity, merger or change in ownership (loss-shifting schemes). The CCTB Directive proposal limits the deduction of subsidiary losses to the amount of holding owned by the PC, for instance if a certain subsidiary resident of a certain MS realizes 100 of losses, considering that the parent company owns 45% of the subsidiary's shares, the PC will only be entitled to offset 45 out of the 100 of the subsidiary's losses. Needless to say, the same ***do not apply to PEs***, that is, to non-resident taxpayer financed by its PC in Source State (Article 42(2) CCTB Directive proposal).

6. Transparent Entities (Articles 62 and 63 CCTB)

The problem of transparent entities have been extensively dealt with throughout this investigation (*partnerships*), when covering *hybrid mismatch arrangements*, CFC etc. The fact of the matter is that transparent entities are important instruments used by MNEs when designing tax schemes, that is to say, it is through such entities that groups are able to exploit opacity differences when conducting intra-group transactions. Therefore, in order to tackle the matter the Commission included in the CCTB Directive proposal the following provision

> "Where an entity is treated as transparent in the Member State where it is established, a ***taxpayer holding an interest in the entity shall include its share in the income of the entity in its tax base***. For the purpose of this calculation, the income shall be computed in accordance with the rules of this Directive."[2293] (emphasis added)

Basically, this provision imposes upon the company holding shares of a transparent entity the duty to include in its books profits received by the transparent entity according to its amount of holdings. Transactions between both PC/subsidiary and the transparent entity must be ignored to the amount of the taxpayer's holdings

[2291] "A qualifying subsidiary means every immediate and lower-tier subsidiary in which the parent company holds the following rights: (a) it has the right to exercise more than 50% of the voting rights; and (b) it has an ownership right amounting to more than 75% of the subsidiary's capital or owns more than 75% of the rights giving entitlement to profit". Article 3(1) CCTB Directive proposal.
[2292] CCTB Directive proposal Article 41(3) (a) (b).
[2293] CCCTB Directive Article 84 (1) and CCTB Directive proposal Article 62 (1).

> "Transactions between a taxpayer and the entity referred to in paragraph 1 ***shall be disregarded in proportion to the taxpayer's share in the entity***. Accordingly, the income of the taxpayer derived from those transactions shall be considered to be a proportion to the amount that would be agreed between independent enterprises calculated on an arm's length basis which corresponds to the third party ownership of the entity." [2294] (emphasis added)

To conclude, it is important to remember that "whether an entity located in a third country is transparent or not ***shall be determined according to the law of the Member State of the taxpayer***"[2295] and that transparent entities ***may not be treated as CFC for the income is already taxed in the parent jurisdiction***. Nonetheless, CFC rules may apply if the income is not taxed in the parent jurisdiction.[2296]

7. Relations (dealings) between Taxpayer and other Entities

In order to tackle tax avoidance, the Commission included the ***switch-over rule*** which allows MS the to deny exemption from profits received from entities resident in third-countries bellow a certain threshold. Article 73 (a) CCCTB Directive proposal provides that MSs may deny exemption, therefore tax such income in case the general regime in that third-country applies a statutory corporate tax rate lower than 40% "of the avarege statutory corporate tax rate applicable in the Member States". Nonetheless, Article 53 CCTB Directive proposal do not provide for such number (40%), that is, it allow MSs to deny exemption or "tax (…) foreign income that the taxpayer received as a profit distribution from an entity in a third country or as proceeds from the disposal of shares held in an entity in a third country where that entity in its country of tax residence is subjected to a statutory corporate tax rate lower than ***half of the statutory tax rate*** that the taxpayer would have been subjected to, in connection with such foreign income, in the Member State of its residence for tax purpose". Nevertheless, after being subjected to the ***switch-over rule***, the taxpayer shall be able to deduct the tax already paid in the third State and the "deduction shall not exceed the amount of tax, as computed before the deduction, which is attributable to the income that may be taxed".[2297] This rule is applicable regardless the company had in fact carried out real economic activity. Another aspect of the CCTB Directive proposal is that, according to the second part of Article 73, the Directive shall not apply where a

> "[a] convention for the avoidance of double taxation between the Member State in which the taxpayer is resident for tax purposes and the third country where that entity is resident for tax purposes ***does not allow switching over from a tax exemption to taxing the designated categories of foreign income***." (emphasis added).

