Ivan Lazarov

Anti-Tax Avoidance in Corporate Taxation under EU Law

The Internal Market Narrative

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Anti-Tax-Avoidance in Corporate Taxation under EU Law

Why this book?

The issue of corporate tax avoidance has been subject to extensive developments in the European Union over the course of recent years, both in terms of the case law of the Court of Justice of the European Union and at the level of secondary legislation with the adoption of instruments such as the Anti-Tax Avoidance Directive. This book analyses whether these developments are in line with the constitutional foundations of EU law, especially with the primary-law standard of protection of the internal market against abusive practices.

This book considers the autonomous concept of abuse under primary EU law as based predominantly on the artificiality test rather than the business purpose test. This is especially true in areas in which domestic laws largely diverge and compete with one another, such as in corporate taxation. Thus, a mere finding of low or no taxation, as well as the tax motives behind an arrangement, generally should not suffice for concluding that a certain structure is abusive. This is because, in the absence of comprehensive harmonization, the primary tool for achieving market integration within the European Union is the endorsement of regulatory competition among Member States. Private parties have, in turn, the right to rely on this competition in their business allocation decisions. Taking the business purpose (no tax reasons) approach would lead to the fragmentation of the internal market, as Member States would be free to discriminate against cross-border arrangements set up for regulatory reasons.

Secondary EU law cannot put the above principles into question, as a deviation from them would constitute a manifestly inappropriate measure in light of the aim to improve the establishment and functioning of the internal market. To the extent that such secondary law measures restrict the rights derived from primary law, these harmonization measures must be in line with the standard of abuse under primary law. Secondary law cannot restrict the scope of primary law. This book analyses the provisions of the ATAD and points out the existing deviations from the object and purpose of the internal market, suggesting either a conforming interpretation or validity review.

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Chapter 1

Introduction

1.1. Context, research questions and scope

Maximization of net profit is the ultimate goal of any business.[1] At the same time, open-market economies and globalization have resulted in greater possibilities for private parties to engage in tax avoidance.[2] The opportunities are more substantial in a system of economic integration, such as the EU and its internal market, where the free flow of production factors and outputs is guaranteed by a supranational legal order.[3] As the mobility of production factors (capital and labour) is affected by taxation,[4] one must build a reliable model which allows for correct differentiation between genuine mobility and abusive arrangements. This model should not be based on a temporal state of affairs but on a strong constitutional foundation that can outlive and look beyond any transitory developments. The present book aims at developing such principle-based model on tax avoidance for the law of the EU internal market as far as corporate taxation is concerned.

Ultimately, the author will look into which business allocation decisions can be classified as tax avoidance – and more importantly, what must be the actual utilization of premises and production factors (labour and capital) so that an allocation decision can be regarded as genuine and not abusive – and whether the mere quantity of production factors utilization is sufficient in all circumstances to rule out abuse. The book will inquire into the legal balance between the right to conduct business and maximize net returns on the one hand and the right of a state to tax the profits that arise on its territory on the other. Addressing these issues boils down to delim-

1. In this regard, the author distances himself from the outset from any debate regarding what is equitable in terms of firm behaviour. From a legal standpoint, this is ultimately an irrelevant question to which the legal science is in any event not apt to give an answer.
2. A. Cobham & P. Janský, Measuring misalignment: the location of US multinationals' economic activity versus the location of their profits, 37 Development Policy Review 1 (2017).
3. H. Huizinga & L. Laeven, *International Profit Shifting within Multinationals: A Multi-Country Perspective*, 92 Journal of Public Economics 5/6 (2008).
4. A. Harberger, *The Incidence of the Corporation Income Tax Revisited*, LXI National Tax Journal 2 (2008); and R. Mundell, *International Trade and Factor Mobility*, 47 The American Economic Review 3 (1957).

iting the scope of anti-abuse rules, and more specifically to looking into when tax-driven mobility can be regarded as abusive. In practical terms, this will be achieved by answering the following research questions, which mostly correspond to a specific chapter of this book:

1. How do business allocation decisions depend on corporate taxation?

2. How does the EU internal market law ensure unimpeded market access in business allocation between the Member States and with respect to third countries?

3. What is the standard of protection under the general principle of the prohibition of abusive practices in the field of corporate taxation?

4. What is the status of secondary law measures, harmonizing the anti-avoidance measures of the Member States, and what is their relationship to the general principle of the prohibition of abusive practices?

Having outlined the focus of this book, it is important to point out what it will not address. First, it will not address the domestic anti-avoidance provisions of the Member States, including their implementation of the EU measures harmonizing anti-avoidance.[5] At least, it will not do so in a systematic way that goes beyond using domestic implementation as a mean to demonstrate existing issues under the EU framework itself.

Second, it will not look into the anti-avoidance measures in areas of tax law other than corporate taxation, such as VAT, personal income tax, etc., as well as in other areas of EU law beyond taxation. Whenever reference to case law or harmonization in such other areas is made, the ultimate goal is to demonstrate the uniformity of the general principle of the prohibition of abuse, thus also informing its content for the area of corporate taxation.

Third, the book leaves outside its scope the anti-abuse standard under international tax law *stricto sensu* – i.e. in the area of double tax treaties (DTTs). Although an argument has been made that the anti-avoidance rules under DTTs must be EU law compatible,[6] the present author does

5. For an examination of the interaction between the domestic legal traditions regarding general anti-avoidance rules and EU law, *see* M. Seiler, *GAARs and Judicial Anti-Avoidance in Germany, the UK and the EU* (Linde 2016).
6. E. Pinetz, *Use of a Principal Purpose Test to Prevent Treaty Abuse*, in *Base Erosion and Profit Shifting (BEPS): the proposals to revise the OECD Model Convention* pp. 293-297 (M. Lang et al. eds., Linde 2016); and A. Moreno, *GAARs and Treaties:*

not share this view. The anti-avoidance provisions of DTTs are ultimately a matter of attribution of taxing rights and, therefore, remains outside the scope of EU law.[7]

From the Guiding Principle to the Principal Purpose Test. What Have We Gained from BEPS Action 6?, 45 Intertax 6/7, pp. 444-446 (2017).

