Susi Baerentzen

The Effectiveness of General Anti-Avoidance Rules

Their Limits, Challenges and Potential in EU and International Tax Law

IBFD DOCTORAL SERIES

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The Effectiveness of General Anti-Avoidance Rules – Their Limits, Challenges and Potential in EU and International Tax Law

Why this book?
General anti-avoidance rules have attracted much attention following their widespread introduction in both the European Union and the OECD, but the question is whether the rules are effective at achieving what they are intended to do.

This book introduces a novel way of assessing the legal and economic impact of the general anti-avoidance rules (GAARs) introduced throughout the European Union and the OECD. The book builds on fundamental legal and economic theory and provides a groundbreaking interdisciplinary tax law and economics method for assessing the impact of the GAAR provided by the EU Anti-Tax Avoidance Directive, as well as the principal purposes test (PPT) introduced with the BEPS Project.

By viewing the global network of international tax treaties as a joint network with multiple facets defined by the domestic tax rules of the participating states, the book uses legal and economic network theory to assess the impact of limiting the taxpayers' choices for tax planning and treaty shopping introduced by the ATAD GAAR and the BEPS PPT. Four different sample countries (Australia, Denmark, France and Germany) are used to assess the impact in light of specific domestic tax legislation in states with different specifications: some with a long-standing history of using GAARs, some that are new to the rules, some that are EU Member States, some that are OECD member countries, and all with different legal constitutional systems.

These impact assessments and legal analyses are applied in order to determine whether the use of GAARs within the European Union and the OECD is actually achieving what is intended, namely (i) from an economic perspective, that the rules contribute to tax income where it is created; and (ii) from a legal perspective, to prevent tax avoidance and ensure harmonization between the states in these matters.

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Preface

Completing a doctoral dissertation requires both courage and energy, and this book is dedicated to my brother, Jesper, who raised me to break down boundaries and always put my education first.

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Chapter 1

Introduction

1.1. The future of international taxation: The 2020s compromise?

At the time of writing, a new financial crisis smolders, austerity budgets are outlined and states prepare for hardship in meeting their domestic social welfare commitments. Corporations are shut, jobs are lost and – in response – states radically mobilize tax systems to deal with the economic downturn by subsidizing, in order to ensure jobs and economic activity. At the same time, one of the most fundamental overhauls of the international tax system in modern times is scheduled to proceed, despite these extraordinary times.[1]

In the wake of the most recent financial crisis in 2008, the issue of international taxation gained higher priority and the rules guarding corporate income tax were strengthened at a global level. The political commitment for international tax coordination was subject to the indignation of public opinion towards multinational enterprises (MNEs) paying little or no taxes worldwide. This catalysed a consensus on approximation in the exercise of taxing powers across borders, in order to effectively combat base erosion and profit shifting (BEPS). This has been done both at a national and international level by states participating in the BEPS Project,[2] supported by the G20 and carried out by the OECD[3] and the European Union with the Anti-Tax Avoidance Directive (ATAD).[4] The intermediate result of these two initiatives is a miasma of complex rules to ensure an international tax system with an increased revenue collection due to reduced levels of tax avoidance.

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1. OECD, *Coronavirus (Covid-19): Update on OECD tax work* (17 Mar. 2020), available at http://www.oecd.org/tax/beps/coronavirus-covid-19-update-on-oecd-tax-work.htm (accessed 23 Mar. 2021).
2. OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report* (OECD 2015), Primary Sources IBFD.
3. As the G20 had no permanent staff, the task of coordinating the multilateral effort and initiating the BEPS Project was delegated to the OECD (OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), Primary Sources IBFD).
4. 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 [hereinafter ATAD], requiring states to adopt (i) one of two versions of a controlled foreign company rule; (ii) hybrid rules modelled after the BEPS proposal but modified for application within the European Union; (iii) exit taxation; (iv) the BEPS limits on interest deductibility; and (v) a general tax anti-abuse rule.

One of the highly potent weapons for the tax administrations and states to fight tax avoidance is the introduction of general anti-avoidance rules (GAARs) in both the ATAD and the BEPS Project, which will be the subject for this book. These rules have appeared in the shape of the general anti-avoidance rules introduced in article 6 of the ATAD (ATAD GAAR) and the principal purpose test (PPT) introduced in article 7 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI),[5] which was negotiated within the framework of the BEPS Project and article 29 of the OECD Model Tax Convention on Income and on Capital (OECD Model).[6]

Concerning the GAAR in the ATAD:

> 1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the *main purpose or one of the main purposes* of obtaining a *tax advantage* that defeats the *object or purpose of the applicable tax law*, are not genuine having regard to *all relevant facts and circumstances*. An arrangement may comprise more than one step or part.
>
> 2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as *non-genuine* to the extent that they are *not put into place for valid commercial reasons which reflect economic reality.*
>
> 3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.[7] [Emphasis added.]

Regarding the PPT in the MLI:

> 1. Notwithstanding any provisions of a Covered Tax Agreement, *a benefit under the Covered Tax Agreement* shall *not be granted* in respect of an item of income or capital if it is *reasonable to conclude*, having regard to *all relevant facts and circumstances*, that obtaining that benefit was *one of the principal purposes* of any arrangement or transaction that resulted directly or indirectly in that benefit, *unless it is established* that granting that benefit in these circumstances would be *in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.*[8] [Emphasis added.]