[2294] CCTB Directive proposal Article 62 (2).
[2295] Directive proposal Article 63 CCTB.
[2296] Designing Effective Controlled Foreign Company Rules (n 1896) 22.
[2297] CCTB Directive proposal Article 53(2).

By including such provision (not present in the CCCTB Directive proposal), [2298] the Commission gives precedence to tax treaties over the switch-over rule, that is, tax Treaties with third countries will "override conflicting rules of the Directive, meaning that a MS will not be hampered from fulfilling its commitments vis-à-vis a third country." [2299] The CCTB Directive proposal provides an exemption to proceeds generated

> "from a disposal of shares, provided that the taxpayer has maintained a minimum holding of 10 % in the capital or 10 % of the voting rights of the company during the 12 months preceding the disposal, with the exception of proceeds resulting from a disposal of shares held for trading as referred to in Article 21(3) and of shares held by life insurance undertakings in accordance with point (b) of Article 28" (Article 8 (c) CCTB Directive proposal).

In respect to transactions between group members and entities outside the group, relief by exemption will be given to third-country branch income, on inbound dividend distributions and on the proceeds from the disposal of shares held in a company outside the group "provided that the taxpayer has maintained a minimum holding of 10 % in the capital or 10 % of the voting rights of the company during the 12 months preceding the disposal". The 2011 CCCTB Directive proposal approached the matter in a much more simpler manner than the 2016 CCTB Directive proposal, by providing that "proceeds from a disposal of shares" shall be tax exempt (Afticle 11 (d) CCCTB Directive proposal).[2300] Now, as for income distribution, the 2016 CCTB Directive proposal maintained the same *gist* as in share disposals, considering as exempt

> "***received profit distributions***, provided that the taxpayer has maintained a minimum holding of 10 % in the capital or 10 % of the voting rights of the distributing company for 12 consecutive months, with the exception of profit distributions from shares held for trading as referred to in Article 21(4) and profit distributions received by life insurance undertakings in accordance with point (c) of Article 28" (emphasis added).

The CCCTB Directive proposal preserved a more simplistic approach. To conclude the topic, both proposals allow a relief by ***credit*** for inbound interest and royalty payments (Article 76 CCCTB Directive proposal and Article 55 CCTB Directive proposal).

[2298] COM (2011) 121/4.

[2299] COM (2011) 121 final. 21.

[2300] "The following shall be exempt from corporate tax: (c) received profit distributions; (d) proceeds from a disposal of shares; (e) income of a ermanent establishment". CCCTB Directive proposal Article 11 (c) (d) and (e).

	CCCTB 2011	CCTB 2016 (1th Step)	CCCTB 2016 (2nd Step)
Optional	X	-	-
Mandatory	-	X	x
Scope and definitions	Articles 1 to 5	Article 1 to 5	Articles 1 to 4
Opting for the Directive's system	Articles 6 to 8	-	-
Calculation of the Tax Base	Articles 9 to 16	Articles 6 to 14	Articles 28 to 45
Timing and Qualifications	Articles 17 to 31	Articles 15 to 29	-
Depreciation of fixed Assets	Articles 32 to 42	Articles 30 to 40	-
Losses	Article 43	Articles 41 and 42	-
Entering and Leaving the Tax Base System	-	Articles 43 to 52	-
Entry and Exit of the Directive	Articles 44 to 53	-	-
Consolidation	Articles 54 to 60	-	Articles 5 to 10
Entering and leaving the group	Articles 61 to 69	-	Articles 11 to 21
Business reorganizations	Articles 70 and 71	-	Articles 22 and 23
Relations (dealings) between Taxpayer and other Entities	Articles 72 to 77	Articles 53 to 55	Articles 24 to 26
Transactions between associated enterprises	Articles 78 to 79	Articles 56 to 57	-
Anti-abuse rules	Atrticles 80 to 83	Articles 58 to 61a	-
Transparent Entities	Articles 84 and 85	Articles 62 and 63	Article 27
Apportionment of the Consolidation Tax Base	Article 86 to 103	-	-
Administration and Proceedures	Articles 104 and 126	Articles 64 and 65	Articles 46 and 68
Intereaction with 2016 CCTB Directive	-	-	Article 69 to 74
Final Provisions	Articles 127 to 136	Articles 66 to 71	Articles 75 to 82

