STUDY

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Harmful tax practices within the EU: definition, identification and recommendations

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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Harmful tax practices within the EU: definition, identification and recommendations

Abstract

The purpose of the present study is to provide a tool for understanding the phenomenon of harmful tax competition within the EU, as well as making an in-depth assessment and proposing solutions. It contains policy recommendations for future EU standards.

This document was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the subcommittee on Tax Matters (FISC).

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LIST OF ABBREVIATIONS

APA	Advance Pricing Agreement
ATAD	Anti-Tax Avoidance Directive
ATR	Advance Tax Ruling
BEPS	Base Erosion and Profit Shifting
CCCTB	Common Consolidated Corporate Tax Base
EC	European Commission
ECOFIN	Economic and Financial Affairs Council
EP	European Parliament
EU	European Union
GDP	Gross Domestic Product
IHS	Institute for Advanced Studies
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
R&D	Research and Development
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom
VAT	Value Added Tax

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EXECUTIVE SUMMARY

Background

Tax competition involves policies put in place by states with the aim to improving the relative competitive position of one country vis-à-vis other countries. This may be realised by reducing the tax burden on businesses (and individuals) in order to retain, gain or regain mobile economic activities and the corresponding tax base, whether at the expense of other countries or otherwise.

Tax competition may have both desirable and undesirable consequences. It can be considered as harmful tax competition where it causes a worse international allocation of mobile factors of production.

As Member States of the European Union retain large portions of sovereignty in the area of direct taxes, the phenomenon of tax competition is quite present also within the EU and risks damaging the Single Market.

In the current post-Covid-19 scenario, where Member States are facing budgetary constraints, there is the risk that tax competition simply serves to shift rather than create economic activity is concrete.

Aim

The purpose of the present study is to provide the general public with a tool for understanding the phenomenon of harmful tax competition within the EU and assessing the solutions proposed to combat it from a legal perspective.

Models of seven tax measures are constructed, which may potentially lead to harmful tax competition if implemented by one or more Member States of the European Union.

Specifically, they are: (1) the lowering of corporate tax rates; (2) the 'patent boxes'; (3) the shell companies; (4) the notional interest deduction regimes; (5) the foreign source income exemption regimes; (6) special economic zones; and (7) tax rulings.

None of these tax measures are in themselves contrary to EU law, but they become so if they are structured by the domestic law-maker in a way that distorts the normal allocation of resources in the single market. In which case, for the purposes of this study, they can be classified as harmful tax practices.

The present study is expected to be satisfactory for lawmakers. It does not have the ambition to be complete and exhaustive on this issue, but to enable the Members of the European Parliament to be in a position to interact with technical experts engaged in EU tax policy-making.

Key findings

The authors provide a set of recommendations. In particular, eight recommendations are identified with regard to which European institutions may have a key-role in the implementation.

Currently, the role of the EU institutions in the fight against harmful tax competition within the Single Market is strongly centred on the European Commission attacking a particular harmful tax practice by bringing an action before the Court of Justice of the European Union, but there are more options which may be considered.

The recommendations elaborated on are:

1) The use of Article 116 TFEU to counter market distortions;

2) Reliance on the state aid rules;
3) Rethinking business taxation in a global and digital economy;
4) Rethinking the Code of Conduct in a global and digital economy;
5) Special and urgent attention for impact of digitalisation;
6) Enabling administrative capacity building and common supervision;
7) Enhancing and monitoring tax transparency of tax rulings; and
8) Providing guidance on cooperative compliance procedures.

In addition to mainly technical aspects, the present study also emphasises that an effective policy against such conduct cannot be achieved without a broad political consensus within the European Union. For some of the proposed solutions, a broad political consensus would also be required, because their implementation would require changes to the fundamental rules underpinning the European legal order.

1. SETTING THE SCENE: WHAT IS (HARMFUL) TAX COMPETITION AND HOW TO DETECT IT

KEY FINDINGS

This section delimits the scope of the research and describes the methodology used in the study. It provides a comprehensive definition of what tax competition is, with particular attention to the definition of the concepts of harmful tax competition. The detection of harmful tax practices results from the analysis of the main policy documents dealing with it. In the end, the ultimate reason why Member States can compete with each other to the point of damaging each other is that the European Union's power of harmonisation in the area of direct taxation is limited.

1.1. Scope and methodology

The present study is aimed at giving to the reader a clear idea of the phenomenon of harmful tax competition among the Member States of the EU in the field of **business taxation**.

It deals with the topic from a legal perspective and collects a number of data which can help the reader in understanding the magnitude of the phenomenon. The collection of the data has been carried out using several other studies and public policy documents as source.

The authors have outlined a definition of what harmful tax competition is and then, according to it, have made an effort in selecting a number of **harmful tax practices** and presenting them. This results in a text that is methodologically rigorous but also easily usable by the general public.

The present document is not intended to be read in isolation. On the contrary, it is conceived to be read in parallel with other documents commissioned by the European Union in order to form a **comprehensive picture** of the phenomena. For example, it is appropriate to read it in conjunction with the report "*Monitoring the amount of wealth hidden by individuals in international financial centres and impact of recent internationally agreed standards on tax transparency on the fight against tax evasion*", commissioned by the European Commission and of which the final version was released on 15 December 2020. Hence, this study will not focus on individuals but on businesses.

Both, the models of harmful tax practices and the recommendations contained in the present study are selected and presented in a way that gives an overall view of the phenomena of harmful tax competition within the EU which is expected to be satisfactory for lawmakers. They do not represent a study that has the ambition to be complete and exhaustive on this issue, but to enable Members of the European Parliament to be in a position to interact with technical experts engaged in EU tax policy-making.

The authors carried out legal desk research, relying on a wide range of publicly available institutional sources (mainly EU, OECD and IMF), as well as on academic literature, think tank publications, published books and articles in mainstream and specialised media.