5. *OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (17 June 2017), Treaties & Models IBFD [hereinafter MLI].
6. *OECD Model Tax Convention on Income and on Capital* art. 29 (27 Nov. 2017), Treaties & Models IBFD.
7. Art. 6 ATAD.
8. Art. 7 MLI.

On 3 May 2019 at a conference in Amsterdam dedicated to GAARs, Graham Aaronson – author of the famous Aaronson Report,[9] which evaluated the need for a GAAR in the United Kingdom – spoke on the desirability of this type of rule, stating the following: "It is said that half a bread is better than no bread. But I am not sure that a half-baked bread is better than no bread. The same is true for the PPT."[10]

The message was clear and concise: GAARs may very well be an effective measure to counter tax avoidance, but in their current shape and preparation, they are not yet mature to do so.

Half-baked or not, these rules have the potential to empower the tax administrations in countering tax avoidance, yet they also possess a high level of uncertainty due to their inherently broad nature,[11] which was also Aaronson's core message. Overall, the BEPS Project and the development of the EU ATAD has provided a boost to international tax coordination while, simultaneously, elevating the level of legal uncertainty for taxpayers. Throughout this development, the BEPS Project has stayed silent on the protection of taxpayer's rights in this new world order of international taxation, in which the modern tax policies of the European Union and the OECD are very much aligned. From an economic and legal perspective, one of the next challenges of the OECD and the European Union is to make this new international tax system sustainable by countering the adverse consequences rising from the uncertainty surrounding it. If unaddressed, this has the potential to undermine the achievement of the objectives intended by the measures.

The thin red line between acceptable tax structuring and illegal tax abuse appears to develop and shift over time based on public acceptance, i.e. by political, economic and moral considerations. In the aftermath of the financial crisis of 2008, an emerging trend has been the fierce media coverage on tax avoidance of large MNEs, which seems to be a highly sensitive topic

9. G. Aaronson, *GAAR STUDY: A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system* (11 Nov. 2011), available at https://webarchive.nationalarchives.gov.uk/20130402163458/http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.pdf (accessed 23 Mar. 2021).
10. L. Berentsen, *Niets is misschien beter dan een halfgebakken brood*, FD (6 May 2019).
11. OECD/IMF, *Tax Certainty: Report for the G20 Finance Ministers* pp. 45-46 (Mar. 2017), available at https://www.imf.org/external/pubs/ft/tltn/2016/tltn1601.pdf (accessed 23 Mar. 2021).

that strikes a sense of unfairness in public opinion.[12] In order to appease the public's discontent, designers of the optimal tax system must attempt to deter this socially undesired behaviour on the basis of assumptions that are laden with both deeply contested value judgments and empirical uncertainty.[13] The reason why tax avoidance prompts states to act and populations to engage in the debate is not hard to comprehend, given that taxation is at the core of their sovereignty and that the phenomena of tax avoidance or tax abuse can severely undermine the exercise of taxing powers by states and potentially reduce their revenue. If the latter occurs, the maintenance of infrastructures and basic state societal functions suffer to the detriment of citizens and their rights.

While the notions of acceptable tax structuring and illegal abuse may vary over time, the dividing line is drawn to secure the economic outcomes for the member states' revenue in today's world. Consequently, both the EU ATAD and the OECD BEPS Project are introduced with two overall objectives, namely to (i) ensure that profits accrued by economic activities in the states are, in fact, taxed correspondingly in these states where the value is created;[14] and (ii) align the rules throughout the states to eliminate differences and ensure transparency of taxpayer rules.

To shore up the existing international tax system, a plethora of rules have been developed and introduced in recent years in order to provide the dividing line between legitimate tax planning and unacceptable tax abuse. The measurement of tax abuse may be in its early stages both from a legal and economic point of view,[15] and it may also very well be prone to variation over time due to developments in public opinion on moral, political and economic considerations.[16] However, when analysing the recent developments in international tax

12. For example, by the International Consortium of Investigative Journalists, which revealed the global scale of tax evasion and corporate tax avoidance and galvanized public attention and fueled reform, as described by S-Y. Oei & D. Ring, *Leak-Driven Law*, 65 UCLA Law Review 65, p. 532 (2018).

13. A. Raskolnikov, *Accepting the limits of tax law and economics*, 98 Cornell Law Review 3, p. 523 (2013).

14. ATAD; and OECD, *Prevention of Treaty Abuse: Peer Review Report on Treaty Shopping* (14 Feb. 2019), available at https://www.oecd-ilibrary.org/docserver/9789264312388-en.pdf?expires=1590350024&id=id&accname=guest&checksum=44AAFC40C5DE004359FD0CE58147211C (accessed 23 Mar. 2021).

15. *See* e.g. J. Vella, *Nominal vs. Effective Corporate Tax Rates Applied by MNEs and an Overview of Aggressive Tax Planning Tools, Instruments and Methods*, European Parliament (Oct. 2015), available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/563450/IPOL_IDA(2015)563450_EN.pdf (accessed 23 Mar. 2021).