7. At the moment, EU law imposes no obligation on Member States to alleviate juridical double taxation stemming from cross-border activities. In *Columbus*, the ECJ ruled that EU law "does not lay down any general criteria for the attribution of areas of competence between Member States in relation to the elimination of double taxation", other than the several explicit harmonization measures, and therefore "no uniform or harmonisation measure designed to eliminate double taxation has as yet been adopted at Community law level" (DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus*, ECLI:EU:C:2007:754, para. 45, Case Law IBFD). As regards the question of attribution of taxing rights, it was noted as far back as *Gilly* that Member States are free to allocate the taxing rights between one another as they deem fit and this question is beyond the scope of EU law (FR: ECJ, 12 May 1998, Case C-336/96, *Gilly*, ECLI:EU:C:1998:221, paras. 30-31, Case Law IBFD). This was further clarified in *Saint-Gobain* where a distinction was made between the issue of *allocation of taxing rights* (outside the scope of EU law) and that of the *application of domestic law, once taxing rights have been allocated* (within the scope of EU law) (DE: ECJ, 11 Sept. 1999, Case C-307/97, *Saint-Gobain*, ECLI:EU:C:1999:438, para. 56, Case Law IBFD). Thus, as per Court case law, the matter of allocation of taxing rights between Member States is outside the scope of EU law. Consequently, there is no duty upon Member States to either conclude a DTT between one another, to maintain in force an existing DTT or even to comply with the provisions of a DTT that is otherwise in force (BE: ECJ, 19 Sept. 2012, Case C-540/11, *Levy and Sebbag*, EU:C:2012:581, Case Law IBFD). If this is the situation under case law, then, *per argumentum a fortiori,* Member States should not be bound to provide the benefits under an existing treaty if an explicit provision of this treaty provides for an exception on whatever grounds, including an otherwise arbitrary anti-avoidance provision. It is true that the ECJ ruled in *Saint-Gobain* that under certain circumstances, Member States must grant DTT benefits. However, in the present author's view, the *Saint-Gobain* decision is sometimes given more weight than it deserves. A close reading of *Saint-Gobain* reveals the above-mentioned distinction between allocation and subsequent execution of taxing rights (compare paras. 56 and 57 of *Saint-Gobain*). The allocation question is outside the scope of EU law, while the execution question is within this scope. The DTTs' anti-avoidance rules are within the first category, as they relate to the matter of entitlement to benefits rather than the subsequent application of domestic law. There would be no such future application if DTT benefits are denied in the first place, since the matter of anti-avoidance under DTT is fundamentally a question of the DTT itself rather than that of domestic law (*see* for instance OECD Comm. 2017 to Art. 1, para. 77). Since DTT anti-avoidance rules concern the attribution of taxing rights, they are outside the scope of EU law. This conclusion is not undermined by the Court's decision in *Renneberg* (NL: ECJ, 16 Oct. 2008, Case C-527/06, *Renneberg*, EU:C:2008:566, Case Law IBFD), where, just as in *Saint-Gobain*, a distinction was drawn between *attribution* of taxing rights and *exercise* of taxing rights, once attributed. Moreover, the ECJ stressed the fact that nothing in a double tax treaty prevents a Member State from granting favourable treatment in its domestic law (*see* paras. 52-53 and 57-58). For a more detailed analysis of these issues, *see* I. Lazarov, *Implementing the Multilateral Instrument in Bulgaria*, in *The Implementation and Lasting Effects of the Multilateral Instrument* (M. Lang et al eds., IBFD 2021), Books IBFD.

Finally, the book will focus on the EU standard of prohibition of abusive practices as applicable *to private parties*. Thus, outside the frame of systematic inquiry will be the obligations that follow from this for Member States, for instance under the rules on State aid,[8] the duty of sincere cooperation,[9] or the obligation to implement secondary EU law accurately and in a timely fashion.[10]

1.2. State of the art and contribution

The question of anti-avoidance measures in corporate taxation is one of the "evergreen" topics of international tax law. It is what captures the attention not only of academics and policy makers but also of the general public. It is one of the few dissertation topics that one can discuss with friends and family beyond receiving a condescending nod. Thus it is not surprising that there is more than a considerable amount of literature on the topic. Some of the more influential monographs are the works of De Broe,[11] Saydee,[12] the collection by de la Feria and Vogenauer,[13] as well as a vast number of journal publications and book chapters that are referred to whenever relevant.

The immediate question that follows concerns the necessity of yet another book on the subject. Here one can take the occasion to point out the divergences in the doctrinal views on issues as basic as the elements of what constitutes abuse under EU law,[14] and suggest that as long as these issues

8. Art. 107 TFEU.
9. Art. 4(3) TEU.
10. Art. 291(1) TFEU.
11. L. De Broe, *International Tax Planning and Prevention of Abuse* (IBFD 2007), Books IBFD.
12. A. Saydee, *Abuse of EU Law and Regulation of the Internal Market* (Hart Publishing 2014).
13. R. de la Feria & S. Vogenauer, *Prohibition of Abuse of Law: A New General Principle of EU Law?* (Hart Publishing 2011).
14. For example, while most authors agree that abuse requires an objective and a subjective element (*see* K. Lenaerts, *The Concept of 'Abuse of Law' in the Case Law of the European Court of Justice on Direct Taxation*, 22 Maastricht Journal of European and Comparative Law 3 (2015)), there is a divergence of views on the exact content of these elements and on the interpretation of the relevant case law: some find the subjective test redundant (*see* M. Lang, *Cadbury Schweppes' Line of Case Law from the Member States' Perspective*, in *Prohibition of Abuse of Law: A New General Principle of EU Law?* (R. de la Feria & S. Vogenauer eds., Hart Publishing 2011)) or see it as a reflection of the factual pattern (P. Pistone, *Abuse of Law in the Context of Indirect Taxation: From (Before) Emsland-Stärke 1 to Halifax (and Beyond)*, in *Prohibition of Abuse of Law: A New General Principle of EU Law?* (*see* R. de la Feria & S. Vogenauer eds., Hart Publishing 2011)); others see the objective test as related only to the exist-

are not settled there is still room for further research. However, the goal of this research goes further than that. It aims to place the anti-abuse standard in EU law against the perspective of the goals of the internal market and demonstrate (i) *why* the standard is as it is; and (ii) in which occasions certain elements of case law or of secondary law run contrary to the spirit of the internal market.

The research is timely. It comes after some substantial developments in both ECJ case law and secondary law, which have not been comprehensively reflected to date in a monograph. The book also serves as something of a counterbalance to certain one-sided international developments that have influenced EU law but are not necessarily in accordance with the spirit of its internal market. These developments are mostly related to the OECD work on the Base Erosion and Profit Shifting (BEPS) Project[15] and the European Commission's Anti-Tax Avoidance Package (ATAP).[16] Of specific interest for this book, and addressed in its final chapter, will be several measures that emerged from the ATAP at EU level – the Anti-Tax Avoidance Directive (ATAD),[17] the Anti-Hybrid Mismatch Rules (ATAD 2),[18] and the "blacklist" of non-cooperative third-countries.[19] One might also argue that some of the more recent case law of the Court of Justice of the European Union (ECJ) is influenced in part by these developments.[20]

ence of a tax advantage (*see* L. De Broe & D. Beckers, *The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: An Analysis Against the Wider Perspective of the European Court of Justice's Case Law on Abuse of EU Law*, 26 EC Tax Rev. 3, p. 133 (2017)), or consider that the two tests apply in turn and with a shifting of the burden of proof (*see* D. Weber, *Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ (Part 1 and Part 2)*, 53 Eur. Taxn. 6/7, pp. 251 and 313 (2013), Journal Articles & Opinion Pieces IBFD). Finally, as will become clear in ch. 4, even within the ECJ itself, there are divergent opinions as to the exact scope of the anti-abuse doctrine and its mode of application.

15. In late 2015, the OECD published a number of Actions aimed at tackling instances of BEPS. *See* https://www.oecd.org/tax/beps/beps-actions/ (accessed 24 Aug. 2021).

16. *See* https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en (accessed 24 Aug. 2021).

17. 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, OJ L 193 (2016), Primary Sources IBFD.

18. Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, OJ L 144 (2017), Primary Sources IBFD.

19. Council conclusions on criteria and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes, 14166/16, FISC 187 ECOFIN 1014 (8 Nov. 2016).

20. This seems to be the case in the landmark "Danish" cases: DK: ECJ, 26 Feb. 2019, Case C-115/16, *N Luxembourg I*, EU:C:2019:134; and DK: ECJ, 26 Feb. 2019, Case C-116/16, *T Danmark*, EU:C:2019:135, Case Law IBFD.