1.2. What is tax competition

Globalisation is favouring the **mobility of companies**, which has in turn often resulted in an increase of tax competition, namely the competition among different jurisdictions' tax policies, both within the EU and outside. This means that governments are increasingly seeking to attract mobile economic

activities to their countries, as well as to retain them by creating a favourable tax climate able to compete with what is on offer abroad.

Back in 2004, Ben Kiekebeld gave the following definition of **tax competition**[1]: "*Improving the relative competitive position of one country vis-à-vis other countries by reducing the tax burden on businesses and individuals in order to retain, gain or regain mobile economic activities and the corresponding tax base, whether at the expense of other countries or otherwise*". The authors agree with this definition and consider it as being the most **accurate** available. In fact, despite being rather wide, it includes all the elements that make it possible to gather the entire spectrum of conducts which, if implemented by one Member State, may damage the others and the Single Market. It is able to include, for example, both specific and generic measures, as well as measures that harm other Member States by enriching the state that implements them, or even harm all of them by reducing the revenues of all of them. Moreover, it is possible to place all recent developments under this definition, such as the increasing **globalisation** and **digitalisation**. These evolutions have in the authors' view not changed the definition of (harmful) tax competition, it simply sped up this phenomenon during the last decades.

Tax competition can be realised in many different ways, which goes from generic to specific measures. Kiekenbeld clarifies that the scope of the first category includes the **generic measures** designed to achieve an overall improvement in the position of a jurisdiction's competitiveness. An example of these generic measures is wide-ranging program of tax reforms leading to a reduction of the tax rate[2]. **Specific measures**, on the other hand, are in contrast designed to increase the competitiveness of specific sectors of a jurisdiction's economy. Some examples of specific tax measures are exemptions, either temporary or permanent, tax reductions for foreigner taxpayers, special tax-free zones, expatriate-dedicated regimes, etc.[3] Several of these measures have appeared over time in the legislation of different EU Member States.

It is difficult to classify tax competition among EU Member States as an exclusively positive or exclusively negative phenomenon[4]. On the one hand, it has the **desirable consequence** to lead to a reduction in tax-driven distortions to the market mechanism and thus to a more efficient allocation of factors of production within the Single Market. On the other hand, tax competition among states, both within the EU and outside, is generally said to have **undesirable consequences** on other states than the one that enacted competitive measures. In particular, consequences can be considered to be undesirable if they lead to a worse international allocation of mobile factors of production, which in the authors' view draws the borderline with **harmful competition**. Any tax measure enacted to foster the competitiveness of a tax system falls within the scope of tax competition, but only those that lead to undesirable consequences amount to harmful tax competition. Within the present study, these measures are also referred to as **harmful tax practices**. In other words, undesirable consequences appear where the allocation of factors results in being less than optimal. Very frequently, the competition that leads to these consequences is 'externally focused'[5], which means that it is aimed at improving the relative competitive position of specific economic sectors in a jurisdiction in order

1 B. J. Kiekenbeld, *Harmful Tax Competition in the European Union: Code Of Conduct, Countermeasures and EU Law*, Alphen aan den Rijn, 2004, 8.

2 B. J. Kiekenbeld 2004, 9.

3 B. J. Kiekenbeld 2004, 9.

4 P. Van Cleynenbreugel, *Regulating Tax Competition in the Internal Market: Is the European Commission Finally Changing Course?*, European Papers, 2019, Vol. 4, No. 1, 227.

5 B. J. Kiekenbeld 2004, 11. See also, O. Pastukhov, *Countering Harmful Tax Competition in the European Union*, Southwestern Journal of International Law, 2010, 16 (1), 159.

primarily to attract investment from abroad and thus increase the jurisdiction's tax base at the expense of other countries.

An explanatory example could be the one of a small state that enacts a legislation allowing the so-called letterbox companies. This cannot be considered *per se* a measure of harmful tax competition and there may be solid arguments to defend the conduct of that state. It is perfectly legitimate for that state to facilitate the localisation of business on its territory and to give the possibility to easily create corporate structures, which are desirable consequences. The situation changes if these measures are aggressive and result in the state becoming the crossroads for numerous corporate structures that are completely disconnected from the real economy on the ground. This **distorts the allocation of resources** at international level and can therefore be considered as harmful tax competition[6].

An inefficient allocation of factors is attained where **investment decisions are taken primarily on tax grounds** and if, in the absence of tax grounds, the investment would otherwise have been made in another jurisdiction. In the current **digitalised post-Covid-19** scenario, where Member States are facing **budgetary constraints**, there is the risk that tax competition simply serves to shift rather than create economic activity and to influence **the allocation of profits** within the Single Market. Taken to extremes, tax competition becomes **harmful** where it prevents the establishment of a real common market in the EU, since it should be real economic factors rather than tax that primarily determine allocation. If that was not the case, the Single Market would turn into an opportunity for some states to attract wealth at the expense of others, without any mutual benefit.

In addition to what is mentioned above, there is the concrete risk that a fierce tax competition among Member States results in further **undesirable policies**, like for example, the shift of the tax burden from capital to labour, which would in turn make it more difficult to pursue redistributive policies in a period of economic constraints like the present post-Covid-19 one.

1.3. The detection of harmful tax competition and the main policy documents dealing with it

It is not an easy task to draw a **dividing line** between desirable tax competition and harmful tax competition. Although tax competition through the introduction of favourable tax measures is likely to be positive from a domestic perspective, it often results in the erosion of tax revenues and an inefficient allocation of factors of production at European level. Ultimately, Member States will be worse off on an overall basis and the outcome if these policies will be in contrast with the goals of the Single Market[7].

Over the years, the **development of criteria to identify harmful tax competition** has been the subject of various policy documents, both from the EU and the OECD.