Pros	Drawbacks
- Increase of tax transparency; - Simplify EU corporate restructuring; - Resolve transfer pricing problems; - Reduce the compliance costs[2301] with the present 27 tax systems.	- The competitiveness of a CCCTB would have to rely on general tax principles such as simplicity and efficiency as well as competitive tax depreciation rates for assets; - Cut down options for MS to grant provisions and incentives.

[2301] COM (2001) 582 final 384.

VI. Conclusion

States make use of a number of different policies in order to promote economic activity, for example, reduce taxes, subsidize rates etc. During Dilma II term (interrupted due to her impeachment in 2016), Brazil could not maintain public policy programs it had previously initiated, such as promoting low interest rates to the agricultural industry (state aid through subsidised rates – Plano Safra). According to Brazilian Law on fiscal liability, whenever the State needs to enhance public spending, the *Kabinet* must beforehand get approval from Congress. However, this was not done a number of times during both Dilma terms (2011-2014 and 2015-2016). To solve the revenue problem, the *Kabinet* contracted with public banks loans in order to continue such programs. Since these loans were not approved by Congress, and were contracted and paid under a "creative accounting basis", financial markets began to doubt the country's financial health. A high degree of insecurity on the quality of Brazilian federal accounts resulted in a massive flight of foreign capital. As Brazilian economic foundations began to deteriorate mainly due to lack of transparency as to the State's actual financial situation, the country experienced the worst economic crises of its history, that is, during 2015 and 2016 Brazil's GDP declined 7.1%, inflation weakend the Real and unemploymemt levels skyrocketed. The years of growth and prosperity that Brazil lived since it changed its currency from Cruzeiro Real to Real (Unidade Real de Valor "URV") was lost.

Various government entities, namely, Ministry of Interior, Ministry of Social Development, Ministry of Cities, Brazilian Central Bank, Ministry of National Treasure, Bank of Brazil (National Bank created in 1805, which almost declared bankruptcy when Portugal's Imperial Family left the country after Napoleon forces were drove away from Portugal), Bank Caixa Economica Federal (State owned bank), BNDS - Banco Nacional de Desenvolvimento Social (Brazilian Bank for Social Development) together, acting harmonically in order to breach Brazilian's law on fiscal liability, deliberately omitted a BRL 40 billion debt. According to a member of the Brazilian Tribunal for National Accounts, "what all these entities (see above) have in common, all of them were under the President's administration at that time, Dilma Rousseff, and it is her duty to act in a responsible manner, that is, according to the Constitution" he continued "if we were to conclude that the President is not responsible for such measures, we have to conclude that someone else governed the country". These "creative" measures occurred from 2013 till 2015, when finally impeachment proceedings was accepted by the Chamber of Deputies. But this is not all! Along the worst economic crises ever, a corruption scandal involving the Brazil's biggest State owned company (Petrobras) came to make things worse, forming therefore a "perfect storm". The federal police named the Petrobras investigation scandal as operation "car wash".