However, in the pages that follow, it will be demonstrated that it is in accordance with the objectives of the EU internal market that private parties are allowed to take business decisions based on tax reasons. Shocking as this might sound to some, this still stands in some circumstances even if these decisions lead to low or no taxation.

1.3. Terminology

As with any doctrinal section on terminology, this one is equally arbitrary, yet necessary. Arbitrary as there is no consistent usage of these terms under EU law – both in case law and in secondary law acts, and necessary as it establishes a common understanding henceforth of what is meant by using one term or another.

The first two terms that need to be distinguished from one another are "tax evasion" (seen here as synonymous with "tax fraud") and "tax avoidance" (seen here as synonymous with "tax abuse"). Tax evasion concerns behaviour whereby the taxpayer misinforms the tax administration by not reporting correctly (or altogether) events that are relevant for tax purposes. It usually involves the criminal responsibility of the taxpayer concerned and can be tentatively referred to as behaviour that *directly breaches* tax law.[21] Tax avoidance or abuse, on the other hand, relates to behaviour that accords with the letter of tax law but nevertheless breaches its spirit. By means of circumvention, an unintended result is achieved. Tax avoidance usually involves no criminal responsibility but rather triggers a possibility for the tax authorities to recharacterize civil law legal relationships for tax purposes. Both evasion and avoidance may involve not only a domestic but also a cross-border element.[22]

This book only aims to address the matter of abuse – i.e. tax avoidance. However, one should note that the ECJ does not clearly differentiate between abuse and evasion, and essentially examines them en bloc.[23] In addi-

21. For instance, the requirement that taxpayers must inform the tax administration, accurately and in a timely manner, of all circumstances that are relevant for correctly establishing their tax liability.
22. Among the clearest and most common examples of cross-border evasion is faking foreign tax residence.
23. For the linguistic reasons behind this, *see* A. Zalasiński, *The ECJ's Decisions in the Danish "Beneficial Ownership" Cases: Impact on the Reaction to Tax Avoidance in the European Union*, 2 Intl. Tax Stud. 4, p. 17 (2019), Journal Articles & Opinion Pieces IBFD.

tion, the Court (alongside the other EU institutions) is far from employing consistent terminology in referring to "tax avoidance".[24] This makes the adoption of the above working terminology for the purposes of this thesis even more important.

The other term that will appear repeatedly throughout this book is *disparity.* A disparity relates to the domestic tax laws of different countries and the differences between these laws. In this regard, unlike evasion and avoidance, disparities arise only in a cross-border context. *Any* difference between the domestic tax laws of different countries is a disparity. The simplest disparity one can think of is a disparity stemming from the different corporate tax rates – e.g. country A levies a corporate tax rate of 10%, while country B levies a rate of 30%. A disparity can also stem from the determination of the tax base – e.g. while both country A and country B levy a 30% corporate income tax (CIT), only country A provides accelerated depreciations. Disparities in the form of so-called hybrid mismatches occur whenever the same arrangement is given a different legal qualification in a cross-border scenario; for instance, one and the same transaction might be treated as debt in one Member State and as equity in another.[25]

The existence of disparities might decrease or increase the overall tax burden of private parties that operate cross-border: for example, all else being equal, relocating from a country with 30% CIT to one with 10% CIT increases the net profit of a company, while doing the opposite decreases the net profit. Disparities in the form of hybrid mismatches have even more profound effects. When done correctly, exploiting such disparities might lead to double non-taxation altogether; for example, the above debt/equity disparity might result in a deduction in the country of the payor, without its inclusion in the taxable income in the country of the recipient when the latter exempts foreign dividend income. When done "incorrectly", however, hybrid mismatches result in double taxation; as a rule of thumb, each hybrid that leads to double non-taxation results in double taxation when performed in a reversed manner. For instance, in the debt/equity example, double taxation would occur when the country of the payor treats the

24. C. Öner, *Is Tax Avoidance the Theory of Everything in Tax Law? A Terminological Analysis of EU Legislation and Case Law*, 27 EC Tax Review 2, pp. 96-112 (2018).
25. As colourfully put by Smit, hybrid mismatches arise due to the different "tax languages" that each country's tax statute "speaks". *See* D. Smit, *International Income Allocation under EU Tax Law: Tinker, Tailor, Soldier, Sailor*, 26 EC Tax Review 2, pp. 67-74 (2017).

instrument as equity (therefore allowing no deduction) while the country of the recipient treats it as debt (therefore including the income in its tax base).

Taking advantage of disparities does not equal abuse. However, there is a certain link between disparities and abuse. On the one hand, there is, conceptually, a Chinese wall between them: genuinely taking advantage of disparities does not constitute abuse but tax planning (and aggressive tax planning in cases involving hybrids).[26] The reason for this lies in the fact that whenever a disparity is used, the taxpayer does not circumvent any of the applicable domestic tax laws; he acts both in accordance with the letter and the spirit of the tax laws of the countries involved taken separately. In the example above, both receiving a deduction for the interest payment as well as getting the exemption regarding the dividends received is in accordance with the spirit of the tax laws; the first to determine the net income, the second to alleviate economic double taxation. Indeed, taken together they lead to an unintended result but not from the standpoint of any of the countries involved if examined in isolation.

And this leads us to the next point: although conceptually different, in practice disparities often go hand in hand with abuse. The reason for this is twofold: first, business decisions are influenced by what countries do;[27] and second, utilizing disparities in a genuine manner might sometimes require substantial allocation decisions by taxpayers that they might not want to factually undertake. In this sense, the disparities are a hidden presence that

26. Aggressive tax planning has a certain negative (value judgment) connotation which, for the purposes of performing legal analysis, might distort the picture. Aggressive tax planning is nothing but taking advantage of the existent disparities between different countries' tax systems. However, these disparities do not necessarily lead to double non-taxation or a reduced effective tax rate, but can result in double taxation or an increase in the combined effective tax rate an entity is facing. It seems, therefore, that in the context of disparities, the antonym of "aggressive" tax planning can be "unintelligent" tax planning. Thus, this contribution will employ the disparities language so that both outcomes are encompassed. In any event, aggressive tax planning is something conceptually different from abuse: *see* P. Piantavigna, *Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD Are Establishing a Unifying Conceptual Framework in International Tax Law, despite Linguistic Discrepancies*, 9 World Tax J. 1 (2017), Journal Articles & Opinion Pieces IBFD.

27. An example for this can be specifically derived from the area of State aid in which taxpayers frequently try to utilize domestic beneficial regimes, for instance, in the "Belgian excess profit", case where the disparity stemmed from the fact that domestic downward transfer pricing adjustments were made with no recourse to upward adjustments performed in other countries. *See* BE: ECJ, 14 Feb. 2019, Case T-131/16, *Belgium v. Commission*, EU:T:2019:91, Case Law IBFD.

often motivates instances of abuse. They can motivate the creation of abusive arrangements. It is for this reason, and because the very existence of lower or no-taxation is perceived as politically undesirable, that taking advantage of disparities is often tackled with rules labelled "anti-avoidance". However, as will become clear by the end of this book, this approach is conceptually incorrect in the context of EU law.