Back in 1997, the Council of Economics and Finance Ministers (ECOFIN) adopted the **Code of Conduct for Business Taxation**[8]. It is not a legally binding instrument, but it has always been considered by European institutions as having a certain 'political force'. Indeed, the adoption of such document implies the intention by Member States to (i) roll back existing tax measures that constitute harmful tax competition, and (ii) refrain from introducing any such measures in the future ('standstill').

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6 C. M. Radaelli, *Harmful Tax Competition in the EU: Policy Narratives and Advocacy Coalitions*, Journal of Common Market Studies 1999, 37, no. 4, 661-682.

7 L. V. Faulhaber, *The Trouble with Tax Competition: From Practice to Theory*, Tax Law Review, 2018, 71, 311.

8 Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy - Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a Code of Conduct for Business Taxation - Taxation of saving, 98/C 2/01, (hereinafter Code of Conduct).

It was specifically structured with the purpose to detect **only such measures which unduly affect the location of business activity in the European Community**, as it was targeted exclusively at non-residents and provided them with a more favourable tax treatment than which is generally available in the Member State concerned.

The **Code of Conduct for Business Taxation** covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on the location of business in the European Union and what remains of central importance even to these days in the current scenario. The criteria set out therein for identifying potentially harmful measures include (but are not limited to)[9]:

a) an effective level of taxation which is significantly **lower than the general level** of taxation in the jurisdiction concerned. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factors. This is a sort of overarching indicator, as it is almost always the consequence of the application of each of the types of measures listed below;

b) tax benefits reserved for **non-residents**: this is the case of tax measures designed solely to attract taxable income from abroad. It is a straightforward criterion, as where benefits are given only to non-residents or in respect of transactions carried out with non-residents. This is a clear indication that the tax measure is harmful;

c) tax incentives for activities which are **isolated from the domestic economy** and therefore have no impact on the national tax base: this is the case of favourable tax measures that are ring-fenced from the domestic market, so that they do not affect the national tax base. Issues are likely to arise in cases where a tax regime is designed to attract economic activities not currently existing in a jurisdiction since the preferential regime will have no effect on the domestic tax base in this situation. Moreover, it has to be noted that there is a partial overlap with the previous point, as isolation of a certain tax regime from the domestic economy exists also where only non-resident taxpayers are allowed to make use of a certain tax measure;

d) granting of tax advantages even in the **absence of any real economic activity**: this is the case of tax advantages granted regardless of whether there is any genuine economic activity and substantial economic presence in the Member State offering them. It is a very useful criterion, as the granting of tax benefits irrespective of whether there are economic activities of substance in a country is an indication of a country consciously pursuing tax policies designed to attract mobile economic activities at the expense of other countries, rather than seeking to achieve sustainable development of its domestic economy;

e) the basis of profit determination for companies in a multinational group **departs from internationally accepted rules**, in particular those approved by the OECD. For example, profit determination on a fixed basis and without regard for arm's length criteria. Experience shows that such regimes often deviate also from the jurisdiction's own standard tax structure; and

f) lack of **transparency**: this includes the tax measures lacking transparency, including legal provisions being relaxed at an administrative level in a non-transparent way. These types of measures have always been (and still are) difficult to detect and widely rely on the discretion of tax authorities. Non-transparent regimes often give scope for negotiations between the tax authorities and taxpayers, thus allowing certain categories of taxpayers to be given preferential treatment in

[9] See the Code of Conduct, §B, 1-5. See also Kiekenbeld, cit., 25-26.

a manner escaping both judicial and administrative control. This is the only criterion within the list that does not deal with the content of the tax measure but deals with the process surrounding it.

Furthermore, the Code of Conduct mentions two **additional economic criteria** that are useful to detect harmful tax competition and assess whether a tax measure can be considered as having a harmful nature. They are[10]:

1) the economic effects of the tax measure on other Member States, inter alia in the light of how the activities concerned are effectively taxed throughout the Community, and
2) insofar as a tax measure is used to support the economic development of particular regions, an assessment should be made as to whether the measure is in proportion to and targeted at the aims sought.

In authors' opinion, there is nothing that suggests that these criteria are outdated or no longer valid nowadays. In fact, although both the legal structure of the European Community/Union and the economy have changed, these criteria are disconnected from specific dynamics and also applicable to a union of states like the one currently in place and to a much more globalised and digitalised economy.

In a report dated November 1999, the **Code of Conduct Group (Business Taxation)** established one year earlier catalogued a total of 66 tax measures classifiable as harmful tax competition: 40 in EU Member States, 3 in Gibraltar and 23 in dependent or associated territories.

In the very same period, the OECD was also focusing on the same issues. Even if a deep analysis of this document would be outside of the scope of the present study, it is worth mentioning that in 1998 the OECD released a milestone report on this topic entitled **Harmful Tax Competition: An Emerging Global Issue**. This report is organised around three 'pillars', namely (i) the identification of harmful tax practices in Member countries; (ii) tax havens; and (iii) the involvement of non-OECD economies. The report introduced the creation of the **Forum on Harmful Tax Practices**. Afterwards, some further progress reports were released, of which a number of findings have converged in the recommendations included in the 2015 Final Reports of **Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements)** and **Action 5 (Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance)** of the OECD and G20 Base Erosion and Profit Shifting (BEPS) Project.

Coming back to the EU work on these issues, in September 2004 the European Commission adopted a **Communication on Preventing and Combating Financial and Corporate Malpractice**[11]. It is a comprehensive document and it provides a strategy for coordinated action in the financial services, company law, accounting, tax, supervision and enforcement areas, to reduce the risk of financial malpractice. With specific regard to taxation, the Commission suggested more transparency and information exchange in the company tax area so that tax systems are better able to deal with complex corporate structures. The Commission also stressed the need to adopt coherent EU policies concerning offshore financial centres, in order to encourage these jurisdictions to move towards transparency and effective exchange of information.