16. As argued by P. Piantavigna, *The Role of the Subjective Element in Tax Abuse and Aggressive Tax Planning*, 10 World Tax J. 2 (2018), Journal Articles & Opinion Pieces IBFD.

law, it appears that an objective economic meaning of "tax abuse" is slowly starting to form and that the legal framework has been put in place to substantiate it. As this book will demonstrate, the connecting link between the objective economic meaning and the legal definition of "abuse" appears to be the GAARs, particularly the subjective element of the abuse test they comprise.

The theory behind modern international tax reforms is that aligned measures and coordination between states should result in increased certainty for taxpayers, but in practice, the measures to ensure this certainty – and thereby, taxpayer rights – do not exist. In recent years, international tax policy has been focused on international coordination and cooperation between countries in response to the increased globalization and on fighting aggressive tax planning. These aligned measures constitute an unprecedented overhaul of the international tax system, and the coordination between states should (in theory) result in increased taxpayer certainty. However, with fundamental and significant changes like these, the measures can become a constant work in progress and even lead to higher uncertainty for a longer period.[17] Building on the hypothesis that international coordination may, in fact, not lead to greater legal certainty and that a significant level of uncertainty can lead to adversarial economic effects, these issues may pose a threat to the rule of law and simultaneously lead to negative economic effects.[18]

1.2. The interdisciplinary field of tax law and economics

When drafting tax legislation, it becomes apparent that its ultimate enactment by the legislative power does not merely depend on legal considerations but also the economic considerations, in terms of the potential revenue to be derived from the change. The same holds true for the ATAD and the BEPS Project. The efficiency of a tax provision may hold drastically different meanings, depending on the context, just as the notion of "tax avoidance" is understood differently by economists, tax lawyers, policymakers and tax administrations.

Even so, the overall aim of implementing the PPT and the ATAD GAAR as minimum requirements have the same ultimate objective, both from an economic and legal point of view: To discourage taxpayers from be-

17. E. Zangari, A. Aciumi & T. Hemmelgarn, *Tax Uncertainty: Economic Evidence and Policy Responses*, European Commission Taxation Papers, Working Paper N. 67, p. 38 (2017).
18. Id., at p. 16.

haviour that is predominantly based tax considerations compared to other valid business considerations. Simultaneously, this aim necessitates that the provisions (i) are sufficiently clear for the taxpayers to apply; (ii) have the sufficient legal base; and (iii) are applied evenly by the different jurisdictions. If this is not achieved, taxpayers' legal certainty may potentially be breached and their rights undermined, just as a distortionary economic effect may follow. In GAAR terms, if the provision is too unclear in drawing the line between acceptable tax planning and illegal avoidance, there is an inherent risk that it will not only deter tax avoidance but also certain valid business activities. Likewise, if the participating jurisdictions apply the measures unevenly, this results in more favourable treatment in some jurisdictions compared to others. This kind of overdeterrence may yield distortionary effects and economic costs for the states' welfare.

This book is based on the fundamental recognition that GAARs have now found their way into both the global tax treaty network through the PPT (via the MLI) and the ATAD GAAR as a minimum standard, resulting in a record high number of participating states. Therefore, the aim of this book is to move away from the lofty goal of conducting a traditional legal dogmatic analysis to establish the optimal tax system and towards a more modest objective of evaluating this significant reform within the overall international and EU tax law. For this purpose, the method of tax law and economics is highly useful since it reveals the interplay between the tax rules, economic theory and the actions of rational taxpayers.[19] Each of these methodical parts will be described in section 1.3.

The aim of introducing the PPT and the ATAD GAAR is both economic and legal, as described above, and the challenge in testing any potential achievement of these goals is that economists examine the tax system from a macro perspective and, therefore, are less likely to grasp the details of the complicated rules, whereas even skilled tax lawyers do not usually possess the empirical and modelling skills necessary to consider the full bigger picture.[20] In order to assess the distortionary impact of introducing new rules, it is both necessary to understand them in full detail and also to be able to evaluate any potential distortionary impact that follows. Combining rigorous economic theory with legal dogmatic analysis provides a unique possibility to examine and understand taxpayer behavioural responses to the introduction of rules in order to prevent tax avoidance, which provides

19. Raskolnikov 2013, at p. 523.
20. Id., at p. 531.

a more realistic scenario than a mere economic analysis, as the legal aspect will entail a historical, philosophical and political analysis as well.

For the purposes of this book, two (perhaps rather controversial) assumptions are made, namely that (i) taxpayers are rational actors who strive to maximize their utility (or well-being); and (ii) the objective of the new legal order introduced by both the OECD BEPS Project and the EU ATAD is (under the positive strand) or *should be* (under the normative strand) to maximize welfare for its society,[21] i.e. to grow the revenue pie. How the pie is to be sliced and who gets the bigger piece is the objective for the ongoing BEPS 2.0 Project – that is, if there is a bigger pie and the exercise is not merely akin to "slicing a shadow".

