European Union

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Tax Avoidance and Harmful Tax Competition: A Proposal for an Alternative Solution

For decades, the European Commission has made attempts to resolve the problem of tax avoidance and harmful tax competition in the European Union. It has proposed various solutions, including the Common Consolidated Corporate Tax Base (CCCTB), the EU Anti-Tax Avoidance Directive (2016/1164) (ATAD), and the recently discussed Pillars One and Two approaches, along with a new Framework for Income Taxation for Business in Europe (BEFIT). This article focuses on why the problem has not been satisfactorily solved to date. It also proposes an alternative approach to address the problem.

1. Initial Problem

In general, tax avoidance is caused by the aggressive tax planning of companies. In the European Union, this problem is rooted in differences between the national tax systems of the Member States. Mismatches between national tax systems create risks of double taxation or double non-taxation and, thereby, distort the "functioning" of the internal market.[1] In particular, controlled foreign companies (CFCs) can be established as taxable entities in a low-tax EU Member State to shift profits and benefit from preferential regimes with reduced tax rates on mobile income (IP boxes). As a result, other Member States may face pressure to reduce their tax rates on mobile income to attract companies. This creates international tax competition, which can turn into a competition to undercut tax rates between states. The result could even be a "race to the bottom", i.e. a tax competition where the final tax rate for mobile income approaches zero.[2]

To date, case law of the Court of Justice of the European Union (ECJ) has not been able to cope with this problem. In fact, it can even be regarded as the origin of the described legal arrangement. The creation of a CFC is easy when the fundamental freedoms can be invoked to justify the entity's establishment.[3] This "rule shopping" was facilitated, in particular, by the leading ECJ decision in *Cadbury Schweppes* (Case C-196/04).[4] In this decision, the ECJ interprets the freedom of establishment in a particularly broad manner. For a restriction on the freedom of establishment to be justified on the ground of the prevention of abusive practices (tax abuse), the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements. The creation of a CFC must be regarded as having the characteristics of a "wholly artificial arrangement" if it is a fictitious establishment "*not carrying out any genuine economic activity* in the territory of the host Member State". Therefore, "tax abuse" could be present in the case of a "letterbox" or "front" subsidiary.[5]

It can be stated that the problem primarily has an economic dimension in terms of an inefficient distribution of taxes. The core problem is the lack of a coordinated allocation of the power to impose taxation (taxing rights) between the various Member States. This is then used by individual taxpayers to engage in aggressive tax planning.

2. The Approaches Taken to Date

2.1. C(C)CTB

The idea behind the Common Consolidated Corporate Tax Base (CCCTB) proposal is to allocate taxing rights in a coordinated manner. The European Commission's last proposal for a Directive, in June 2015, indicates a two-step approach to implementing the CCCTB.[6] An initial Directive proposal (COM(2016) 685) is limited to the rules for calculating the Common Corporate Tax Base (CCTB), including certain provisions to counter tax avoidance and on the international dimension of the proposed tax system.[7] After the elements of this CCTB have

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1. European Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM(2016) 683 final, p. 2 (25 Oct. 2016), Primary Sources IBFD.
2. *See* M. Valta, *Das internationale Steuerrecht zwischen Effizienz, Gerechtigkeit und Entwicklungshilfe* pp. 174-175 (Mohr Siebeck 2014); N.I. Schaper, *Steuerstaat im Wettbewerb*, p. 27 (Nomos 2014); and W. Schön, *Internationale Steuerpolitik zwischen Steuerwettbewerb, Steuerkoordinierung und dem Kampf gegen Steuervermeidung*, 31 IStR 6, pp. 181-182 (2022).
3. D. Gosch, *Missbrauchsabwehr im Internationalen Steuerrecht*, in *Internationales Steuerrecht* p. 206 (M. Achatz ed., Dr. Otto Schmidt 2013); *see also* SE: ECJ, 21 Nov. 2002, Case C-436/00, *X & Y v. Riksskatteverket*, paras. 42 and 61, Case Law IBFD; NL: ECJ, 30 Sept. 2003, Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd*, para. 136, Case Law IBFD; UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, para. 57, Case Law IBFD; UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, para. 55, Case Law IBFD; and UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, para. 74, Case Law IBFD.
4. *Cadbury Schweppes plc* (C-196/04).
5. Id., paras. 55 and 68.
6. European Commission, Communication on a Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, COM(2015) 302 final, p. 8 (17 June 2015), Primary Sources IBFD.
7. European Commission, Proposal for a Council Directive on a Common Corporate Tax Base, COM(2016) 685 final, p. 3 (25 Oct. 2016), Primary Sources IBFD.

been politically agreed upon, a second Directive proposal (COM(2016) 683) lays down (i) the conditions for companies to be in a group with consolidated income and (ii) rules regarding the technicalities of such consolidation. One of the principal elements of the proposal is formulary apportionment, i.e. the mechanism used to allocate the consolidated tax base of the group to the eligible Member States. To preserve the Member States' sovereignty, this final CCCTB does not affect the right of Member States to set their own corporate tax rates. Instead, the allocated share of the profit will still be taxed according to the applicable national tax rate.[8]

2.2. ATAD

In July 2016, the European Union reached an initial milestone with the adoption of the EU Anti-Tax Avoidance Directive (2016/1164) (ATAD).[9] The ATAD lays down rules to counter tax avoidance practices that directly affect "the functioning of the internal market". In this context, the initial problem is to be solved through a harmonized minimum standard for legal instruments, i.e. a General Anti-Abuse Rule (GAAR) and a CFC rule. The approach is that tax is to be paid where profits and value are generated. The ATAD was enacted in response to concrete action recommendations made in the context of the OECD/G20 project to combat Base Erosion and Profit Shifting (BEPS).[10]