Indeed, it is true that disparities might lead to distortions of competition. Such distortions arise whenever there is a lack of common policy in an international setting. Albeit economically integrated in a number of areas, the EU still lags substantially behind in its integration in the field of corporate income tax. This leads to a proliferation of disparities between Member States, very often precisely *because* of a conscious choice of a Member State, and an underlying industry that is aimed at exploring tax planning opportunities. However, EU law itself guarantees that, in the absence of harmonization, Member States are free to engage in such *regulatory competition* and private parties to take advantage of it.[28]

Two very important points must be made here. The first is that abusive arrangements go hand in hand with the proliferation of the disparities within the Union, although taking advantage of a disparity and setting up an abusive arrangement is not one and the same.[29] The second is that tax planning, when it does not involve abuse, is the only rational and legitimate choice in a system constructed around the premise of regulatory competition. Reducing tax planning can only be achieved by removing the premise of regulatory competition by increasing the level of harmonization within the Union and creating a regulatory neutral environment.[30]

While the focus of this book is primarily on the subject of abuse, it will, wherever relevant, touch upon some regulatory disparities that predicate certain common instances of abuse.[31] Most importantly, it will continuously draw a distinction between arrangements that involve tax avoidance and those that involve the utilization of a disparity. While the first are to be treated with anti-avoidance rules, the latter are to be removed only by

28. *See* sec. 3.3.4.
29. The reasons for this are set out in sec. 4.3.4.
30. *See* sec. 3.4.
31. Instances of such to which special attention will be paid are the examples of directive shopping whereby third-country investors exploit the lack of harmonization concerning the withholding tax (WHT) treatment of outbound dividend, interest and royalty payments to third countries.

means of harmonizing the underlying divergent rules that lead to the disparity.

1.4. Expected findings and structure

The author defines the anti-abuse principle in the internal market as a single uniform concept which acts as a self-standing rule of primary law and has fundamentally different manifestations depending on whether private parties are facing (i) divergent domestic rules and thus can engage in jurisdiction shopping, or (ii) are operating in a fully harmonized area and are facing uniform domestic rules throughout the Union. In the first scenario, market integration through regulatory competition between Member States requires that tax driven cross-border mobility cannot be regarded as abusive per se and, therefore, a business purpose (commercial reasons) anti-abuse test is unfit to serve in non-harmonized areas. Instead, the narrower artificiality test must be applied. In the second scenario, where the matter at stake is fully harmonized, the more rigorous business purpose anti-abuse test can be applied as private parties no longer enjoy a right to cherry-pick between jurisdictions. Moreover, as a rule of primary law, the self-standing general principle overrides any piece of secondary legislation that may potentially restrict the fundamental freedoms, and this is achieved either by means of conform interpretation or in extreme circumstances by means of validity evaluation.

To develop these points, the author will proceed as follows. First, the book will address how direct taxation affects business allocation decisions in order to illuminate the underlying economic reasons for tax-driven mobility. Second, it will explain the overall goal of the EU internal market – removal of barriers to trade and factors of production mobility – and the means by which this is achieved – negative and positive integration. The purpose of this is to have a benchmark as to the aims of the law that can be circumvented. Third, the author will look into the more intricate details of the general principle of the prohibition of abusive practices as part of primary EU law. Starting with its constitutional features, the book will demonstrate the dramatic shift that the general principle introduces as compared to the pre-existing justification approach in evaluating domestic anti-avoidance provisions. It will further demonstrate how the anti-abuse principle applies differently to different instances of alleged abuse (e.g. regarding an entity or transaction, or when a third country is involved), as well as to negative and positive integration due to the inherent differences in the way these two modes of integration achieve their objective of removing obstacles before cross-border mobility. This will pave the way for providing certain guidance as to the dividing line between abuse and genuine (yet tax-saving) arrangements. Finally, the book will examine the secondary law measures that were adopted on the basis of ATAP and test them against the general prohibition of abusive practices, as informed by the goals of the internal market.

The adopted approach will be slightly unorthodox in several ways, but necessary in the author's view. First, the systematic evaluation of anti-abuse principles under primary law will be performed in two separate steps; first exclusively under primary law and without any recourse whatsoever to secondary law measures that harmonize the abuse definition (this will be done in chapter 4). This will allow demonstration of what the primary law treatment of certain arrangements would be, and more importantly how this treatment follows from the aims of the internal market. Only then, in a second step (in chapter 5), will the secondary legislation be introduced to assess how similar arrangements will be treated, this time under secondary law. Such an approach will allow for an increasing level of complexity, while at the same time highlighting any existing mismatches.

Second, in terms of the general structure of the book, the starting point will not be the applicable legal rules that regulate the anti-tax avoidance standard in the EU, but the factual distortive effects of direct taxation on business allocation decisions (chapter 2). Only by understanding this factual reality can one evaluate the existing normative anti-avoidance rules that are trying to override it. What is more, only against the background of the clash between the factual and the normative worlds can one determine, in light of the higher goals in the internal market (chapter 3), which of the two should take precedence, and how and when the legal standard of anti-abuse (chapter 4) is appropriate for correcting the factual behaviour of private parties operating cross-border. What *Is* will be examined before looking into what *Ought*.

Such a method has a solid foundation in legal philosophy and the studies devoted to the normative force of the factual.[32] According to the founding father of the concept, Jellinek, an inquiry regarding a particular phenom-

32. The concept originates in the works of G. Jellinek, *Allgemeine Staatslehre* (3rd ed., O. Häring 1914). A prominent recent contribution to this stream of literature can be found in *The normative force of the factual: legal philosophy between Is and Ought* (N. Bersier Ladavac et al. eds., Springer 2019). An inspiring monograph on the same topic was written by Z. Stalev, *Normativnata Sila na Fakticheskoto* (Sofia University 1997).

enon (be it a general theory of the state, for Jellinek, or direct taxation as in this study) will never be complete without looking both into the normative and the factual reality of the matter. The reason lies in the interrelationship between *Is* and *Ought*, which not only influence one another (what *Is* sometimes translates into law, and what *Ought* sometimes translates into actions), but can also in some circumstances be so detached that the proper functioning of the legal rules is frustrated. As Bezemek colourfully puts it in these cases of material mismatches between *Is* and *Ought*:

> […] necessity bursts through the well-regulated channel shaped by the norm: Whenever the 'Normative Force of the Factual' applies, the force of the normative becomes a negligible factor, in a single instance as well as in a multitude of instances or, in extremis, concerning the normative order of a political community as a whole. To refer to the 'Normative Force of the Factual' then means to accept that, sometimes, the legal order is overwhelmed, and legal doctrine with it.[33]

In other words, the law can regulate human behaviour only so much when not sufficiently enhanced by socio-psychological powers.[34] Therefore, this study, while remaining centrally legal, will deviate from Kelsen's Pure Theory of Law, where the *Sein* and the *Sollen* remain strictly separated.[35] However, even Kelsen recognizes that the validity of a legal norm depends, inter alia, on it being "efficacious to a certain degree".[36]

The proposed approach is even more necessary in tax law, in which the rather complex rules governing corporate tax avoidance were not conceived as a "factual practice, the continuity of which caused the perception of its normative character",[37] which is how most other laws are conceived. On the contrary, the rules on corporate tax avoidance aim at shaping the factual reality; the *Ought* should translate into *Is*, therefore the threat of a substantial mismatch between *Sein* and *Sollen* is greater, thereby threatening the efficacy of the rules. This is why there are more disputes on whether a certain tax arrangement is abusive than there are on whether one must pay for shopping in a supermarket.