Ultimately, the litmus test for the GAARs is centred on the notion that taxpayers make decisions based on a hypothetical world without taxes, in order to reduce their tax liability. This reduction in tax burden is a money transfer from the rest of society to the taxpayer, which gives rise to social losses or transfer costs. From an efficiency point of view, it does not matter whether or not the underlying activity is legal.[22] This is where the purely economic analysis falls short, as policy measures to fight tax avoidance inherently depend on a dividing line between acceptable tax planning and illegal tax abuse. The solution to this problem is to cast the litmus test for the GAARs both as an economic impact assessment coordinated with a legal analysis of its uniform application and quality (in terms of legal certainty).

1.3. Methodology

Chapter 2 of this book provides an overview of the principles of international taxation and their conflicts – which lead to tax competition among states and double taxation – and the rationale for avoiding these conflicts. It will further address the methods and measures to accomplish this result. This introduction will facilitate the study of how tax competition among states is weighed against the aim to ensure that income accrued by economic activity in the relevant states is, in fact, taxed correspondingly in these states.

Chapter 3 will apply the analytic legal method to expose the legal sources for anti-avoidance in the OECD. This is done to establish the development

21. Id., at p. 531.
22. W. Kopczuk, *Tax simplification and tax compliance: An economic perspective*, in *Bridging the Tax Gap: Addressing the Crisis in Tax Administration* p. 112 (M. Sawicky ed., Economic Policy Institute 2006).

from the notion of beneficial ownership to the PPT in the MLI and reveal the nature of the rules by analysing their sources, the power behind them and the interconnection with other systems. This part will facilitate the analysis of the underlying global developments that have paved the way for introducing anti-abuse measures in the global tax treaty network and elevating the fight against abuse to the same level as double taxation avoidance. The research question for chapter 3 is as follows: "What defines treaty abuse, and what are the limitations to the BEPS PPT?"

Chapter 4 of this book will similarly apply the analytic legal method to interpret and analyse the sources of law of judicial anti-avoidance within the European Union. This is done to establish the development of the general EU principle of anti-abuse in primary law and the development of the ATAD GAAR. Like the analysis in chapter 3, this part will facilitate the analysis of the underlying developments leading up to the introduction of the ATAD GAAR. Due to the interlocking relationship between the OECD and the European Union, both aspects are key in assessing the PPT and the ATAD GAAR and evaluating their effectiveness as measures to achieve the objectives at both levels. Consequently, what is understood by the analytical legal method here is not merely a method to test a theory or a doctrinal approach; it is a method to expose the interlocking relationship between the OECD and the European Union and to develop a new and independent theory on the effectiveness of GAARs within this framework.

The research question for chapter 4 is as follows: "What defines tax avoidance, and what are the limitations to the ATAD GAAR?"

In chapter 5, an effort is made to delineate accepted tax structuring from illegal abuse within the framework of the European Union and the OECD in order to analyse the development and provide an intermediary conclusion to the alignment between the two systems. This is done with reference to economic theory and multinational firm theory. While this is prone to a high level of uncertainty, as the development is still in its early stages, this is still a pivotal part of assessing the effectiveness of the measures. The research question for chapter 5 is as follows: "What is the legal/economic substance according to the GAARs, and how are these notions carrying the tax systems towards the objectives behind the BEPS and ATAD initiatives?"

Chapter 6 introduces a method for analysing MNE behaviour by utilizing the global tax treaty network to assess the economic impact of the anti-abuse provisions. For this part of the book, a network analysis developed by Maarten van 't Riet and Arjan Lejour from CPB Netherlands Bureau for

Economic Policy Analysis is applied. The findings in this part of the book have been published previously in an article co-authored with the two creators of the network analysis.[23] This method is applied to the conclusions in chapters 2 through 5 in order to assess whether the GAARs as a measure will have the intended effect. This analysis is theoretical in the sense that it is not done based on observed MNE behaviour but rather on facts about the global treaty network and the participating states, as well as the opportunities these provide for MNE tax planning. By applying the recent limitations throughout the OECD and the European Union to this analysis, it is possible to theorize about the economic effectiveness of the measures. This is done by applying the method of tax law and economics, which builds on the legal rules – in this case, the GAAR and the PPT – and uses economic theory, methods and analytical tools to assess the impact (e.g. behavioural response of taxpayers) and, hence, desirability of the rules. Ultimately, this method analyses the economic implications, utility and efficiency of the rule.[24]

Chapter 7 addresses the alignment of the rules throughout the participating states in the BEPS Project in order to determine whether they eliminate differences and ensure transparency of taxpayer rules. This is done by using the comparative legal method to analyse the GAARs in four countries in order to establish how they are faring in light of the legal and constitutional backgrounds of the states. The comparative approach is based on functionality, aiming at relating solutions to common policy issues by identifying patterns for comparability between tax systems.[25] In addition to classifying countries according to legal families, it is also highly useful to classify them according to their economic features for the purposes of tax policy analysis, as it is important to be aware of the role of the tax system in the economy and to understand the legal tradition.[26] The research question for chapter 7 is as follows: "What defines the selected GAARs, and how do they unfold in the domestic legislation of the jurisdictions?".