2.3. Pillar One

To address the tax challenges that have arisen from digitalization of the economy, the OECD has proposed the Pillar One approach, which re-allocates taxing rights. In particular, the OECD proposes that 25% of residual profit should be allocated to the end market jurisdiction where goods or services are used or consumed. In-scope companies are multinational enterprises (MNEs) with global turnover above EUR 20 billion and profitability above 10%.[11] In response to the OECD's initiative, the European Commission announced, in December 2021, that it would table a proposal for an EU Directive giving effect to Pillar One in compliance with EU law.[12]

2.4. Pillar Two

The idea of applying full tax harmonization in the European Union has long been discussed in the literature, as well as in independent expert committees. In addition to rigid rules on the allocation of taxing rights, tax harmonization should include a minimum corporate income tax rate to prevent tax competition.[13] The idea of such a minimum tax rate is also reflected in the OECD's Pillar Two approach,[14] which was adapted in a proposed EU Directive (COM(2021) 823) issued by the European Commission in December 2021. Accordingly, MNEs with a sales threshold of above EUR 750 million are subject to a minimum tax rate of 15%. Each time the effective tax rate of an MNE in a given jurisdiction is below 15%, an additional tax is to be collected (top-up tax). Primarily, the parent entity of an MNE located in a Member State has the obligation to apply a top-up tax relating to any entity of the group that is low-taxed, regardless of whether or not the entity is located within the European Union (Income Inclusion Rule). In cases where the entire amount of top-up tax relating to low-taxed entities cannot be collected by parent entities through the application of this rule, a constituent entity of an MNE group collects an allocable share of top-up tax according to a backstop rule (Undertaxed Payment Rule).[15] The implementation of the Income Inclusion Rule could interact with the ATAD and, therefore, have implications, particularly in respect of the CFC rule.[16]

2.5. BEFIT

In May 2021, the European Commission announced that it would be presenting a new framework for business taxation in the European Union by 2023. The "Business in Europe: Framework for Income Taxation" (BEFIT) will provide a single corporate tax rulebook for the European Union to achieve fairer allocation of taxing rights between Member States. It will replace the pending proposal for a CCCTB, which will be withdrawn. Like the CCCTB proposal, BEFIT will consolidate the profits of the EU members of a multinational group into a single tax base, which will then be allocated to Member States using a formula, to be taxed at national corporate income tax rates. Unlike the CCCTB proposal, the new proposal is supposed to better reflect the realities of today's economy and global developments, in particular, by taking better account of digitalization and giving effect to Pillar One.[17]

8. COM(2016) 683 final, *supra* n. 1, at pp. 3, 5, 20-25 and 28-33.
9. Council Directive 2016/1164 of 12 July 2016 Laying down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193/1 (2016), Primary Sources IBFD [hereinafter ATAD 1].
10. ATAD 1, at pp. 1 and 5-6.
11. OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, pp. 1-2 (8 Oct. 2021).
12. *See* European Commission, Communication on the Next Generation of Own Resources for the EU Budget, COM(2021) 566 final, p. 3 (22 Dec. 2021).
13. European Commission, *Report of the Committee of Independent Experts on Company Taxation* (Ruding Report) pp. 143-153 (1992); S. Cnossen, *Reform and Coordination of Corporation Taxes in the European Union: An Alternative Agenda*, 58 Bull. Intl. Taxn. 4, p. 148 (2004), Journal Articles and Opinion Pieces IBFD; P.B. Sørensen, *Company Tax Reform in the European Union*, 11 Intl. Tax Publ. Fin. 1, pp. 105-106 (2004); D. Wellisch, *Maßstäbe zur indirekten Gewinnaufteilung im Rahmen einer neuen Konzernbesteuerung in der EU: Möglichkeiten und Grenzen*, 81 StuW 3, pp. 272-273 (2004); J. Hey, *Europäische Steuergesetzgebung zwischen Binnenmarkt und Fiskalinteressen*, in *Europäisches Steuerrecht* pp. 47-48 (M. Lang ed., Dr. Otto Schmidt 2018); *see also* A. Tsourouflis, *Die Harmonisierung der Körperschaftsteuer in der Europäischen Union*, pp. 318-326 (Peter Lang 1997); Advisory Board to the German Federal Ministry of Finance, *Einheitliche Bemessungsgrundlage der Körperschaftsteuer in der Europäischen Union* pp. 72-75 (2007); and M. de Wilde, *Tax Competition within the European Union: Is the CCCTB Directive a Solution?*, 7 Erasmus Law Rev. 1, p. 31 (2014).
14. In detail, *see* OECD/G20, *supra* n. 11, at pp. 3-5.
15. European Commission, Proposal for a Council Directive on Ensuring a Global Minimum Level of Taxation for Multinational Groups in the Union, COM(2021) 823 final, pp. 14 and 18-19 (22 Dec. 2021).
16. Id., at p. 2.
17. European Commission, Communication on Business Taxation for the 21st Century, COM(2021) 251 final, pp. 12-13 (18 May 2021).

2.6. Summary

It can be argued that the ATAD, by harmonizing legal instruments, regulates the restriction of the rights of taxpayers to freely choose a legal arrangement. In comparison, the approaches regarding a coordinated allocation of taxing rights (CCCTB, Pillar One and BEFIT) follow an approach of restricting the sovereignty of states to freely determine the tax due. Furthermore, Pillar Two effectively interferes with state sovereignty, as national regulation of a corporate tax rate below 15% seems pointless. In short, the ATAD concerns the application of the law at the level of *taxpayers*, while the remaining approaches concern tax sovereignty at a *state* level. It should be noted that an essential difference with regard to the latter is that the determination of the sovereignty of states is primarily a *political* matter. The question of the application of law, however, remains a *legal* matter, as the concrete interpretation of the regulated legal instruments continues to be reserved for the case law.