The OECD and the EU also joined forces and work together on these issues. The **Joint Transfer Pricing Forum**, for example, was established jointly by these two institutions and is assisting the European Commission on transfer pricing matters. In the last years, it has worked on a number of prominent

[10] See the Code of Conduct, §G.

[11] Communication from the Commission to the Council and the European Parliament on Preventing and Combating Corporate and Financial Malpractice, Brussels, 27.09.2004, COM(2004)611 final.

issues with the purpose to guarantee a fair allocation of resources among Member States, among which: the use of economic valuation techniques (2017)[12], a coordinated approach on transfer pricing controls within the EU (2018)[13], and the application of profit split method within the EU (2019)[14].

On 28 April 2009, the European Commission released a **Communication on Promoting of Good Governance in Tax Matters**[15]. Therein, a fair tax competition is identified as one of the main components of a good governance in the tax area, together with transparency and exchange of information. In particular, it is underlined that legal instruments on administrative cooperation shall be complemented by a political agreement between Member States to tackle harmful tax competition in the area of business taxation under a peer review process.

The Commission recalled, although with a different intensity, the issues related to harmful tax practices and the work of the Code of Conduct also in the **Action Plan in Corporate Taxation**[16] of 17 June 2015, where five key-areas of intervention to build a fair and efficient tax system in the EU are outlined. The five key-intervention areas identified by the European Commission on the context of this project are: (1) re-launching the Common Consolidated Corporate Tax Base (CCCTB); (2) ensuring fair taxation where profits are generated; (3) creating a better business environment; (4) increasing transparency; and (5) improving EU coordination.

In the **Anti-Tax Avoidance Package** of 28 January 2016, the corporate tax rules of Member States (or lack thereof) were reviewed, with the purpose to identify the ones that can facilitate aggressive tax planning and key structures used by companies to avoid taxation. Although these measures are not specifically aimed at countering tax competition among Member States, but rather misconducts carried out by taxpayers, it is reasonable to expect that closing loopholes and quitting aggressive tax planning opportunities in certain jurisdictions will also have the effect of reducing possible competition between Member States. Tax planning, in any case, took a completely different meaning (after the introduction of ATAD, for example).

Nowadays, the **Code of Conduct Group** is active in a number of **monitoring processes**, periodically assigned by the Council of the European Union[17]. Among the most relevant of these activities in the last three-year period, for example, the following may be mentioned: (i) the review of tax measures notified by Member States in the course of several rounds of rollback and standstill notifications (for example, guidance on notional interest deduction regimes); (ii) the monitoring of implementation of the commitments made by non-EU jurisdictions (the so-called 'tax havens') in the field of taxation; (iii) support in the update of the EU list of non-cooperative jurisdictions for tax purposes (which is periodically revised by the ECOFIN Council); (iv) the promotion of public discussions around the criterion to exchange beneficial ownership information; (v) the screening of the foreign source income exemption regimes identified in the jurisdictions falling within the scope of the EU listing process; (vi) monitoring of the implementation of the country by country reporting anti-BEPS minimum standard; and (vii) seeking coherence with the OECD in respect of international tax good governance standards and listing criteria.

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[12] Report on the use of Economic Valuation Techniques in Transfer Pricing, Meeting of 22 June 2017, Brussels, 16 October 2017 Taxud/D2 DOC: JTPF/003/2017/FINAL/EN.

[13] Report on a coordinated approach on transfer pricing controls within the EU, Brussels, October 2018, Taxud/D2 DOC: JTPF/013/2018/EN.

[14] Report on the application of profit split method within the EU, Brussels, March 2019, Taxud/D2 DOC: JTPF/002/2019/EN.

[15] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee Promoting Good Governance in Tax Matters, Brussels, 28.4.2009 COM(2009) 201 final.

[16] Communication from the Commission to the European Parliament and the Council – A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action {SWD(2015) 121 final}, Brussels, 17.6.2015 COM(2015) 302 final.

[17] European Council, Code of Conduct Group (Business Taxation), available at https://www.consilium.europa.eu/en/council-eu/preparatory-bodies/code-conduct-group/.

On 27 November 2020, the ECOFIN mandated the **Code of Conduct Group** to discuss the scope of its mandate, as soon as there are relevant developments at international level but no later than by the beginning of 2022, and agreed that the ongoing discussion on the scope of the mandate should also cover features of tax systems that have general application and that may have harmful effects[18].

In the middle of the Covid-19 pandemic, the EU **Tax Package on Fair and Simple Taxation Supporting the Recovery Strategy** was launched, formed by three main elements: (i) an action plan for fair and simple taxation supporting the recovery strategy; (ii) a legislative proposal to revise the directive on administrative cooperation; and (iii) a communication on tax good governance in the EU and beyond. As far as the present study is concerned, it is proposed to introduce an automatic exchange of information between Member States' tax administrations for income and/or revenues generated by sellers on digital platforms. This information would help tax administrations verify that those who earn money through digital platforms pay the appropriate share of taxes, and therefore, indirectly, they may contribute to detect harmful tax practices put in place by Member States.

On 15 July 2020, the European Commission released a **Communication** to the European Parliament and the Council **on an Action Plan for Fair and Simple Taxation Supporting the Recovery Strategy**[19]. This document aims at elaborating the main features of European future tax policy, and includes 25 actions. In recent years, the EU has focused its efforts on tackling tax evasion and boosting transparency. The European Commission explains in this Communication that several legislative initiatives have made it harder for taxpayers to avoid and evade their taxes than ever before, including ground-breaking transparency and Member States' cooperation projects. Specific examples include the Anti-Tax Avoidance Directive[20], the Commission recommendation on implementation of measures against tax treaty abuse[21], and transparency rules for tax rulings[22] and introduction of country-by-country reporting between tax authorities[23]. However, revenue loss in the EU due to corporate tax avoidance remained very high, according to several estimates[24]. Moreover, the Covid-19 pandemic and the digital economy form important challenges for the EU to face urgently.