33. C. Bezemek, *The 'Normative Force of the Factual': A Positivist's Panegyric*, in *The Normative Force of the Factual: Legal Philosophy Between Is and Ought* pp. 65-66 (N. Ladavac, C. Bezemek & F. Schauer eds., Springer 2019).
34. G. Jellinek, *Allgemeine Staatslehre* p. 344 (1st ed., O. Häring 1900).
35. H. Kelsen, *Reine Rechtslehre* (Franz Deuticke 1934).
36. H. Kelsen, *Was ist juristischer Positivismus?* p. 465 (Juristenzeitung 1965), cited in Bezemek, *supra* n. 33, at p. 67.
37. G. Jellinek, *Allgemeine Staatslehre* (1st ed., O. Häring 1900), cited in Bezemek, *supra* n. 33, at p. 73.

Thus, the approach in this work will consist of four main steps. The first will concern the factual reality. On the basis of management science and economic studies, it will be demonstrated that direct taxation is in some circumstances the sole reason for business allocation decisions and that this is only natural when the corporate tax systems of the different countries diverge in the absence of barriers to the mobility of the factors of production (in particular capital mobility). This step will serve the purpose of drawing the factual restraints derived from the Normative Force of the Factual before the rules on anti-abuse. This step is performed in chapter 2.

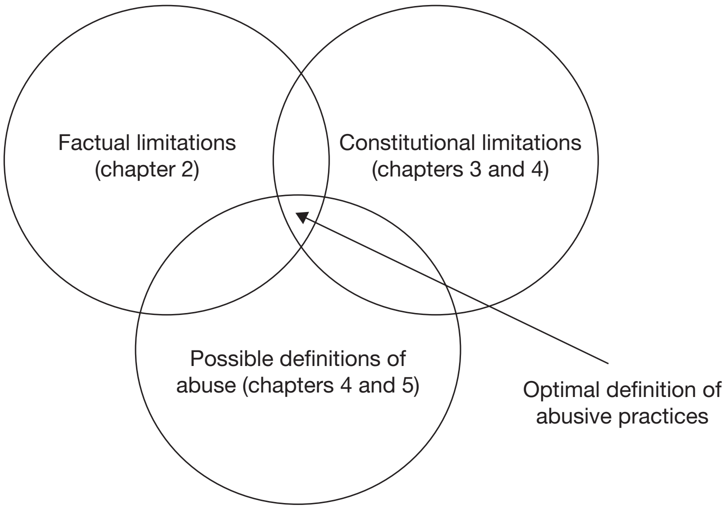
The second step will examine the normative reality in the EU at the highest level of abstraction. It will demonstrate that it is in accordance with the means to achieve European economic integration to allow for divergences in the domestic regulatory frameworks of Member States, including in the field of direct taxation. It flows logically from this that corporate mobility will be exercised within the Union for tax reasons. This step will serve the purpose of drawing *the constitutional restraints* for the rules on anti-abuse. Chapter 3 deals with the second step.

The third step also examines the normative reality – this time at a lower level of abstraction – by looking into the general principle of the prohibition of abusive practices as developed in ECJ case law. Building upon the conclusions of the first two steps, it will indicate that this principle cannot apply to situations where corporate mobility was exercised even if solely for tax reasons in areas that remain non-harmonized. In other words, the general principle's content is substantially restricted by the Normative Force of the Factual and by the constitutional limitations inherent in the EU treaties. This analysis is contained in chapter 4.

The fourth and final step also focuses on the normative reality, this time at its lowest level of abstraction, by looking into the secondary law EU norms that were adopted for harmonizing the anti-avoidance rules in the Union. It examines the relationship between the primary and secondary law governing anti-abuse in the area of direct taxation and draws conclusions regarding the constitutional validity of a number of secondary law provisions. This is done in chapter 5.

The overall approach of this work can be represented in the following manner:

Figure 1.1. Chapter overview



Chapter 2

The Distortive Effect of Direct Taxation on Factors of Production Allocation

2.1. General considerations

This chapter will demonstrate that in the absence of other barriers to factors of production reallocation, taxation might affect the investment decisions of private parties internationally due to the existing disparities in the tax regimes of different countries. It will show that corporate taxation, in particular, affects investors' choices concerning if and where to invest abroad. Thus, the international mobility of capital is affected by direct taxation in the different jurisdictions around the globe.[38]

To prove the above theoretically, one should look at models regarding the international mobility of capital and the impact of corporate direct taxation on this mobility. However, before doing so, one must examine the simpler basic models regarding the *domestic* incidence of corporate direct taxation.[39] The international mobility of capital only magnifies the effects of this incidence as a new set of potential (this time, international) tax distortions is introduced.[40] A greater focus on the distortive effect of corporate taxation on investment decisions is made in sections 2.2. (in a domestic setting) and 2.3. (in an international setting). Before adopting this ultimately micro-economic approach in the upcoming sections, a few macroeconomic considerations are in order.

The economic theory of comparative advantage states that when two countries trade with one another, each will increase the production of the goods in which it has the lower relative marginal cost and will export such goods rather than consume them.[41] This difference in the marginal cost will result

38. Tentatively, this is also true with respect to trade in production outputs (goods and services), to the extent the market country has taxing rights over the income generated. It is also true about labour, but the latter remains outside the scope of this book, which focuses on corporate taxation rather than personal income taxation.
39. A. Harberger, *The Incidence of the Corporation Income Tax*, 70 Journal of Political Economy 3, pp. 215-240 (1962).
40. A. Dixit, *Tax Policy in Open Economies,* in *Handbook of Public Economics*, p. 313 (vol. 1, A. Auerbach & M. Feldstein eds., Elsevier 1985).
41. A.K. Dixit & V. Norman, *Theory of International Trade: A Dual, General Equilibrium Approach* p. 2 (Cambridge University Press 1980). And, of course, one cannot

either from the difference in the factors of production endowment (e.g. the country with greater abundance of labour will have lower wages, and therefore a comparative advantage for labour-intensive goods) or from other factors such as the existing technological differences.[42] However, the theory presupposes the immobility of the factors of production; i.e. the factors of production cannot relocate freely between the countries thereby reducing or eliminating altogether the possible effects of existing disparities.[43]

The reality, nevertheless, is somewhat different. Both capital and labour can relocate from less productive to more productive locations, thereby increasing the total output and overall efficiency in the global economy.[44] Capital has higher relative mobility relative to labour, even in the absence of any regulatory (including tax) burdens or incentives, due to reasons such as language differences and emotional ties, which only affect labour mobility. Moreover, the regulatory restrictions on international labour mobility are often more severe – e.g. immigration laws. Thus, money is more likely to be shifted across the border as compared to people,[45] which makes the tax competition logically more substantial in the field of corporate taxation.[46]

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rely on the theory of comparative advantage without mentioning its "founding fathers", A. Smith, *The Wealth of Nations* (W. Strahan and T. Cadell 1776); and D. Ricardo, *On the Principles of Political Economy and Taxation* (John Murray 1817). The author will not challenge the idea that one should not attempt to make what will be cheaper to buy and thus will accept the theory of comparative advantage as given.