3. Reasons Why a Solution Has Not Been Found to Date

3.1. Introductory remarks

With the different levels of resolving the initial problem of tax avoidance and harmful tax competition come different challenges to success. This is shown by the experience with the ATAD (as a legal option to solve the problem) and the CCCTB (as a political option to solve the problem).

3.2. Regarding the CCCTB approach

The basic idea of a CCCTB will be 21 years old this October.[18] Despite its age, however, the approach has not matured. Instead, the Directive remained on the European Commission's shelves as a proposal. In May 2021, the European Commission announced that it would withdraw the pending proposal and, therefore, finally declared that the approach had failed.[19] The Member States could not agree on a concrete formula to allocate a consolidated tax base. The primary reason for dissent appears to be that individual Member States are turning their gazes away from the larger goal of improving corporate taxation throughout the European Union to promote its growth and economic development, as well as the collective well-being of their peoples. Instead, they have focused more on preserving the existing balance of power, as well as maximizing state-owned revenues. The most important goal for each Member State seems to be taxing as much profit as possible on its own.[20] When it comes to allocating a consolidated tax base, each Member State consequently opts for the formula that promises the largest possible share. Due to the different conditions and locations of the Member States, the importance of individual factors in determining the formula is also assessed differently depending on each state's preference.[21] The core problem with regard to the adoption of the CCCTB is, therefore, an unresolved conflict of the Member States' political interests.

3.3. Regarding the ATAD approach

With regard to the ATAD, ECJ case law comes into focus.[22] As the ATAD harmonizes the rules to combat tax avoidance practices within the European Union, it is necessary that its interpretation be centralized to ensure a uniform application of the law.[23] In this respect, the ATAD is to be interpreted in light of the ECJ's decision in *Cadbury Schweppes*. Because this case law essentially endorsed the initial problem,[24] the ATAD has thus far been considerably limited in terms of its possible effectiveness. The core problem of the ATAD is, therefore, the status of the ECJ's case law.

4. Statement

4.1. Introductory remarks

In seeking to understand the lack of an ultimate solution, one must first consider its cause. Because the initial problem is primarily economic in nature,[25] economic assumptions should be the focus (*see* section 4.2.). In this light, the following sections evaluate the mentioned approaches (*see* sections 4.3. to 4.7.).

4.2. Economic assumptions

4.2.1. The Member State: A "Leviathan"

Regarding the character of a state, Hobbes coined the idea of the "Leviathan state" in 1651, which is still widely accepted in the literature.[26] He emphasized the extent of state power and the concomitant danger of excess power in the absence of, or due to inadequate, political control.[27] The literature concludes from this preponderance

18. For the initial approach, *see* European Commission, Communication on a Strategy for Providing Companies with a Consolidated Corporate Tax Base for their EU-Wide Activities, COM(2001) 582 final (23 Oct. 2001).
19. COM(2021) 251 final, *supra* n. 17, at p. 12.
20. A. Neumann-Tomm, *BEPS: Wenn überhaupt nationale Gegenmaßnahmen, dann mit Augenmaß*, 24 IStR 12, p. 436 (2015); *see also* K. von Brocke & G. Rottenmoser, *Die GKKB im Lichte der Rechtsetzungskompetenzen der EU: Harmonisierung direkter Steuern?*, 16 IWB 16, pp. 623-626 (2011); M. Vascega & S. van Thiel, *The CCCTB Proposal: The Next Step towards Corporate Tax Harmonization in the European Union?*, 51 Eur. Taxn. 9/10, pp. 379-380 (2011), Journal Articles & Opinion Pieces IBFD; and H. Kahle & S. Schulz, *Sachstand und Lösungsansätze zur Entwicklung einer G(K)KB*, 95 FR 2, p. 51 (2013).
21. T. Rödder & R. Pinkernell, *Zum Seminar F: 20 Thesen zur BEPS-Diskussion*, 22 IStR 16, p. 620 (2013); and OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, para. 1.23 (2022).
22. *See* A. Cordewener, *Anti-Abuse Measures in the Area of Direct Taxation: Towards Converging Standards under Treaty Freedoms and EU Directives?*, 26 EC Tax Rev. 2, pp. 65-66 (2017); and J. Hey, *Harmonisierung der Missbrauchsabwehr durch die Anti-Tax-Avoidance-Directive (ATAD): Rechtsmethodische, kompetenzielle und verfassungsrechtliche Fragen unter besonderer Berücksichtigung der Auswirkungen auf § 42 AO*, 94 StuW 3, p. 254 (2017).
23. Hey, *supra* n. 22, at pp. 257 and 263-264.
24. *See* sec. 1.
25. *See* sec. 1.
26. The "Leviathan" represents a biblical sea monster from the Old Testament (in detail, *see* C. Schmitt, *Der Leviathan in der Staatslehre des Thomas Hobbes* pp. 9-23 (Hanseatische Verlagsanstalt 1938)).
27. In detail, *see* T. Hobbes, *Leviathan, or the Matter, Forme, and Power of a Common-Wealth Ecclesiastical and Civil*, chs. XX, XXI (Cambridge English Classics 1651).

of power that the state, through the taxation of income and profits, pursues less the goal of maximizing welfare and more the goal of maximizing state-owned revenues.[28] To reach a higher level of efficiency, the Leviathan must be "tamed". A suitable instrument for this goal is intergovernmental (tax) competition between states.[29]