The four countries selected here both represent some with an established tradition concerning GAARs and one newcomer, just as both EU and OECD member countries are represented. Both civil law and common law

23. S. Baerentzen, M. van 't Riet & A. Lejour, *Limitation of Holding Structures for Intra-EU Dividends: An End to Tax Avoidance?*, 12 World Tax J. 2 (2020), Journal Articles & Opinion Pieces IBFD.
24. M.J. Bonell et al., *Liber Amicorium Ole Lando* (DJØF Publishing 2012).
25. C. Garbarino, *Comparative Taxation and Legal Theory: The Tax Design Case of the Transplant of General Anti-Avoidance Rules*, 11 Theoretical Inquiries in Law 2, pp. 765-790 (2010).
26. V. Thuronyi, *Comparative Tax Law* p. 10 (Kluwer Law International 2003).

countries are represented, as well as a variety of economic backgrounds. The four countries selected are (i) France; (ii) Germany; (iii) Denmark; and (iv) Australia. The aim of this part of the book is not to deconstruct the different GAARs of the selected sample countries in order to make a one-to-one comparison of each element. Rather, an effort is made to take a step back and reconstruct the path that has led to the current GAARs and the changes in tax policies encountered along the way. The objective is to understand these developments against the legal and economic features of each country in order to discover the challenges, limits and potentials an international general anti-avoidance provision may encounter.

Chapter 8 uses the findings from chapters 2, 6 and 7 to conclude on the effectiveness of GAARs in relation to (i) their economic aspects to ensure that income accrued by economic activity in the states is, in fact, taxed correspondingly in these states; and (ii) their legal aspects to align the rules throughout the states in order to eliminate differences and ensure transparency of taxpayer rules.

These findings are then summarized in order to provide a number of recommendations.

1.4. Terminology

For the purpose of determining the effectiveness of GAARs as a tool to distinguish between accepted tax planning and illegal tax abuse, a short introduction to the different terminology is required.

1.4.1. Tax evasion

There appears to be a broad consensus in literature that "tax evasion" concerns actions where the taxpayer makes false declarations, disguises or conceals facts, with the result that tax authorities claim too little in taxes. Accordingly, "tax evasion" implies an element of criminal activity and is synonymous with "tax fraud": "The expression tax evasion should be deleted from the vocabulary as it is a euphemism which covers its true name, which is tax fraud. Tax evasion requires falsehood of some kind. Basically, it requires either non-disclosure, or fabrication of a story, which differs from the facts."[27]

27. M. Seiler, *GAARs and Judicial Anti-Avoidance in Germany, the UK and the EU* p. 2 (Linde Verlag 2016).

Accordingly, the situations contained within the meaning of "tax fraud" are not the ones teetering on the edge between accepted tax planning and illegal abuse, as they extend well beyond this dividing line towards the latter side.

1.4.2. Tax avoidance and tax abuse

Composing tax legislation is always difficult, especially shaping it to be sufficiently efficient in countering anti-avoidance. This is mainly because for every piece of anti-abuse legislation, the taxpayer is able to counter the measure through a new tax structure or plan. This is where the distinction between tax planning and tax avoidance/abuse becomes relevant. Tax avoidance corresponds to what civil law jurisdictions would define as abuse of law, which is used in several areas of civil law to describe the correct application of law to a specific set of facts. For the purposes of this book, "tax abuse" is synonymous with "tax avoidance".

Placing this notion within the context of today's international tax law, the hallmark for tax avoidance appears to be that the taxpayer reduces his tax liability without incurring the intended economic consequences for qualifying for such a reduction. Conversely, the hallmark for acceptable tax planning is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the legislation and genuinely suffers the economic consequences that those taking advantage of the option were intended to suffer.

"Abuse of law" must therefore be distinguished from "abuse of rights", which deals with the excessive exercise of an individual right that causes harm to another person without good reason.[28] However, as will be demonstrated in chapter 4 of this book, this distinction is not always clear especially when dealing with case law from the Court of Justice of the European Union (ECJ), as the Court seems to use the concepts "abuse of rights" and "abuse of law" synonymously in several cases.

This distinction is of particular importance for this book, as it pertains to the subjective elements in the ATAD GAAR and the PPT and, as will be demonstrated throughout this book, has been a real game changer for the

28. T. Tridimas, *Abuse of Rights in EU Law: Some Reflections with particular Reference to Financial Law*, Queen Mary School of Law Legal Studies Research Paper N. 27, p. 2 et seq. (2009).

effectiveness of these anti-avoidance rules. One of the first mentions of a GAAR in EU tax law was the European Commission's Recommendation on Aggressive Tax Planning,[29] which provided the Commission's vision of a GAAR for the EU single market. This recommendation defined "the purpose of avoiding taxation" and, importantly, distinguished between "avoidance" and "evasion", namely "tax avoidance" occurs where the arrangement (or series of arrangements) defeats the object and purpose of the tax provision that would otherwise apply, irrespective of any subjective intentions of the taxpayer. By contrast, "tax evasion" denotes an infringement of the law, whereas for "tax avoidance", the taxpayer's behaviour is in accordance with the letter of the law but fails to honor the spirit of it. This clarification is pivotal because, in contrast to what the term "subjective element" suggests, this part of the abuse test should not be based on an inference regarding the personal intentions of the taxpayer or the persons who are legally responsible for corporate decisions relevant to the taxpayer for that matter.[30]

29. Commission Recommendation of December 6 2012 on aggressive tax planning, OJ L 338/41 (2012), Primary Sources IBFD.
30. I. Mitroyanni, *European Union*, in *GAARs – A Key Element of Tax Systems in the Post-BEPS World* pp. 21 and 26 (M. Lang et al. eds., IBFD 2016), Books IBFD.