Politicians, in an attempt to tackle the advancement of the so called "Lava Jato" (car wash), proposed the enactment of a law to criminalize the law's interpretation in the event of an abuse (only God knows what an abuse might be). Such law would empower congressman (specifically) to challenge the Justice Department or the Judiciary, should the law be abusively interpreted. A Supreme

Court's Justice, who is considered within the legal field to be an "outvoted Justice" for his substantially controversial, but nevertheless "legally grounded" opinions, announced in an interview to a major television channel in Brazil, and making an allusion to the American reality show *Big Brother* in a jokingly manner, "*I will surely be regularly put on the eviction episode*" should the bill pass. The criminalization of legal hermeneutic, in our opinion, precedes a dictatorial state, where only the interpretation of a certain group of people, namely, the dictators (congressman) is considered adequate. Have we not seen equivalent circumstances here in Europe in the past? In 1990, operation *Mani Pulite* (Clean Hands), discovered a kickback scheme paid to public officials (congressman) in order to guarantee contracts with the Italian Government, which lead to the demise to the "First Republic", and a number of political parties. Ultimately, the Italian Congress passed laws that contributed to the operation's collapse and managed to retard the investigation as much as possible, leading to Berlusconis' acquittal. As in Italy, a number of Brazilian politicians (approximately 108 were expressively mentioned in a leniency agreement), with the help of three Supreme Court Justices, try halt the operation due to selfish reasons as of yet uncler. The outcome of the episode is still to be concluded. The Brazilian society as a whole, as well as the Justice Department and Federal Police, impose great pressure on Congress to refrain from voting the bill, and it is already expected that such law will fail to pass.

During 2008 to 2012 the ***national champions*** policy was implemented in Brazil. Governments encourage such policy in order to create "larger domestic firms more capable of competing on international markets". National champions may be free from the "disciplining effect on competition on their domestic markets", [2302] but in international markets may lack the skills necessary to succeed. However, the national champions policy was adjusted according to selfish reasons. The backbone of such policy was to finance political parties, that is, the State would contribute with large capital injections in companies which would pay back political contributions. In sum, the ***national champions policy***[2303] was mainly designed to finance political parties with the goal of ruling the country indefinitely. Although the State currently struggles with the old political body, which tries to survive, the people deposit their hope on the so-called operation car wash.

The last generation, which had very few rights due to a long period of dictatorship in Brazil, had no other choice but to overprotect constitutional rights before inexistent. However, this reality is long gone and Brazil came to be a democratic country with strong and functioning institutions. The fact that more than 40.000[2304] public workers have the right to be trialed by higher courts, has flood Brazilian courts generating impunity. In fact, the law created a true "*caste society*".[2305]

What we see here, is clearly a fight between generations, an old class of politicians who try, at all costs, to survive, and a new younger class, that neither accept nor understand this actual clash. The effects of the dictatorship that lasted

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[2302] Richard Whish & David Bailey (n 734) 858.

[2303] Competition Policy, Industrial Policy and National Champions. OECD. (2009) https://www.oecd.org/daf/competition/44548025.pdf. Accessed in 02 Jun 2018.

[2304] Interview given by Deltan Dallagnol for a Brazilian channel "Rede TV" in 06.05.2017.

[2305] Ibid.

more than 25 years is still present in Brazilian's society and cannot be ignored. Due to the absence of certain basic rights (the right to a fair trial, for example), due to AI-5,[2306] Brazilian's procedural law allows parts to a dispute to challenge almost every court's decision to Superior Courts, creating thus perpetual litigation, that is to say, the current procedural law creates a *Kafkaesque* world, where the road to nowhere, leads to nothing. Such peculiarities creates an inappropriate investment environment, which generates uncertainty, hindering the possibility of injection of FDI, preventing the creation of jobs, consumption, taxes etc. All this is a clear indication that in fact lack of transparency leads to insecurity, inevitably compromising the country's ability to sustainable economic growth.