On the same day, the European Commission also released a **Communication on Tax Good Governance in the EU and beyond**[25]. It also mentions "*the reform of the Code of Conduct for Business Taxation*". As to this reform, the document makes the following concrete proposals to effectively tackle all forms of **harmful** (or will it be 'unfair' in the future?) **tax competition**:

1) if there is no consensus on minimum taxation at the global level, such a concept of minimum taxation may need to be introduced in the code as an EU standard;

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18 Council Conclusions on fair and effective taxation in times of recovery, on tax challenges linked to digitalisation and on tax good governance in the EU and beyond, Brussels, 27.11.2020, 13350/20, FISC 226, ECOFIN 1097, §46.

19 Communication from the Commission to the European Parliament and the Council – An Action Plan for Fair and Simple Taxation supporting the Recovery Strategy, Brussels, 15.7.2020, COM(2020) 312 final.

20 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, 19.7.2016.

21 Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse, OJ L 25, 2.2.2016, p. 67–68.

22 Council Directive (EU) 2015/2376 of 8 December 2015 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, OJ L 332, 18.12.2015.

23 Council Directive (EU) 2016/881 of 25 May 2016 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, OJ L 146, 3.6.2016.

24 Communication from the Commission to the European Parliament and the Council – An Action Plan for Fair and Simple Taxation supporting the Recovery Strategy, Brussels, 15.7.2020, COM(2020) 312 final, footnote 23.

25 Communication from the Commission to the European Parliament and the Council – Communication on Tax Good Governance in the EU and Beyond, Brussels, 15.7.2020, COM(2020) 313 final.

2) the scope of the Code of Conduct should be broadened beyond only looking at specific tax measures and regimes which are introduced by jurisdictions, to cover further types of regimes and general aspects of the national corporate tax systems which have the same effects as such specific regimes, such as, for example, exemptions of foreign income; and

3) to make more information on the work of the Group publicly available on a dedicated website.

An **Action Plan for Business Taxation for the 21st century** is put on the EU agenda for the following years as well: a deep reform of the corporate tax system to fit the modern and increasingly **digitalised economy** is now even more important to support growth and generate needed revenues in a fair way, by realigning taxing rights with value creation and setting a minimum level of effective taxation of business profits[26].

Finally, in the month of March 2021, the Council of the European Union and the European Parliament instructed their respective negotiators to start discussing a **Public Country-by-Country Reporting** mechanism[27]. The idea behind this initiative is that companies and groups operating in the EU, either headquartered therein or not, of which the net turnover exceeds EUR 750 million in each of the last two consecutive financial years, will have to disclose on their website a number of data, including the corporate income tax paid in each Member State. The draft documents on which negotiations will be conducted does not include a concrete starting date, which will depend on the speediness of interinstitutional negotiations themselves.

1.4. The legal framework behind fighting harmful tax competition in the EU

The **founding Treaties of the EU** leave to European institutions a power to harmonise direct taxation that is significantly narrower than the one in the field of indirect taxation. In fact, they make no explicit provision for legislative competences in the area of direct taxation.

The ultimate reason for this is that the main barriers to a proper functioning of the Single Market are created by indirect taxes. In addition to that, direct taxes are often seen as **one of the main components to the sovereignty of states**, as well as one of the most efficient tools to pursue socio-economic and financial policies, with the consequence that Member States remain reluctant to transfer this power to a higher, supranational level.

Direct taxation is therefore a **primary responsibility of Member States**, with the exception of those situations where, on the basis of the principle of subsidiarity, an intervention at European level is appropriate due to the circumstance that common objectives cannot be sufficiently achieved by Member States themselves.

Harmonisation concerning the legislation on the taxation of companies has usually been based on Article 115 TFEU, which authorises the Union to adopt directives on the approximation of laws, regulations or administrative provisions of the Member States, which directly affect the internal market; these require unanimity and the consultation procedure.

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[26] Communication from the Commission to the European Parliament and the Council – An Action Plan for Fair and Simple Taxation supporting the Recovery Strategy, Brussels, 15.7.2020 COM(2020) 312 final, 2.

[27] European Council, Council approves greater corporate transparency for big multinationals, Press release, 3 March 2021, available at https://www.consilium.europa.eu/en/press/press-releases/2021/03/03/council-approves-greater-corporate-transparency-for-big-multinationals.

More specifically with regard to harmful tax practices, under certain circumstances the European Commission has the power to tackle them under the state aid rules[28]. Under Article 107, paragraph 1 of the TFEU, "any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the Internal Market"[29]. State aid rules apply regardless of the form the aid is given and, i.e. any kind of tax relief can potentially constitute state aid if all the remaining criteria are fulfilled.

Recently, Schoueri gave an overview of the existing hard law and soft law framework of Tax Competition[30].

[28] See also E. Traversa, A. Flamini, *Fighting Harmful Tax Competition through EU State Aid Law: Will the Hardening of Soft Law Suffice*, European State Aid Law Quarterly 2015, no. 3, 323-331.

[29] TFEU, Article 107 (1), available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:12008E107.

[30] See also P. Schoueri, *Conflicts of International Legal Frameworks in the Area of Harmful Tax Competition. The modified nexus approach*, Amsterdam, IBFD, European and International Tax Law and Policy Series, 2019, no. 14, 11-101.