Chapter 2

Tax Policy in a Time of Crisis: Ensuring the Tax Revenue

2.1. Introduction to the global tax arena

Today's international tax system has been pieced together into a mosaic of domestic tax regimes and an extensive network of bilateral tax treaties (DTTs) linking them together. Essentially, this vast network of DTTs contains numerous routes for corporations to choose from when establishing their multinational businesses and carrying out their activities and payments globally. Within this global network, the EU internal market constitutes a subnetwork with its own unique legal and economic characteristics, just as each state comprises its own set of domestic tax policies, legal tradition and economic features. Several legal and economic factors intensify tax competition, and this fragmentation of tax law into national systems is one aspect that facilitates competition for paper profits (which generate tax revenue) and real factors of production (which generate wealth and jobs for national residents).

The entire international tax system is built upon the concepts of source and residence, and the challenges of this system stem from the fact that – under international law – each state is entitled to tax persons or transactions with which it has a sufficient nexus. Consequently, states generally tax companies based on their residence or the source of the relevant income. In cases of cross-border activity, two or more states may have a sufficient nexus and, therefore, the right to tax. States navigate this issue both unilaterally (through domestic law) and bilaterally (through DTTs). "Corporate tax residence" is arbitrarily but clearly defined as a company's place of incorporation or place of management and control (according to article 4 of the OECD Model Tax Convention on Income and on Capital (OECD Model), which defines "residence" by reference to domestic law).[31] It follows from international custom and tax treaties that a state may only tax a non-resident corporation on income *sourced* from its territory. On the contrary, the company's state of *residence* may tax the corporation's entire worldwide income, as outlined in article 7 of the OECD Model.[32] Essentially, the tax treaties constrain source tax entitlements and thereby shift revenue from

31. *OECD Model Tax Convention on Income and on Capital* art. 4 (27 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model* (2017)].
32. Id., at art. 7.

the source states to the residence states, as well as coordinate certain tax administrative functions and information sharing.[33] These features form the basis of some of the most important cornerstones in evaluating any provision introduced to the international tax arena, such as tax competition, treaty networks and withholding taxes. In order to fully understand these notions and review the general anti-avoidance rules (GAARs) in light of them, a proper introduction will be provided.

2.2. The history of the international tax system: The harmonization vs. tax competition controversy

Throughout the 20th century, states have globally competed for mobile business and investment, which has prevented cooperation in combatting corporate tax avoidance and thereby resulted in a collective action problem. Historically, this has prevented them from joining forces and effectively combatting corporate tax avoidance. However, this trend reversed with the financial crisis in 2008, which galvanized public demand for political change following a series of tax leaks and thereby provided the political impetus for the multilateral reform that became the base erosion and profit shifting (BEPS) Project.[34] The streamlined approach that came with the project set a uniform formula for, inter alia, incorporating anti-abuse measures and coordinating rules on the use of flow-through and opaque entities.

2.2.1. The global network of tax treaties

While it is certainly idealistic to think that an international tax system will eliminate all international inefficiencies and assist all the nations in the world in maximizing their relative advantages,[35] the familiar frameworks and language of the tax treaties have provided at least some sort of ready-made, off-the-shelf tool for streamlining. Consequently, DTTs have

33. T. Dagan, *Tax Treaties As A Network Product*, 41 Brooklyn Journal of International Law 5, pp. 1081-1106 (2016).
34. P. Saint-Amans, 20th Annual David R. Tillinghast Lecture on International Taxation (10 Oct. 2015), available at https://www.youtube.com/watch?v=qUy-_gHe-Mg (accessed 23 Mar. 2021); and R. Mason, *The Transformation of International Tax*, Virginia Public Law and Legal Theory Research Paper No. 2020-36, p. 355 (2020).
35. Y. Brauner, *An International Tax Regime in Crystallization-Realities, Experiences and Opportunities*, NYU Law School, Public Law Research Paper No. 43, p. 1 (2003).

increased the level of certainty for taxpayers when conducting business abroad, making them pivotal for states seeking to attract foreign investment and economic activities.

Throughout the years, several initiatives have been launched aimed at cooperation among states to alleviate the issue of decentralization, and the most successful is the international network of tax treaties for the prevention of double taxation and the initiatives in the BEPS Project. More than 3,000 treaties were signed on the basis of the OECD Model, and this network of treaties set a standard not only for the negotiations of such treaties between the contracting states but also for the international tax regime, as cross-border transactions will very often be governed by tax treaties.