4.2.2. The "race to the bottom": A "prisoner's dilemma"

Undercutting competition that threatens to make tax competition harmful presents a "prisoner's dilemma",[30] which is derived from the concept of "game theory".[31] With regard to tax competition, a situation may arise in which no Member State will make the irrational decision to abandon its dominant strategy,[32] i.e. of cutting taxes to raise tax revenues without being sure that other Member States will do the same. Instead, each Member State expects the other Member States to make an individually rational choice to cut taxes to optimize tax revenues by attracting more companies. As a result, each Member State chooses the dominant strategy of cutting taxes. If, however, all Member States make this rational decision, a race to the bottom occurs, and the result becomes *sub*-optimal.[33] Considering the interests of the Member States collectively, the optimal result will be that all Member States jointly forego their (harmful) tax cuts. To achieve this "*pareto optimum*",[34] as a higher level of efficiency, it is argued that a suitable instrument would provide for full tax harmonization between the states.[35]

4.2.3. Promoting the "well-being of the peoples": The economic purpose of the European Union

4.2.3.1. General objectives and purposes of the European Union

The CCCTB and ATAD aim to improve the "functioning of the internal market" and emphasize the priority Europe puts on promoting sustainable growth and investment within a fair and better integrated market.[36] According to article 3(1) of the Treaty on European Union (TEU) (2007),[37] the economic purpose of promoting the well-being of the peoples of the European Union can be derived from EU law. This EU purpose is served by both the EU objective of "establishing an internal market" (article 3(3)(1), sentence 1 of the TEU) and the EU objective of "balanced economic growth" (article 3(3)(1), sentence 2 of the TEU).[38] From an economic perspective, "well-being" is measured primarily in terms of economic prosperity.[39] This prosperity is expressed by the standard of living of a people. In determining the standard of living, the economic growth of the individual economies, as a phenomenon, plays a central role.[40] In this context, the European internal market is (only) an idea of an open economy, which, in turn, serves economic growth.[41] In short, economic growth is a real phenomenon that goes *hand in hand* with the well-being of peoples in economic terms. The internal market, on the other hand, is just a fictious concept that serves as *a tool to promote* the well-being of peoples or economic growth.[42] Therefore, it can be stated that it is not the internal market but rather economic

28. G. Brennan & J.M. Buchanan, *Towards a Tax Constitution for Leviathan*, 8 J. Publ. Economics 3, p. 258 (1977); W.A. Niskanen, *On the origin and identification of government failures*, in *Political Economy and Public Finance* p. 114 (S.L. Winer & H. Shibata eds., Edward Elgar 2002); and S. Homburg, *Allgemeine Steuerlehre* p. 312 (7th ed., Vahlen 2015).
29. *See* S. Sinn, *The Taming of Leviathan: Competition Among Governments*, 3 Constitutional Political Economy 2, p. 177 (1992).
30. The term "prisoner's dilemma" is rooted in the original 1957 example by Luce & Raiffa. They illustrated the dilemma by reference to a decision-making process of two suspects of a crime, to whom the public prosecutor's office explained the consequences of their strategy options. The options were to confess or to remain silent. If both confessed, they would be charged together, however, they would not face the maximum sentence. If both continued to remain silent, they would both be charged with lesser offences and receive a lesser sentence. If only one of the suspects confessed, while the other continued to remain silent, the confessor would receive only a very light sentence and would be released from prison early, while the other would receive the maximum sentence. The suspects were not able to coordinate in their individual choice of strategy (in detail, *see* R.D. Luce & H. Raiffa, *Games and Decisions* pp. 94-95 (John Wiley & Sons 1957)).
31. In detail, *see* J.F. Nash, *Non-Cooperative Games*, 2nd series, 54 Annals of Mathematics 2, pp. 286-295 (1951).
32. The strategy that promises the individually optimal result in the sense of a maximum advantage for an individual player, viewed in isolation or subjectively, is to be described as "dominant" (D. Fudenberg & J. Tirole, *Game Theory* pp. 6-7 (MIT Press 1991); R. Gibbons, *A Primer in Game Theory* p. 5 (Prentice Hall 1992); and S. Tadelis, *Game Theory* p. 46 (Princeton University Press 2013)).
33. *See* F.W. Scharpf, *Globalisierung als Beschränkung der Handlungsmöglichkeiten nationalstaatlicher Politik*, in *Globalisierung, Systemwettbewerb und nationale Politik* p. 53 (K.-E. Schenk et al. eds., Mohr Siebeck 1998).
34. A "*pareto optimum*" is a state in which no player can improve without making an opponent worse off at the same time (M.J. Holler & G. Illing, *Einführung in die Spieltheorie* p. 24 (7th ed., Springer 2009)).
35. *See* Cnossen, *supra* n. 13, at p. 148; Wellisch, *supra* n. 13, at pp. 272-273; De Wilde, *supra* n. 13, at p. 31; and Hey, *supra* n. 13, at pp. 47-48.
36. ATAD 1; COM(2016) 685 final, *supra* n. 7, at p. 2; and COM(2016) 683 final, *supra* n. 1, at p. 2.
37. Treaty on European Union of 13 Dec. 2007, OJ C 306 (2007), Primary Sources IBFD [hereinafter TEU].
38. *See* A. Bleckmann & S.U. Pieper, *Europarecht* para. 33 (A. Bleckmann ed., 6th ed., Carl Heymanns Verlag 1997); F. Reimer, *Ziele und Zuständigkeiten: Die Funktionen der Unionszielbestimmungen*, 38 EuR 6, p. 1007 (2003); J.-P. Jacqué, *Europäisches Unionsrecht*, art. 3 TEU, para. 3 (H. v. d. Groeben et al. eds., 7th ed., Nomos 2015); and M. Ruffert, *EUV/AEUV*, art. 3 TEU, para. 13 (C. Calliess & M. Ruffert eds., 5th ed., C.H. Beck 2016).
39. J.P. Terhechte, *Das Recht der Europäischen Union*, art. 3 TEU, para. 32 (E. Grabitz, M. Hilf & M. Nettesheim eds., 66th supplement, C.H. Beck 2019).
40. Economic growth primarily increases the supply of better food, larger homes, more resources for medical care and environmental protection, and comprehensive education for children. It is a "phenomenon" that can be observed through empirical findings of a constant increase in hourly wages and output per hour worked, and a steady increase in aggregate output (*see* P.A. Samuelson & W.D. Nordhaus, *Volkswirtschaftslehre*, pp. 744 and 759-761 (5th ed., FinanzBuch Verlag 2016)).
41. An "open economy" is characterized, above all, by goods, services and assets being traded on a large scale with other countries (P.R. Krugman & R. Wells, *Volkswirtschaftslehre* p. 661 (2nd ed., Schäffer-Poeschel Verlag 2017); on the dynamic effects of an open economy, *see* M. Frenkel & H.-R. Hemmer, *Grundlagen der Wachstumstheorie* p. 294 (Vahlen 1999)).
42. In the Treaty of Nice, this conclusion resulted from the wording of art. 2, according to which the European Union shall have the objective "to promote economic and social progress and a high level of employment and to achieve balanced and sustainable development, *in particular through* the creation of an area without internal frontiers, through the strengthening of economic and social cohesion and through the establishment of economic and monetary union, ultimately including a single currency in accordance with the provisions of this Treaty" [emphasis added] (Treaty on European Union of 26 Feb. 2001, OJ C 325 (2002)).