2. MODELS OF HARMFUL TAX PRACTICES

KEY FINDINGS

According to the definitions and frameworks in the previous section, the authors **identify seven tax measures** that states can use to render their tax system more competitive in this section. These measures are legitimate in themselves and may even have a positive impact on the economy of the state that implements them. They become harmful, as explained in the previous section, if they are structured in such a way as to distort the natural allocation of resources (which is something for economists to study) and create fiscal outcomes that are disconnected from economic reality. In such a case, one can talk of harmful tax competition. Described models do not refer to the specific legislation of any Member State, so they can be used in a generalised way.

2.1. The lowering of corporate tax rates

Corporate tax reduction has always been associated, also in the eyes of public opinion, to a positive economic development, even if this fact is not universally agreed as being definitively proved empirically. This field of direct taxation is not directly governed by the European Union and remains one of the prerogatives most jealously **retained by Member States**. Member States have a wide leeway to shape their corporate tax rates structure in a way that is exclusively aimed at maximising their own welfare, even if it is to the detriment of other Member States.

It is not an exaggeration to affirm that under the current legal framework, while Member States have achieved coordination in certain areas, such as double taxation, the driving forces of the corporate tax rates policies are **unilateralism and competition**. However, new initiatives towards the introduction of a concept of minimum taxation as an EU standard have been mentioned in the previous section (such as Tax Good Governance in the EU and beyond).

As a consequence of this framework, the lowering of corporate tax rates can be considered as a **harmful tax competition practice** from the point where an excessive decline alters a physiological allocation of resources within the Single Market (which is something for economists to decide[31]). In general, states lower their statutory tax rates for two main reasons: (i) to attract potential investors; and (ii) to compensate the expected or actual losses occurred from the lowering of tax rates by other jurisdictions[32].

In the last decades, the corporate tax rates have come under a significant pressure because of economic integration (both at European and global level), technological developments (e.g. 3-D printing and advanced robotics) and a radically renewed legal framework. Due to these factors, the **mobility of capital** has escalated and the businesses operating internationally were incentivised to relocate their assets, risks and functions in the perspective to pursuit lower tax rates.

Already in the nineties, the Ruding Committee[33] analysed the trends in the statutory corporate tax rates and concluded that tax un-coordination and competition leads to lower tax rates. It observed that during the 1980s the **statutory tax rates declined in Europe** while taxable bases became broader.

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31 See, among others, M. T. Alvarez-Martinez et al, *Falling Corporate Tax Rates in the EU: Is there a case for harmonisation?*, JRC Working Papers on Taxation and Structural Reforms No 4/2016.

32 R. Teather, *The benefits of tax competition*, The Institute of Economic Affairs, 2005, 165.

33 Report of the Committee of Independent Experts on Company Taxation, Commission of the European Communities, March 1992.

Also from the 1990s on, effective average corporate tax rates marked a clear **downward pattern**[34]. Devereux et al., in investigating data on corporate income tax revenue in respect to the GDP of several advanced economies, with regard to the 1960-1999 period, concluded that (i) statutory tax rates have fallen; (ii) tax bases have been broadened; (iii) effective tax rates have fallen; and (iv) tax revenues have remained stable as a share of the GDP. Similar results were obtained by Soresen with regard to the 1982-2004 period[35].

In the 2008-2019 period, the rates of the corporate income tax **continued to be gradually decreased** for the purpose to minimising the effects of the crisis. The same trend can be recognised also with regard to year 2020, with the consequence that all the warning on the risk to trigger a race to the bottom are turning out to be realistic[36].

Table 1: The corporate income tax rate dynamics in the EU, 1995-2018

Country	1995	2000	2005	2008	2009	2010	2014	2015	2016	2017	2018	1995–2018	2008–2018
Belgium	40.2	40.2	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	29.0	−11.2	−5.0
Denmark	34.0	32.0	28.0	25.0	25.0	25.0	24.5	23.5	22.0	22.0	22.0	−12.0	−3.0
Finland	25.0	29.0	26.0	26.0	26.0	26.0	20.0	20.0	20.0	20.0	20.0	−5.0	−6.0
Germany	56.8	51.6	38.6	29.5	29.4	29.4	29.6	29.7	29.7	30.2	30.0	−26.8	0.5
Greece	40.0	40.0	32.0	25.0	25.0	24.0	26.0	29.0	29.0	29.0	29.0	−11.0	4.0
Spain	35.0	35.0	35.0	30.0	30.0	30.0	30.0	28.0	25.0	25.0	25.0	−10.0	−5.0
France	36.7	36.7	35.0	33.3	33.3	33.3	33.3	33.3	33.3	33.3	33.0	−3.7	−0.3
Ireland	40.0	24.0	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	−27.5	0
Italy	52.2	41.3	37.3	31.4	31.4	31.4	31.4	31.4	31.4	24.0	24.0	−28.2	−7.4
Luxembourg	40.9	37.5	30.4	29.6	28.6	28.6	29.2	29.2	29.2	27.1	26.0	−14.9	−3.6
Netherlands	35.0	35.0	31.5	25.5	25.5	25.5	25.0	25.0	25.0	25.0	25.0	−10.0	−0.5
Austria	34.0	34.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	−9.0	0
Portugal	39.6	35.2	27.5	25.0	25.0	25.0	23.0	23.0	21.0	21.0	21.0	−18.6	−4.0
Sweden	28.0	28.0	28.0	28.0	26.3	26.3	22.0	22.0	22.0	22.0	22.0	−6.0	−6.0
U.K.	33.0	33.0	30.0	30.0	28.0	28.0	21.0	20.0	20.0	19.0	19.0	−14.0	−11.0
Average (EU-15)	38.0	35.5	30.1	27.3	27.0	26.9	25.8	25.7	25.3	24.6	24.2	−13.9	−3.2
Czech Republic	41.0	31.0	26.0	21.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0	−22.0	−2.0
Estonia	26.0	26.0	24.0	21.0	21.0	21.0	21.0	20.0	20.0	20.0	20.0	−6.0	−1.0
Latvia	25.0	25.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	20.0	−5.0	5.0
Lithuania	29.0	24.0	15.0	15.0	20.0	15.0	15.0	15.0	15.0	15.0	15.0	−14.0	0
Hungary	19.6	19.6	16.0	16.0	16.0	19.0	19.0	19.0	19.0	9.0	9.0	−10.6	−7.0
Slovenia	25.0	25.0	25.0	22.0	21.0	20.0	17.0	17.0	17.0	19.0	19.0	−6.0	−3.0
Slovakia	40.0	29.0	19.0	19.0	19.0	19.0	22.0	22.0	22.0	21.0	21.0	−19.0	2.0
Poland	40.0	30.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	−21.0	0
Malta	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	0	0
Cyprus	25.0	29.0	10.0	10.0	10.0	10.0	12.5	12.5	12.5	12.5	12.5	−12.5	2.5
Bulgaria	40.0	35.0	15.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	−30.0	0
Romania	38.0	38.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0	−22.0	0
Croatia	25.0	35.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	18.0	−7.0	−2.0
Average (EU-13)	31.4	29.4	19.6	18.4	18.6	18.3	18.5	18.4	18.4	17.7	18.0	−13.5	−0.4