With the establishment of such a network, as states continue to join, it spreads and reinforces itself, becoming more valuable.[36] One way to develop a common standard for the network is via consensus and cooperation and, as pointed out by G20 leaders in the BEPS Action Plan,[37] it is critical that governments achieve consensus on actions that deal with the weakness of unilateral measures: “Despite the challenges we all face domestically, we have agreed that multilateralism is of even greater importance in the current climate and remains our best asset to resolve the global economy’s difficulties.”[38]

If a viable standard is achieved by cooperation, competition between differing and prevailing standards can also result in a dominant (and viable) new standard.[39] This does not mean that a critical mass of participating states cannot consolidate to establish such a standard within the framework, which could gain traction due to the network effect (e.g. an EU-initiated standard that challenges those set by the OECD). As will be analysed in chapter 4 of this book, the EU general anti-avoidance principle could prove to be such a challenge to the OECD standard in terms of determining tax abuse.

As will be demonstrated, developing a joint standard is not without obstacles, but – if successful – the value of the standard will increase as more states opt in. In order for this to happen, there must be limited opportuni-

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36. Dagan 2016, at p. 1094.
37. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), Primary Sources IBFD.
38. Id., at p. 11.
39. S.M. Besen & J. Farell, *Choosing How to Compete: Strategies and Tactics in Standardization*, 8 The Journal of Economic Perspectives 2, pp. 117-131 (1994).

ties for taxpayers to impose negative externalities by taking advantages of the public services of a jurisdiction without paying taxes for these services. In theory, the more standardized the international tax rules are, the fewer opportunities there are for taxpayers to maneuver between diverging standards that better serve their interests. With more states adopting the standard, loopholes and opportunities will diminish and become more conspicuous. The question then arises of how to develop a standard that transcends the prevailing legal systems and traditions of the participating states. Given that the states have different incentives for the unique structures of their tax systems, a joint standard would have to find some kind of common denominator to set the bar. In any such network, there is an advantage for the first participant, as it can establish its product as a standard.

2.3. The international standards set by the OECD Model

In terms of international tax standards, most states follow the OECD Model – which traces back to the 1920s – and today, its influence extends far beyond the 38 OECD member countries. Even though the OECD Model is soft law, adherence to its standards is widespread and even forms the basis of the UN model tax treaties, despite the fact that the UN Model[40] was generated by states as an alternative to the OECD Model to counter undesired tax shifts to residence states (i.e. developed countries), which resulted from developing countries being disproportionately source states.[41]

The OECD Model limits source taxation on business profits in the following two ways:

– states may only tax non-resident corporations if the corporation has a permanent establishment in the state (i.e. a physical presence or a dependent agent through which the business activity is carried out, according to article 5 of the OECD Model); and
– if a non-resident corporation has a permanent establishment in the source state, this state can only tax the income attributable to this establishment (according to article 7 of the OECD Model).

Determining the attributable income raises numerous questions that are outside the scope of this book. Though, it is important to note that the

40. P. Pistone, *General Report*, in *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* pp. 1-36 (M. Lang et al. eds., Cambridge University Press 2012).
41. *United Nations Model Double Taxation Convention between Developed and Developing Countries* (1 Jan. 2011), Treaties & Models IBFD.

OECD Transfer Pricing Guidelines (OECD Guidelines) and other OECD publications are widely followed throughout the world and that these guidelines lay out the attribution process not only for permanent establishments[42] but also for separate legal entities within multinational enterprises (MNEs).[43] Even prior to the BEPS Project, the OECD Model and its Commentary (along with the OECD Guidelines) were the main elements of the standards for MNE corporate tax structures. Therefore, in a sense, the OECD Guidelines are also a key component in drawing the line between acceptable tax planning and illegal abuse in relation to the GAARs.

2.3.1. The 1920s compromise: A system welded for tax competition

Despite the vast guidelines, tax competition has been commonplace throughout the 20th century due to a number of economic and legal factors. A key catalyst, in this regard, is the distinction traditionally made between business (active) and investment (passive) income, and the OECD defines the latter as "income in respect of which, broadly speaking, the recipient does not participate in the business activity giving rise to the income, e.g. dividends, interest, rental income, royalties etc.'[44]

At a unilateral level, states may choose to tax certain forms of passive income paid to foreign companies at lower rates or not at all (e.g. dividends paid to shareholders holding more than a certain percentage of shares in a domestic company). At a bilateral level, the tax treaties generally allocate the primary taxing rights over passive income, such as dividends and interest, subject to the source state's restricted right to impose a withholding tax. The result is that, under the tax treaties, the source countries forfeit their right to tax passive income paid to non-residents or to reduce this tax. This feature provides the backbone for many archetypes of tax planning structures. At an EU level, the Parent-Subsidiary Directive,[45] the Interest

42. OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2010), Primary Sources IBFD.
43. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (10 July 2017), Primary Sources IBFD [hereinafter *OECD Guidelines*].
44. OECD Glossary of Tax Terms, available at https://www.oecd.org/ctp/glossaryoftaxterms.htm (accessed 23 Mar. 2021).
45. 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 345/8 (2011), Primary Sources IBFD.

and Royalties Directive[46] and the case law of the Court of Justice of the European Union (ECJ) has significantly influenced the domestic laws of the Member States and considerably constrained their freedom to design their domestic tax laws on cross-border activity.