growth that should be regarded as the actual measure of the well-being of peoples in economic terms.

"Economic growth" refers to an increase or improvement in the goods and services produced by an economy. Thus, its focus is on the productivity of enterprises established in each country. It has been empirically proven that countries can only converge economically under certain conditions. To do so, they must be similar in terms of influencing factors, allowing them to belong to a "convergence club". These influencing factors include, above all, equally aggregated production technologies and the same standard of education and infrastructure.[43]

4.2.3.2. Economic situation within the European Union

Rather than the aforementioned conditional convergence, the initial problem of harmful tax competition suggests that Member States have different economic interests, which could lead to economic *divergence*. To understand this conflict of interests, it is necessary to divide Member States into those that are economically weak and those that are economically strong. "Economically weak" Member States are characterized by comparatively low economic activity and low expenditures in the research sector. These include, for example, Hungary, Luxembourg and Cyprus. "Economically strong" Member States are categorized by, in addition to a high level of economic activity,[44] comparatively high expenditures in the research sector. Apart from France, this primarily concerns Germany.[45] A difference in terms of the interests of the economically weak and strong became apparent in respect of the design of IP boxes before a change was forced due to the OECD/G20 BEPS Project. In particular, the economically weak states regulated preferential regimes to encourage companies to shift their profits. These states did not, however, provide the necessary infrastructure to generate such profits and value.[46] In comparison, Germany refrained from such preferential regimes and made legislative changes to even counter this type of profit shifting. To safeguard its own tax revenue, Germany sought to ensure that MNEs were taxed where profits and value were generated.[47]

4.2.4. Summary

It can be argued that the Member States represent individual Leviathans that, in principle, can be tamed by tax competition. However, the different economic strengths of these states have led to diverging economic interests, which make tax competition harmful based on a prisoner's dilemma. A solution to this problem should initially be to seek to change this trend of *diverging* economic interests into *convergence*. Whether the politically shaped proposals of Pillar One, Pillar Two, BEFIT or CCCTB are suitable for this purpose is examined in sections 4.3. to 4.6.

4.3. Regarding the Pillar One and Pillar Two approaches

For all EU Member States to belong to the same convergence club, the economically weaker Member States must be given the opportunity to catch up. To this end, the economically weak states must generate particularly high economic growth. Capital expenditures in domestic locations are seen as an important aspect of promoting economic growth. These investments can, in turn, be generated primarily through tax incentives.[48] The argument against harmonizing a minimum tax rate under Pillar Two is that states would no longer have the ability to promote investment through tax incentives. Under Pillar One, allocating taxable profits to the end market jurisdictions would also avoid direct incentives to promote economic growth. The strength of consumption in such a market jurisdiction would be an indicator of a country's prosperity. Thus, countries are financially rewarded for their existing economic strength, while economically weak states are disadvantaged. In this way, divergence among Member States could be supported under both Pillars One and Two.