Source: KPMG, Corporate tax rates table[37].

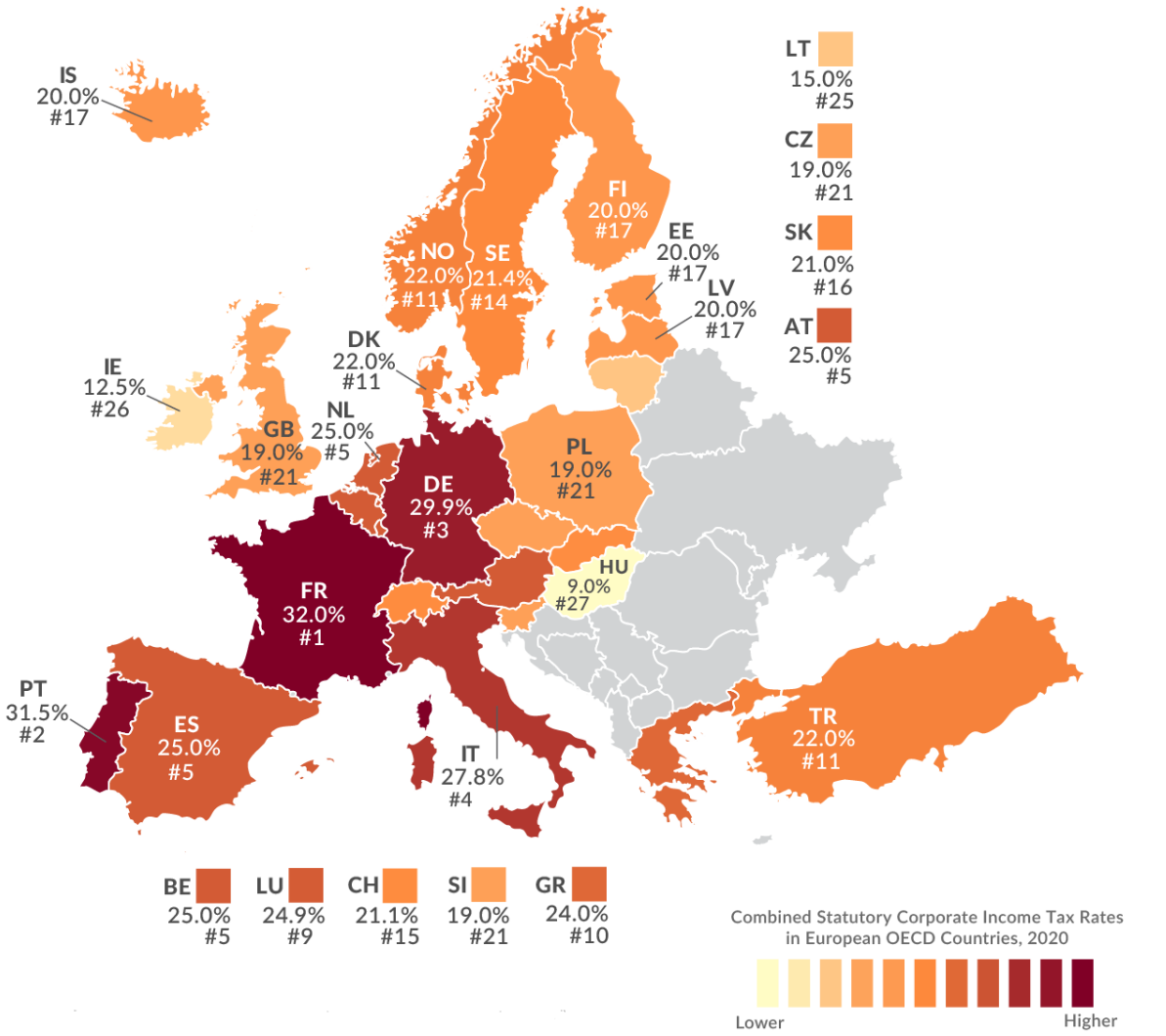
[34] M. P. Devereux, R. Griffith, A. Klemm, *Corporate income tax reforms and international tax competition*, Economic Policy, 2002, 17(35), 449; see also C. Cozmei, *Is It any EU Corporate Income Tax Rate-Revenue Paradox?*, 2nd Global Conference on Business, Economics, management and tourism, 30-31 October 2014, Prague, Procedia Economics and Finance, 2015, 818-827.

[35] P. B. Soresen, *Can capital income taxes survive? And should they?*, in CESifo Economic Studies 2006, 53(2), 172.

[36] See also KPMG, Corporate Tax Rates Table, available at https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html.