The fundamental allocation of taxing rights for active income to source states and taxing rights for passive income to residence states pervades the international tax system and has also been dubbed the "1920s compromise",[47] as it originates back to the work of the League of Nations almost a century ago. This system is flawed in the context of today's world since it is ill-suited to contain modern MNEs and their cross-border activities, and especially because the system invites states to compete, which undermines itself.[48]

2.4. Alleviating double taxation by allocating tax revenue

The mosaic of international taxation consists of numerous states with different economies and legal systems. Each state is entitled to make its own rules and guard its own tax sovereignty in accordance with international law. In such a decentralized tax market, where each state builds its own tax foundation, there tends to be great divergence among countries between their specific systems. Considerable similarities can be observed between the different policies in the states – and therefore also their rules[49] – and, at the same time, disparities between the various systems remain substantial, and not only in terms of tax rates.[50] In fact, the following has been argued: "[I]t is fairly amazing that the taxing jurisdictions of the world, with their diverse political and economic systems, have reached a point of sufficient understanding in matters of law and taxation that the concepts of 'residence', 'corporation' and 'stock' are generally comprehensible almost everywhere."[51]

46. Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157/49 (2003), Primary Sources IBFD.
47. M.J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax Law Review (2001).
48. For a thorough analysis on this issue, *see* Vella 2015.
49. R. Avi-Yonah, *International Tax as International Law, An Analysis of the International Tax Regime* (Cambridge University Press 2007).
50. Dagan 2016, at p. 1084.
51. D.H. Rosenbloom, *International Tax Arbitrage and the "International Tax System"*, 53 Tax Law Review, p. 137 (1999).

One might add that it is equally amazing that these same states, with their diverging backgrounds, have agreed to something as massive as the BEPS Project – let alone a GAAR.

2.4.1. Different forms of double taxation

The international network of tax treaties is extensive and thriving, and they serve as an efficient way to allocate tax revenue, thereby alleviating double taxation. Historically, much effort has been dedicated to defining "double taxation", and several types have been defined over the years, including domestic and international double taxation[52] as well as juridical and economic double taxation.[53] For the purposes of this book, "double taxation" will denote "the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter for identical periods", i.e. international juridical double taxation.[54]

In modern international taxation, the focus has broadened from merely aiming to alleviating double taxation to including efforts to ensure taxation in the first place. According to the OECD and general consensus, double taxation "[has] harmful effects on the exchange of goods and services and movements of capital, technology and persons [and that] it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries".[55]

Generally, tax treaties are not intended to prevent multiple impositions of tax in an economic sense.[56] If a corporation in country A distributes a dividend to its shareholder in country B, the tax treaty between country A and country B will assign the right to tax the dividend to either country (or

52. Domestic double taxation arises when comparable taxes are imposed within a federal state by sovereign tax jurisdictions of equal rank. International double taxation arises when comparable taxes are imposed in two or more states on the same taxpayer in respect of the same taxable income or capital (e.g. where income is taxable in the source country and in the country of residence of the recipient of such income). *Compare* OECD Glossary of Tax Terms.

53. Double taxation is juridical when the same person is taxed twice on the same income by more than one state. Double taxation is economic if more than one person is taxed on the same item (*compare* OECD Glossary of Tax Terms).

54. Introduction to the *OECD Model* (2017).

55. Id.

56. S. van Weeghel, *The Improper use of Tax Treaties* (Kluwer 1998).

both) in part but will not prevent full taxation of the corporate income on the company and full taxation of the dividend on the shareholder.

In the beginning of the 20th century, a structured approach emerged towards avoidance of double taxation alongside studying the effects of double taxation from an economic point of view. This approach has influenced international tax policies as far back as the BEPS Project and the introduction of the principal purpose test (PPT). In order to thoroughly understanding the provision, a short introduction to these significant developments will be provided.

2.4.2. A brief history of relieving double taxation

Since the inception of the International Chamber of Commerce (ICC) in 1919 and the League of Nations in 1920, both organizations placed great importance on the issue of double taxation. Many present-day scholars have noticed that the modern OECD Model is a direct descendant of the League of Nations' model treaty from the mid-1920s, and some have recognized traces of the League's effort in earlier work by the ICC.[57] Newly organized in 1920, the ICC – an umbrella organization with ties to national chambers of commerce in many nations – placed double taxation on the international diplomatic agenda and formulated an influential early approach to the problem. The ICC adopted a resolution at its organizational meeting in Paris in 1920, calling for "prompt agreement between the Governments of the Allied countries in order to prevent individuals or companies from being compelled to pay a tax on the same income in more than one country".[58]

2.4.2.1. The economic consequences of double taxation

In 1922, the League of Nations and its Financial Committee requested a report from four economists, namely (i) Bruins (the Netherlands); (ii) Einaudi (Italy); (iii) Seligman (the United States); and (iv) Stamp (the United Kingdom). They were requested to consider, broadly speaking, the economic consequences of double taxation and whether any overall principles could be formulated as a basis for a general international convention (or separate conventions between particular countries) to remove its "evil consequences", as described by W.H. Coates in his summary of the report,

57. M.J. Graetz & M.M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke Law Journal, p. 1066, note 181 (1997).
58. Id., at p. 1066, note 183, quoting the organizational meeting of the International Chamber of Commerce Res. 11 (28 June 1919).

Notes

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