To ensure convergence within the European Union, each Member State must have the option of setting an effective tax rate that *optimally* meets the state's needs. This tax rate could also be below 15%.[49] Concrete incentives are needed to ensure that countries actively determine and apply this individually optimal tax rate. To justify these incentives, the allocation of taxing rights (i.e. the question of "whether" to impose taxation) must be taken into account. A "benefit approach" seems necessary, according to which companies are to be taxed where they have actu-

43. L. Bretschger, *Wachstumstheorie* pp. 45-46 (3rd ed., Oldenbourg 2004); Krugman & Wells, *supra* n. 41, at pp. 747 and 749-750; *see also* Frenkel & Hemmer, *supra* n. 41, at pp. 149-151; P. Aghion & P. Howitt, *Wachstumsökonomie* pp. 2-3 and 51 (De Gruyter Oldenbourg 2015); in general, *see* N.G. Mankiw, D. Romer & D.N. Weil, *A Contribution to the Empirics of Economic Growth*, 107 Quarterly J. Economics 2, pp. 407-437 (1992).
44. Germany and France are the Member States with the highest gross domestic product (GDP). In 2021, Germany's GDP amounted to around EUR 3,570 billion and France's amounted to around EUR 2,483 billion. In Hungary, it amounted to only around EUR 154 billion, and in Luxembourg, it amounted to only around EUR 73 billion (Eurostat, *GDP and main components (output, expenditure and income)*, available at https://ec.europa.eu/eurostat/databrowser/view/nama_10_gdp/default/table?lang=en (accessed 30 May 2022)).
45. Germany and France have comparatively high gross domestic expenditures on research and development (GERD). In 2020, Germany's GERD amounted to 3.14% and France's amounted to 2.35%. In Hungary, the GERD amounted to only 1.61%, and in Luxembourg it amounted to only 1.13% (Eurostat, *Gross domestic expenditure on research and development (R&D)*, available at https://ec.europa.eu/eurostat/databrowser/view/tipsst10/default/table?lang=en (accessed 30 May 2022)).
46. L. Evers, H. Miller & C. Spengel, *Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations*, ZEW Discussion Paper 13-070, pp. 8 and 10 (2013); and European Parliament (Policy Department A), *Intellectual Property Box Regimes*, p. 7 (2015).
47. *See* German Bundestag (Finance Committee), *Entwurf eines Gesetzes gegen schädliche Steuerpraktiken im Zusammenhang mit Rechteüberlassungen*, BT-Drucks. 18/12128, pp. 1-2 and 24 (26 Apr. 2017).
48. M.J. Ellis, *The Code of Conduct in 2000: Cracking the Code or Coating the Crack?*, 40 Eur. Taxn. 9, p. 416 (2000), Journal Articles & Opinion Pieces IBFD; and J.A.M. Klaver & A.J.M. Timmermans, *EU taxation: policy competition or policy coordination?*, 8 EC Tax Rev. 3, pp. 187-188 (1999).
49. The fact that the optimal tax rate of economically weak Member States could be below 15% is indicated by an international comparison of current data on corporate income tax rates. Economically weak countries from Eastern Europe (i.e. Bulgaria and Hungary) currently apply corporate income tax rates of 9% or 10% (German Federal Ministry of Finance, *Die wichtigsten Steuern im internationalen Vergleich* p. 12 (2020)).

ally received domestic public services to generate their income.[50] In this way, each state would have an incentive to invest tax revenues in state inputs for the private sector and to promote these corporate revenues or productivity, thus increasing the tax substrate, as well as the state's share within it. In other words, each state would have an incentive to invest in influencing factors to promote economic growth. A possible consequence would be a convergence between the Member States. This converging economic interest in the necessary financing of public goods would, in turn, be reflected in the level of the tax rate (i.e. the question of "how" to impose taxation). Therefore, the *pareto optimum* of a minimum tax rate of the states could be generated autonomously. A race to the bottom would thereby be prevented.[51] In this context, the harmonization of a minimum corporate tax rate would be redundant, provided that the Member States' power to impose taxation can be sufficiently determined in accordance with the benefit approach.

4.4. Regarding the BEFIT approach

It is rather unlikely that such a benefit approach will be considered under the BEFIT formula. The European Commission announced that it would build BEFIT on the Pillar One approach, and take it further to create a simpler system for the reallocation of profits within the internal market.[52] Thus, it can be assumed that the BEFIT formula will also allocate profits to the end market jurisdictions. As mentioned in section 4.3., direct incentives to promote economic growth will most likely be avoided.

4.5. Regarding the CCCTB approach

The CCCTB formula, on the other hand, aims to operate as a tool for attributing income to where the value is created. The factors mentioned in the formula are supposed to be attached to where a company earns its profits.[53] Therefore, the formula could be based on a benefit approach. Furthermore, this indirect method to allocate profits based on a predetermined formula for all taxpayers could be more resilient to known (classic) tax avoidance practices than the widespread transfer pricing methods, which allocate profits directly on a case-by-case basis.[54] On the downside, however, the formula-based approach of the CCCTB could also lead to new types of tax avoidance practices. Possible loopholes in the formula could be exploited, and fictitious relocation of the factors mentioned in the formula could result in the shifting of profits.[55] For this reason, the results can be corrected by means of a safeguard clause (article 29 of the CCCTB (2016)) which requires, among other things, an agreement between the competent authorities of the Member States concerned (article 29, sentence 2 of the CCCTB (2016)). The possibility of using a different method on a case-by-case basis rather than the one unanimously agreed upon by all Member States could, however, ultimately turn the concrete design of profit sharing and the definition of taxing rights into a bilateral political issue. The Member States concerned, in their role as Leviathans, could subsequently duel for their economic interest in maximizing state-owned revenues. In the end, the alternative method (i.e. the safeguard clause) is more likely to reflect the power relations between the states within the European Union.

It can be stated that the safeguard clause is essentially nothing more than a bilateral renegotiation of a previously collectively negotiated formula to allocate a consolidated tax base. This erodes the value of the initial formula, even though it might have defined the allocation of taxing rights between the Member States in an appropriate manner to ensure economic growth and convergence within the European Union based on a benefit approach.