In fact, we will never be able to create a perfect system, where entities are fully economically, socially, politically etc, assisted. There is no such thing as a single road to *Schlaraffenland*, only the cynical and short-sighted idea that someday one will be able to achieve it. If one walks 10 steps towards it, *Schlaraffenland* will move 10 steps away, if one walks 20 steps towards it, *Schlaraffenland* will move 20 steps away, thus we know one will never reach *Schlaraffenland*. Question: Since *Schlaraffenland* is unreachable and has no practical use, what is *Schlaraffenland's* purpose? Its purpose is not goal itself, but to remind us to keep on walking…

[2306] Political meetings not authorized by the police were illegal, censorship of movies, music, television (media in general), suspension of habeas curpus for political motivated crimes etc.

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Abstract

Taxation is an important tool used by Countries worldwide to conduct public policies. For that matter, States fight to preserve their right to levy taxes according to national circumstances (a State whishes to maximize itself as politicians work to stay in power as long as possible – vote seeking behaviour). There are basically two forms of calculating tax liability on cross-border transactions, namely, using a separate accounting approach or a global formulary apportionment. The separate accounting approach (separate entity basis) is used by most OECD Members and is easily manipulated through a number avoidance/evasion methods, and despite its shortcomings, is already operational. The global formulary apportionment, is used nationally by the USA and Canada and also give rise to problems such as tax competition. In Europe, the Commission has worked on a Common Corporate Consolidated Tax Base (CCCTB) which will be implemented on a two step approach for the sake of practicality. The CCCTB will allocate tax revenue according to an apportionment formula which measures equally sales, labor and assets, and distributes to Member States where activity occurred its fair amount of tax. We will discuss both systems both on international and supra-national levels as well as pointing their differences out. We have concluded that, although the global formulary apportionment is highly unlikely to be applied internationally, it provides a more fair revenue distribution generated by taxation and reduces the possibility of tax schemes construed mainly to avoid taxation.

Besteuerung ist ein wichtiges Instrument, dass von den Ländern weltweit zur Durchführung öffentlicher Maßnahmen genutzt wird. Zu diesem Zweck kämpfen die Staaten dafür, dass sie ihr Recht behalten, Steuern gemäß den nationalen Gegebenheiten zu erheben (ein Staat will sich selbst maximieren und Politiker wollen so lange wie möglich an der Macht bleiben - Wahlverhalten). Bei grenzüberschreitenden Transaktionen gibt es im Wesentlichen zwei Arten der Berechnung der Steuerschuld, nämlich die Verwendung eines getrennten Rechnungsführungsansatzes oder einer globalen Formelsummenumlage. Der getrennte Rechnungslegungsansatz (getrennte Rechtsgrundlage) wird von den meisten OECD-Mitgliedern verwendet und lässt sich leicht durch eine Anzahl von Vermeidung- / Steuerumgehungsmethoden manipulieren, und ist trotz seiner Mängel bereits funktionsfähig. Die globale Formelsammlung ist landesweit von den USA und Kanada verwendet und wirft auch Probleme wie Steuerwettbewerb auf. In Europa hat die Kommission an einer Gemeinsamen Konsolidierten Körperschaftsteuer-Bemessungsgrundlage (GKKB) gearbeitet, die aus Gründen der Praktikabilität in einem zweistufigen Ansatz umgesetzt wird. Die GKKB teilt die Steuereinnahmen nach einer Aufteilungsformel auf, die Verkäufe, Arbeit und Vermögenswerte gleichermaßen misst und an die Mitgliedstaaten ausschüttet, in denen die Tätigkeit in angemessenem Umfang besteuert wurde. Wir werden beide Systeme sowohl auf Internationaler als auch auf Supranationaler Ebene diskutieren und auf ihre Unterschiede hinweisen. Wir sind zu dem Schluss

gekommen, dass die globale Formelumlage zwar höchstwahrscheinlich nicht international angewendet wird, aber eine gerechtere Verteilung der durch die Besteuerung erzielten Einnahmen ermöglicht und die Möglichkeit von Steuerschemas reduziert, die hauptsächlich zur Vermeidung von Steuern ausgelegt werden.