42. A. Maneschi, *Comparative Advantage in International Trade: A Historical Perspective* p. 92 (Edward Elgar 1998).

43. T.S. Eicher, J.H. Mutti & M.H. Turnovsky, *International Economics*, p. 221 (7th ed., Routledge 2009).

44. Id., at p. 224.

45. The difference between the relative mobility of capital and people leads some economists to suggest taxation models such as Destination-Based Cash Flow Taxation which revolve around consumption rather than capital. *See* A. Auerbach et al., *Destination-Based Cash Flow Taxation*, Oxford University Centre for Business Taxation WP 17/01 (2017), available at https://ssrn.com/abstract=2908158 (accessed 24 Aug. 2021). For an in-depth study on the relationship between capital and labour mobility and its impact on capital and labour taxes, *see* H. d'Albis, A. Bénassy-Quéré & A. Schurich-Rey, *Taxing capital and labor when both factors are imperfectly mobile internationally*, Paris School of Economics Working Paper 2018-40 (2018), available at: https://halshs.archives-ouvertes.fr/halshs-01851492/document (accessed 24 Aug. 2021).

46. The numbers on this are crystal clear when one looks at statistics regarding OECD countries: the average statutory corporate tax rate fell from 32.24% in 2000 to 23.47% in 2019, a decrease of 27.2% over a period of 19 years (this is the author's calculation using the OECD data at https://stats.oecd.org/ (accessed 24 Aug. 2021). When one looks at the total burden on labour, the decrease is from 37.4% on average in 2000 to 36.0% in 2019, which is a decrease of only 3.74% (*see* OECD, *Taxing Wages 2020* (OECD 2020), available at https://www.oecd-ilibrary.org/sites/047072cd-en/1/3/1/6/index.html?itemId=/content/publication/047072cd-en&_csp_=61ab1636a3c5e6e66df4c2ea29c39562&itemIGO=oecd&itemContentType=book (accessed 6 Dec. 2021).

Although factor reallocation certainly benefits the economic operators (they may employ their capital or labour force in a location where the rate of return is higher than in their home country), it leads to redistribution of the public revenue whereby some countries lose their possibility to tax the income arising from the productive activity due to reallocation,[47] while other countries naturally gain this possibility. Besides the increased overall tax base, the country to which capital is relocated gains further economic activity and jobs in its territory. Tax competition is born.

Countries have an incentive to lower their effective corporate tax burden (in particular the tax rate but also the tax base), thereby creating a higher net return on capital in order to attract more investment and increase their capital stock.[48] In other words, all else being equal, when a country taxes less, its inflow of capital stock increases, thereby incentivizing countries to *create* tax distortions. This, in principal, remains valid even if the home country applies the credit method, when there are meaningful legal ways to avoid immediate repatriation.[49] The resulting overall lowering of global corporate tax rates is often referred to as a race to the bottom.[50]

Some economic studies on the optimal level of taxation in an international setting assume that when countries are deciding their tax policy, they disregard said policy's impact on the welfare of other countries.[51] Moreover, it is assumed that a country has a full range of possible policy choices and

47. Eicher, Mutti & Turnovsky, *supra* n. 43, at p. 226.
48. For a model demonstrating the relationship between tax cuts and international capital mobility, *see* J. Mutti & H. Grubert, *The Taxation of Capital Income in an Open Economy: The Importance of Resident-Nonresident Tax Treatment*, 27 Journal of Public Economics 3, pp. 291-309 (1985). For empirical evidence confirming this, *see* J. Mutti & H. Grubert, *Empirical Asymmetries in Foreign Direct Investment and Taxation*, 62 Journal of International Economics 2, pp. 337-358 (2004).
49. A. Harberger, *The Incidence of the Corporation Income Tax Revisited*, 61 National Tax Journal 2, pp. 309-310 (2008). A famous example of a proponent for achieving tax neutrality in investment decisions via the credit method can be found in P.B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Harvard Law School 1969). One can argue that the effect of international neutrality can be achieved by means of the ordinary credit method, applicable to foreign investments without distinction on the basis of the legal form and tax competition regarding the foreign tax liability, i.e. the foreign country will set its effective corporate tax rate in a way which does not dissuade inbound investment decisions.
50. Interestingly enough, the fall in corporate tax rates does not necessarily lead to a corresponding fall in the corporate income tax revenue to GDP ratio. Some attribute this to the phenomenon of "corporatization" – *see* J. Piotrowska & W. Vanborren, *The corporate income tax rate-revenue paradox: Evidence in the EU*, European Commission, Taxation and Customs Union Working Paper No 12 (2007).
51. Dixit, *supra* n. 40, at p. 313.

can choose between taxes on consumption, income, tariffs, subsidies, etc.[52] These assumptions are not necessarily true at the EU level where Member States strive for "an ever closer union" based on solidarity and sincere cooperation,[53] thereby weakening the assumption that a country's concerns end at its borders. Second, where the Union has exclusive competences (customs)[54] or where the competences are shared but the Union has legislated based on the principle of pre-emption (VAT,[55] excise duties,[56] withholding taxes (WHT) on certain qualifying dividends, interest, and royalties[57]), the Member States are banned from having divergent laws. Member States are similarly restricted in their use of subsidies by the rules on State aid. Thus, in an EU context, the tax policy choices for Member States are to a large extent restricted to direct taxation, with fiscal sovereignty being further restrained by the fundamental freedoms, the relevant secondary legislation and the rules on State aid.

> Capital is the most mobile factor of production and, all else being equal, is internationally allocated to the country offering the greatest net return. Tax-policy naturally plays a role in this respect, but EU Member States' choices are substantially restricted by EU law.

52. Id., at p. 314.
53. *See* art. 4(3) and Preamble TEU.
54. *See* Regulation (EU) No 952/2013 of the European Parliament and of the Council of 9 October 2013 laying down the Union Customs Code, OJ L 269 (2013), Primary Sources IBFD.
55. Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347 (2006), Primary Sources IBFD.
56. Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty and repealing Directive 92/12/EEC, OJ L 9 (2009), Primary Sources IBFD; Council Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages, OJ L 316 (1992), Primary Sources IBFD; Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco, OJ L 176 (2011), Primary Sources IBFD; and Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity, OJ L 283 (2003), Primary Sources IBFD.
57. Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 345 (2011), Primary Sources IBFD; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157 (2003), Primary Sources IBFD.

2.2. Domestic distortive effects of direct taxation on investment decisions

Taxes create market distortions, with direct taxation being no exception.[58] In other words, private parties change their economic behaviour due to tax considerations. At first glance, this statement is rather self-evident and not especially insightful. Indeed, taxes driven by a specific behaviour-related regulatory aim – i.e. compensating for negative externalities – have been a mainstream issue in economics for a century and have been extensively used by governments.[59] However, this book focuses on the revenue-raising objective of corporate taxation and its unintended distortive effects,[60] rather than the intended outcomes from an explicit tax incentive.

To understand the wider implications of direct taxation on international investment decisions, one must start by looking at their effect in a purely domestic setting. Predetermined by the topic of this book, the focus here will be on the effects of corporate income tax on investment decisions. The author will prove in this respect only one point that will have important implications for the upcoming analysis: *corporate taxation can change the investment decision between investment alternatives as compared to a pre-tax evaluation*. In other words, taxation affects and changes private parties' behaviour.[61] Nothing demonstrates this better than the so-called "income tax paradox", where an unviable pre-tax investment decision, turns viable post-tax.[62]

58. A. Harberger, *Taxation, Resource Allocation, and Welfare*, in *Role of Direct and Indirect Taxes in the Federal Reserve System* (Princeton University Press 1964).
59. A.C. Pigou, *The Economics of Welfare* (Macmillan and Co. 1920). Examples of such taxes will be taxes on tobacco, alcohol, carbon, etc. Of course, these are not instances of direct taxes.
60. Of course, the CIT serves more than a revenue-raising function; a lot of the rules of different countries' corporate tax codes aim at incentivizing certain forms of behaviour, for example, an IP box regime that aims at incentivizing investments in R&D.
61. This conclusion has long been clear in economic studies – *see*, for example, S. Johansson, *Income Taxes and Investment Decisions*, 71 The Swedish Journal of Economics 2, pp. 104-110 (1969).
62. D. Schanz & S. Schanz, *Business Taxation and Financial Decisions* pp. 97-106 (Springer 2011). *See* also D. Schanz & S. Schanz, *The Income Tax Paradox*, 38 Intertax 3, pp. 167-169 (2010).