4.6. Regarding the CCTB approach

Under the CCTB, the Member States retain their state sovereignty to the greatest possible extent. The direct method of profit allocation remains in place. This is associated with known (classic) tax avoidance practices. To prevent tax avoidance practices, the CCTB does not focus on the cause but on the consequences of aggressive tax planning. In this respect, the allocation of taxing rights first comes into play when applying the anti-abuse provisions under article 58 of the CCTB (GAAR) or articles 59 and 60 of the CCTB (CFC rules). As a result, the question of the (balanced) allocation of taxing rights is to be answered by the case law. The advantage here is that the issue is not resolved through negotiations between conflicting parties. Rather, this is accomplished by an impartial, supranational body of the European Union that is committed solely to the purposes and objectives of EU law. As a result, a decision is sought from an international organization[56] that represents the interests of all Member States to achieve a *pareto optimum*.[57]

50. Valta, *supra* n. 2, at p. 47.
51. D. Wellisch, *Dezentrale Finanzpolitik bei hoher Mobilität* pp. 83-84 and 87 (J.C.B. Mohr 1995); *see also* M.E. Streit & D. Kiwit, *Zur Theorie des Systemwettbewerbs*, in *Systemwettbewerb als Herausforderung an Politik und Theorie* pp. 26-28 (M.E. Streit & M. Wohlgemuth eds., Nomos 1999); H.-D. Höppner, *Das Äquivalenzprinzip als zentraler Maßstab für fairen Steuerwettbewerb: Bemerkungen dazu aus der Sicht der Finanzverwaltung*, in *Regeln für den europäischen Systemwettbewerb* pp. 92-93 and 103 (W. Müller, O. Fromm and B. Hansjürgens eds., Metropolis-Verlag 2001); and J. Lang, *Steuergerechtigkeit und Globalisierung*, in *Steuerzentrierte Rechtsberatung* p. 51 (Essays in Honour of H. Schaumburg) (W. Spindler, K. Tipke & T. Rödder eds., Dr. Otto Schmidt 2009).
52. COM(2021) 251 final, *supra* n. 17, at p. 13.
53. COM(2016) 683 final, *supra* n. 1, at p. 2.
54. Id., at p. 2.
55. N. Herzig, M. Teschke & C. Joisten, *Between Extremes: Merging the Advantages of Separate Accounting and Unitary Taxation*, 38 Intertax 6/7, pp. 337 and 339-341 (2010); M.J. García-Torres Fernández, *Corporate Tax Harmonization: Key Issues for Ensuring an Efficient Implementation of the CCCTB*, 40 Intertax 11, p. 599 (2012); De Wilde, *supra* n. 13, at pp. 30 and 34-38; and OECD, *supra* n. 21, at para. 1.23.
56. For the importance of international organizations in the event of a prisoner's dilemma, *see* A.A. Stein, *Coordination and Collaboration: Regimes in an Anarchic World*, 36 Intl. Organization 2, p. 311 (1982); R. Axelrod & R.O. Keohane, *Achieving Cooperation under Anarchy: Strategies and Institutions*, 38 World Politics 1, pp. 234-238 (1985); D. Snidal, *Coordination versus Prisoners' Dilemma: Implications for International Cooperation and Regimes*, 79 American Political Science Rev. 4, p. 927 (1985); L.L. Martin, *Interests, Power, and Multilateralism*, 46 Intl. Organization 4, pp. 772-773 (1992); B. Zangl, *Interessen auf zwei Ebenen*, pp. 87-89 (Nomos 1999); and V. Rittberger, B. Zangl & A. Kruck, *Internationale Organisationen* pp. 36 and 134 (4th ed., Springer VS 2013).
57. J.M. Gabriel makes a similar argument, viewing the ECJ as a supranational body that contributes to the creation of a collectively optimal

The GAAR under the CCTB is in line with the text featuring in the ATAD and was proposed with explicit reference to this Directive. Furthermore, the CFC rule largely refers to the rule in the ATAD.[58] Therefore, an evaluation of an alternative approach to address the initial problem of tax avoidance could be based on the ATAD, which is already in force. The main question would then be as follows: *What concrete effects could the ATAD have on the current understanding of "tax abuse"?*

4.7. Regarding the ATAD approach

As mentioned in section 3.3., the potential of the ATAD is currently limited by the ECJ decision in *Cadbury Schweppes*. It should be noted that the broad interpretation of the fundamental freedoms in this decision is aimed at ensuring the EU objective of "establishing" an internal market.[59] The ATAD, however, focuses on the "functioning" of the internal market. The literature is of the opinion that the "establishment" of the internal market, as an EU objective, refers to the initial elimination of internal market barriers. In comparison, "functioning" is a downstream objective, which refers to the subsequent adjustment of the internal market, due to a changing environment, to defend the *status quo* of its original establishment.[60] In other words, "functioning" only serves as a means to ensure the "establishment" of an (unrestricted) internal market in terms of article 3(3)(1), sentence 1 of the TEU. Based on this understanding, it is arguable that the ATAD misses its mark. The ATAD, as the first Directive in the context of direct taxation, only *disadvantages* the taxpayer. The exercise of fundamental freedoms that ensure the "establishment" of an internal market[61] is actually being restricted.[62] Further, the ATAD might even be unlawful, as the requirements of the enabling provision of article 115 of the Treaty on the Functioning of the European Union would not be met.

As an alternative approach, it is possible that a further *development* of the concept of the "functioning" of the internal market could be derived from the Directive. The aim could have been better served through the adoption of a gradual process based on the development of economic policy to combat BEPS. The "functioning" may no longer ensure the EU objective of "establishing" an (unrestricted) internal market (according to article 3(3)(1), sentence 1 of the TEU) but rather the overarching economic EU purpose of promoting the well-being of the peoples of the European Union (according to article 3(1) of the TEU). In economic terms, the well-being of peoples goes hand-in-hand with economic growth.[63] Thus, a "functioning" internal market needs to be understood as an internal market that ensures economic growth (according to article 3(3)(1), sentence 2 of the TEU). In particular, the balanced allocation of taxing rights comes into focus to promote economic growth. Considering that the Directive was introduced to impose taxes where profits and value are generated,[64] the provisions, including the GAAR and CFC rules, could be interpreted and applied in light of a benefit approach. Under this benefit approach, the ATAD could have an impact on the prevailing understanding of the term "tax abuse". Namely, "tax abuse" might arise where a taxpayer obtains a tax benefit in a low-tax Member State, in circumstances in which the substantial domestic public services to generate the taxable income in question were performed in another state. To further clarify the "substantial domestic public services to generate the taxable income", the outcomes of the OECD/G20 BEPS Project, as well as the formulary apportionment under the CCCTB, could be transferred over. With this definition, the requirements for justifying a restriction on the freedom of establishment to prevent abusive practices would be lower than today's requirements under ECJ case law. Consequently, the establishment of CFCs through rule shopping could be avoided, which, in turn, would prevent harmful tax competition between the Member States to attract these companies. As a result, the initial problem could be solved if the ECJ were to reconsider its case law.[65]

5. Conclusion

The proposals to date for addressing tax avoidance and harmful tax competition within the European Union focus primarily on restricting the sovereignty of Member States. Therefore, they are more political in nature. However, political agreement among the Member States has failed, thus far, due to the different economic interests of individual states. The reason for this could be that the countries differ significantly in terms of key factors that influence economic growth, such as the infrastructure for

result from the point of view of the overall organization of the European Union (J.M. Gabriel, *Die Renaissance des Funktionalismus*, 55 Aussenwirtschaft 1, p. 156 (2000)).

58. COM(2016) 685 final, *supra* n. 7, at p. 11.
59. According to the ECJ, it is necessary, in assessing the conduct of the taxable person, to take particular account of the objective pursued by the freedom of establishment (*see Cadbury Schweppes plc* (C-196/04), paras. 52-53). The objective pursued by the freedom of establishment, however, is to solidify the internal market (Treaty on the Functioning of the European Union of 13 Dec. 2007, OJ C 115 (2008), art. 26(2), Primary Sources IBFD [hereinafter TFEU]).
60. P.-Ch. Müller-Graff, *Die Rechtsangleichung zur Verwirklichung des Binnenmarktes*, 24 EuR 2, p. 131 (1989); H.C. Taschner, *Vertrag über die Europäische Union und zur Gründung der Europäischen Gemeinschaft*, art. 94 EEC, para. 41 (H. v. d. Groeben & J. Schwarze eds., vol. II, 6th ed., Nomos 2003); C.D. Classen, *Europäisches Unionsrecht*, art. 114 TFEU, para. 41 (H. v. d. Groeben, J. Schwarze & A. Hatje eds., 7th ed., Nomos 2015); and M. Schröder, *EUV/AEUV*, art. 115 TFEU, para. 7 (R. Streinz ed., 3rd ed., C.H. Beck 2018).
61. *See* TFEU, art. 26(2).
62. *See* C. Kahlenberg, *BEPS wird Realität: Die Anti-BEPS-RL als Sekundärrechtsakt gegen Gewinnverlagerung und Bemessungsgrundlagenerosion*, 15 StuB 23, p. 911 (2016); A. Linn, *Die Anti-Tax-Avoidance-Richtlinie der EU: Anpassungsbedarf in der Hinzurechnungsbesteuerung?*, 25 IStR 16, p. 652 (2016); A. Schnitger, D. Nitzschke & R. Gebhardt, *Anmerkungen zu den Vorgaben für die Hinzurechnungsbesteuerung nach der sog. "Anti-BEPS-Richtlinie": Systematische Würdigung der Implikationen für den deutschen Rechtskreis*, 25 IStR 23, p. 960 (2016); and C. Spengel & K. Stutzenberger, *Widersprüche zwischen Anti-Tax Avoidance Directive (ATAD), länderbezogenem Berichtswesen (CbCR) und Wiederauflage einer Gemeinsamen (Konsolidierten) Körperschaftsteuer-Bemessungsgrundlage (GK(K)B)*, 27 IStR 2, p. 41 (2018).
63. *See* sec. 4.2.3.1.
64. ATAD 1, at p. 1.
65. As to the question of the extent to which this investigative approach will be successful, *see* the author's doctoral dissertation, M. Krümpelmann, *Der steuerrechtliche Missbrauch in der Europäischen Union* (Peter Lang 2022).

generating value. Therefore, the Member States have not been able to "converge" as a "club".

To overcome this conflict of interests, a trend towards convergence among the Member States should be encouraged. A supranational body appears to be necessary, which should reflect less the interests of individual states and more the interests of the collective. It should be committed solely to the objectives and purposes of the European Union. In this context, the ECJ enters the spotlight.

The problem of tax avoidance and harmful tax competition within the European Union could be resolved by means of a legal instrument to prevent tax abuse. This requires an adjustment to the ECJ case law. Rather than defining "tax abuse" solely by ensuring the EU objective of the "establishment" of an (unrestricted) internal market, the term should be associated more with the "functioning" of an (restricted) internal market as aimed for under the ATAD. With the ATAD, the European Union has committed itself to imposing taxes where profits and value are generated. This "benefit approach" to allocating taxing rights ensures the EU objective of balanced economic growth, which, in turn, goes hand in hand with the overarching EU purpose of promoting the well-being of the peoples of the European Union. Defining "tax abuse" under this approach would lead to a more far-reaching application of instruments that are enacted to prevent tax avoidance practices.