Take a simple numerical example to demonstrate this point.[63] Imagine, an investor has EUR 3,000 to invest either on the financial market with a guaranteed rate of return of 10% per year or in a project with a useful life of 3 years, which is predicted to yield the following cash flow (*see* Tables 2.1.-2.3.).[64]

Table 2.1. Investment in a project over 3 years

Real Project Investment (cash flow)				
Year	0	1	2	3
Cash flow	-3,000	1,050	1,150	1,450

Absent taxation, the investment in the financial market will result in a total gain of EUR 993 in the course of three years, assuming reinvestment of the interest gained each year. This can be represented with Table 2.2.

Table 2.2. Financial market investment over 3 years

Financial Market Investment (no tax)				
Year	0	1	2	3
Principal	3,000	3,000	3,300	3,630
Interest income		300	330	363
			Withdrawal	3,993

The project on the contrary, would result in a gain of only EUR 985.50, assuming that all incoming cash flow is reinvested in the financial market at a 10% interest rate (*see* Table 2.3.). Thus, the investment in the project is not economically viable as it does not beat the financial market.

63. The example is taken from Schanz & Schanz (2011), id., at pp. 97-106. For the sake of greater clarity for non-specialized audiences, the author has chosen to represent the investments with a financial plan rather than the more "classical" net present value (NPV) formula for comparing investments:

$$NPV = -I_0 + \sum_{t=1}^{n} \frac{CIF_t - COF_t}{(1+i)^t} = -I_0 + \sum_{t=1}^{n} \frac{CF_t}{(1+i)^t}$$

Where I_0 is the initial investment, n – the time horizon, CF_t – the cash flows, and i – the discounted rate, representing the opportunity cost of capital, if it were invested in the financial market.

64. Assuming the investment is risk-free for the sake of simplicity.

Table 2.3. Investment in a project over 3 years without taxation

Real Project Investment (no tax)				
Year	0	1	2	3
Cash flow	-3,000	1,050	1,150	1,450
Financial investment		1,050	2,305	
Interest income		0	105	230.5
Total cash flow	-3,000	1,050	1,255	1,680.5
			Withdrawal	3,985.5

Let us, however, introduce a corporate income tax of 50% into the picture with a straight line of depreciation of 3 years. In this case, the "income tax paradox" realizes itself; an unviable pre-tax investment in a project now turns viable due to the corporate tax imposed.[65] The point becomes clear when we take a look at the numbers in Table 2.4. The investment in the financial market results in an ultimate post-tax profit of EUR 472.90:

Table 2.4. Financial market investment over 3 years with taxation

Financial Market Investment (with tax)				
Year	0	1	2	3
Principal	3,000	3,000	3,150	3,307.50
Interest income		300	315	330.75
Tax base		300	315	330.75
Tax liability		150	157.50	165.375
Net income		150	157.50	165.375
			Withdrawal	3,472.875

65. Again, the traditional way of calculating this would be with the NPV formula that takes taxation into account:

$$NPV^{\tau} = -I_0 + \sum_{t=1}^{n} \frac{CF_t - T_t}{(1+i^{\tau})^t} = -I_0 + \sum_{t=1}^{n} \frac{CF_t - \tau \times \overbrace{(CF_t - D_t)}^{tax\ base\ TB_t}}{(1 + i \times (1-\tau))^t}$$

The new elements as compared to the pre-tax NPV formula are T_t – the tax payment, i^t – after-tax interest rate, D_t – depreciation, and τ – tax rate.

However, an investment in the project with a depreciation over the course of 3 years will result in a more beneficial outcome and a total after-tax profit of EUR 483.80, represented in Table 2.5.

Table 2.5. Investment over 3 years with depreciation

Real Project Investment (with tax)				
Year	0	1	2	3
Cash flow	-3,000	1,050	1,150	1,450
Depreciation		1,000	1,000	1,000
Financial investment		1,025	2,151.25	3,483.8125
Interest income		0	102.50	215.125
Tax base		50	252.50	665.125
Tax liability		25	126.25	332.5625
Post-tax cash flow		1,025	1,126.25	1,332.5625
			Withdrawal	3,483.8125

The assumption is, as in Tables 2.1.-2.3., that all positive after-tax cash flow is reinvested in the financial market. One can see that the real project now beats the market due to the introduction of taxation into the equation and what was not commercially viable becomes viable. In this case, the distortion is caused by a depreciation allowance that exceeds in present value the present value of a so-called "economic depreciation" in a neutral tax system of "taxation of true economic profit". This economic depreciation is determined on the basis of future cash flows.[66] In common real-world tax systems, the tax-relevant depreciation is based on a set schedule rather than future cash flows. However, the "income tax paradox" can be caused by other factors in the corporate tax system such as different tax rates applied to different income, as well as tax base reasons such as tax-exempted items of income or the treatment of losses.[67] Of course, in absolute terms, both

66. For a more detailed explanation of a system based on "economic depreciation", *see* Johansson, *supra* n. 61, at pp. 104-110; and P.A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 Journal of Political Economy 6, pp. 604-606 (1964).
67. Schanz & Schanz (2011), *supra* n. 62, at p. 109. Thus, the distortive effect all boils down to the elasticity of substitution between different alternative investments and their tax treatment; *see* S. Fatica, *Do corporate taxes distort capital allocation? Cross-country evidence from industry-level data*, European Commission Economic Papers 503 (2013).

the real project investment and the alternative investment in the financial market end up leaving the investor worse-off due to the newly introduced corporate tax. However, comparatively and due to the underlying rules on the determination of the tax base, the rational investor's decision changes in favour of the real investment. Thus, the "income tax paradox" can be summarized in the following statement:

> Investment decisions that are profitable (unprofitable) on a pre-tax basis can be unprofitable (profitable) because of the taxation of the corresponding income. An optimal investment decision can only be made by taking taxes into account.[68]

Thus, when the "income tax paradox" manifests itself, the essential reason for taking an investment decision is the imposition of taxation. Theoretically, the income tax paradox should not occur under a neutral tax system, where the pre-tax and post-tax ranking of investments always coincide. The macroeconomic rationale for striving for a neutral tax system is that factors of production allocation decisions must not be affected by taxation.[69] Such neutral tax systems are, for example, envisaged as a form of cash flow-based taxation.[70] However, since one sees in practice no non-distortive systems of corporate taxation such as cash flow-based systems, no further elaboration on the matter is necessary here.

All of the above calculations are based on the assumption that the investments are risk-free for the sake of simplicity. However, introducing risk into the equation only reinforces the conclusion that investment decisions

68. Schanz & Schanz (2011), *supra* n. 62, at p. 101.
69. Id., at p. 159. For a more elaborate analysis, *see also* D. Schneider, *Investition, Finanzierung, Besteuerung* p. 206 (7th ed., Gabler 1992); R. König & M. Wosnitza, *Betriebswirtschaftliche Steuerplanungs- und Steuerwirkungslehre* p. 139 (Physica-Verlag 2004); and F.W. Wagner, *Besteuerung*, in *Vahlens Kompendium der Betriebswirtschaftslehre – vol. 2* pp. 407-477 (5th ed., M. Bitz et al. eds., Vahlen 2005).
70. There are different possible designs of the cash-flow taxation, but the feature that differentiates it from income taxation is that, in calculating the tax base, the taxpayer is taxed on its net cash flows, without the usual distinction between capital and revenue – i.e. all expenses are immediately deducted. Some of the different possible designs are discussed, for instance, in P. Shome & C. Schutte, *Cash-Flow Tax*, 40 IMF Staff Papers 3, pp. 641-642 (1993). *See* the first proponent of the idea of cash-flow taxation in C.E. Brown, *Business-income taxation and investment incentives*, in *Income, Employment, and Public Policy: Essays in Honor of Alvin H. Hansen* pp. 300-316 (L.A. Metzler ed., W.W. Norton & Co. 1948); Johansson, *supra* n. 61, at pp. 104-110; and M.P. Devereux & H. Freeman, *A general neutral profits tax*, 12 Fiscal Stud. 3, pp. 1-15 (1991). More recently, the idea was also pushed in an international setting: *see* M. Devereux & R. de la Feria, *Designing and Implementing a Destination-Based Corporate Tax*, Oxford University Centre for Business Taxation Working Paper Series (2014).

are tax sensitive.[71] Higher effective taxation may lead to a reduction in corporate risk-taking, thereby again leading to changes in investment decisions as compared to a pre-tax assessment.[72] The reason for this is simple: if things go well, the government gets its share of the pie. If things go badly, no reimbursement of the negative corporate income tax follows under a limited loss carry-forward regime.[73] In other words, profits are shared between the firm and the government, while losses remain private.[74] A simple numerical example illustrates the point.

Imagine that a private party can choose between two potential investments – A and B – having two potential outcomes – "good" and "bad" – with the likelihood of both outcomes being equal.[75] Investment A results in a

71. There is a substantial amount of literature regarding the possible designs of tax systems in the presence of uncertainty: *see*, for instance, J.K. Mackie-Mason, *Some non-linear tax effects on asset values and investment decisions under uncertainty*, 42 Journal of Public Economics 3, pp. 301-327 (1990); S.R. Bond & M. P. Devereux, *On the design of a neutral business tax under uncertainty*, 58 Journal of Public Economics 1, pp. 57-71 (1995); C. Sureth, *Der Einfluss von Steuern auf Investitionsentscheidungen bei Unsicherheit* (Deutscher Universitäts-Verlag, Wiesbaden 1999); C. Sureth, *Partially Irreversible Investment Decisions and Taxation under Uncertainty: A Real Option Approach*, 3 German Economic Review 2, pp. 185-221 (2002); T. Gries, U. Prior & C. Sureth, *A Tax Paradox for Investment Decisions under Uncertainty*, 14 Journal of Public Economic Theory 3, pp. 521-545 (2012); and R. Niemann & C. Sureth, *Sooner or Later? Paradoxical Investment Effects of Capital Gains Taxation under Simultaneous Investment and Abandonment Flexibility*, 22 European Accounting Review 2, pp. 367-390 (2013).

72. A. Ljungqvist, L. Zhang & L. Zuo, *Sharing Risk with the Government: How Taxes Affect Corporate Risk Taking*, 55 Journal of Accounting Research 3, pp. 669-707 (2017); D. Langenmayr & R. Lester, *Taxation and Corporate Risk-Taking*, 93 The Accounting Review 3, pp. 237-266 (2017); and B. Osswald & C. Sureth-Sloane, *Do Country Risk Factors Attenuate the Effect of Taxes on Corporate Risk-Taking?*, WU International Taxation Research Paper Series No. 2018-09 (2020).

73. An empirical correlation between risk-taking and the expectation of future loss-recovery has been demonstrated: *see* D. Langenmayr & R. Lester, *Taxation and Corporate Risk-Taking*, 93 The Accounting Review 3 (2017). However, the relationship between taxes and risk-taking goes beyond corporate taxation and might also stem from the different regimes for taxing different incomes, for example business income and personal income tax, *see* J. Cullen & R. Gordon, *Taxes and entrepreneurial risk-taking: Theory and evidence for the U.S.*, 91 Journal of Public Economics 7/8, pp. 1479-1505 (2007). Literature has long suggested that the relationship between tax rates and risk-taking is complex and a higher rate might incentivize risk as long as there is a possibility of offsetting potential losses thereby reducing the (otherwise positive) tax base: *see* E.D. Domar & R.A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 The Quarterly Journal of Economics 3, pp. 388-422 (1944).

74. W. Schön, *Ein Steuerrecht für Katastrophen* (Frankfurter Allgemeine Zeitung 2020).

75. The example is taken with a small modification from A. Ljungqvist, L. Zhang & L. Zuo, *Sharing Risk with the Government: How Taxes Affect Corporate Risk Taking*, 55 Journal of Accounting Research 3, p. 670 (2017).

profit of EUR 39 in both scenarios, while Investment B results in a profit of EUR 100 in the "good" scenario and a loss of EUR 20 in the "bad" one. Assuming that risk is diversifiable, the expected profit of Investment B is EUR 40.[76] Thus, the private party should choose the risky investment B over the safe investment A. However, once corporate income tax of 20% is introduced, the outcome changes leading to a post-tax return of EUR 31.20 for investment A (risk-free) and a post-tax return of EUR 30 for investment B.[77] This remains valid only under the given set of assumptions and to the extent that there is no corporate income tax reimbursement in the event of losses and no assumption of unlimited carrying forward or back of losses with certainty of profits in the past or future.[78] It remains, of course, also valid in a tax system without loss offset provisions.

Therefore, in designing a tax system, the country-specific risk matters.[79] Thus, the higher the country-specific risk, the more caution a government must observe to avoid disincentivizing risk-taking by its corporate tax system. This is because the introduction of corporate income tax incentivizes private parties to reduce risk-taking. Again, in our example, corporate income tax is the sole reason for choosing one investment over another.

> Corporate income tax impacts factors of production allocation (investment) decisions even to the point where a tax can be the sole factor in making a commercially unviable investment viable (and vice versa).

76. The formula for calculating the expected profit while accounting for risk is 0.5*(100-20).
77. The return-on-investment A is calculated as follows: 39*(1-0.2) = 31.2; the return-on-investment B is calculated as follows: 0.5*((1-0.2)*100-20) = 30, where (1-0.2) represents the return net of taxes, 0.5 is the likelihood of occurrence of both scenarios and 100-20 their possible outcomes.
78. Had this been the case, the ultimate outcome of the pre- and after-tax investment decisions would coincide. In the case of Investment B, the return would be calculated as follows: 0.5*((1-0.2)*100-16)=32, and would thus still be higher than the after-tax return of Investment A at 31.2 with the same ratio (40 is higher than 39) (the pre-tax outcomes). In this case, the "bad" scenario is reduced to "-16" as, if losses occur, the negative corporate income tax of 4 will either be reimbursed or utilized against other corporate profits.
79. *See* B. Osswald & C. Sureth-Sloane, *Do Country Risk Factors Attenuate the Effect of Taxes on Corporate Risk-Taking?*, WU International Taxation Research Paper Series No. 2018-09, pp. 4-5 (2020).

Notes

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