[37] A. Podviezko, L. Parfenova, A. Pugachev, *Tax Competitiveness of the New EU Member States*, Journal of Risk and Financial Management, 2018, 12, 34, 3.

Figure 1: The corporate income tax rate in the EU, 2020



Source: OECD, Tax Database: Table II.1. Statutory corporate income tax rate, https://taxfoundation.org/2020-corporate-tax-rates-in-europe/.

As to nowadays, the highly decentralised corporate tax rates policies have proven unable to stop tax-oriented mobility of capitals, assets and functions, which appear to be unavoidable under the current European legal framework. In 2013, the G20 and the OECD have identified the risk of a **'race to the bottom'**[38] as an issue to concern in proposing a comprehensive action plan to tackle base erosion and profit shifting issues. It is probably the greatest challenge to face.

Nevertheless, the proposals contained in the BEPS are mostly focused on **managing artificial structures and reducing disparities between the place where the value is generated and the place where the taxes are levied**. Moreover, they are not specifically tailored for the European Union, which has a peculiar and unique legal framework and equilibrium among its components (which is the reason why in the field of direct taxation it often limits its intervention to soft law).

In addition to what is mentioned above, the reported data do not take into consideration the fact that several jurisdictions have 'further harmful tax practices' in force (some of which are analysed in the

[38] OECD, Action Plan on Base Erosion and Profit Shifting, at 8, 17, 27 (2013).

present report) which can help corporations in furtherly **lowering or even avoiding paying the official corporate income tax rate** where they do business. Experience shows that most of the times these practices are designed specifically for cross-border activities and are of no use to companies that are only present in one country, which is especially the case for many small and medium enterprises. If the trend observed at world level in the period 1980-2015 was to continue, the global corporate tax rate would hit **zero by 2052**[39].

The **unilateral initiatives** of Member States to strengthen their anti-profit shifting legislations are not expected to invert or stop this race to the bottom. The ultimate reason for this is that the race to lower tax rates is inherent to the current system of direct taxation governance within the European Union. In a decentralised and competitive environment, Member States will always have the natural incentive to enhance their **competitiveness** by, among others, reducing their statutory rates. It seems a natural consequence of the fact that profit shifting is becoming harder due to the international pressure and unilateral reforms that Member States improve their competitive position by means of 'non-internationally condemned' measures.

The consequence of the described race to the bottom is that governments are faced with three alternatives, namely to **cut spending, to increase other taxes or to broaden the tax base**. Even if rates are low, if the taxable base is kept broad, business taxation income can still be generated. Therefore, it is important to address the tax base. However, it is likely that for budgetary reasons workers and consumers are asked to pay more. This is likely to cause a number of problems that go beyond the 'pure tax dimension' and have social consequences as well. For example, the increase of VAT rates is often seen as regressive, as it risks contributing to the inequality between rich and poor, as opposed to reducing it. This is because consumption taxes such as VAT target consumers on a wide range of products and are applied in the same way to everyone, but the consumption of everyday household goods and services usually entails a larger share of the income of poorer rather than wealthier people. It is also legitimate to have concerns that women will be impacted harder than men, due to the simple fact that women are more likely to live in poverty[40].

Although there is no doubt that the attraction of foreign investment is a positive factor and increases the overall wealth of a society, it is also noteworthy that a wide debate is ongoing on whether the lowering of corporate tax rates is a proper mean for this[41]. Recent trends and studies[42] argue that in many cases the share of income going to workers has dropped and low wages have stagnated[43].

2.2. Patent boxes

The expression 'patent box', or 'knowledge box', refers to special types of incentives offered to corporations entitling them to reduce the tax burden on **intellectual property**. To put it in a very simple way, they result in a lower corporate tax rate of corporate tax to profits earned from its patented inventions. It is one of the main instruments through which **governments can support private**

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39 For updated data on the revenue structure, see also the Report titled *Taxation Trends in the European Union - Data for the EU Member States, Iceland and Norway 2020 Edition*, Publications Office of the European Union, 2020.

40 UN Women, *The Beijing Declaration and Platform for Action Turns 20*, Summary of the Report of the Secretary-General on the 20-year review and appraisal of the implementation of the Beijing Declaration and Platform for Action and the outcomes of the twenty-third special session of the General Assembly (E/CN.6/2015/3), March 2015.

41 See, for example, the official website of the Tax Justice Network, according to which "*The idea that countries can "compete" like companies in a market is a deeply incorrect analogy*".

42 L. Zingales, *Who Is Responsible for a Declining Labor Share of Output?* Michael Porter', ProMarket, 16 November 2016; S. Barkai, Declining Labor and Capital Shares, The Journal of Finance, 2020, 2421.

43 For additional data on this point, see also C. Spengel, F. Schmidt, J. Heckemeyer, K. Nicolay, Centre for European Economic Research, Project for the EU Commission TAXUD/2013/CC/120 Final Report 2017 - *Effective Tax Levels Using the Devereux/Griffith Methodology*, 2018.

research and development. One of its main advantages lays with the very low administrative costs that it generates for both governments and businesses.

Over the last decade, patent box regimes providing for the possibility to opt for an advantageous tax treatment with respect to profits generated by 'qualified intangibles' (namely those intangible that fall within the scope of application of the domestic legislation enacting the patent box), whilst promoting the **research and development (R&D) activity**, have increasingly been introduced by Member States (e.g. Belgium, Cyprus, France, Greece, Hungary, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal and Spain)[44].

From a more technical point of view, in most countries that have adopted patent box regimes the tax incentive takes the form of a **partial exemption or notional deduction** of qualifying income. However, unlike other tax incentives, which are provided at the outset of the innovation process (in other words, upon incurring connected expenditures), patent box regimes intervene at the back end of such process, namely when income is received.

They have often been criticised, in fact, for being an **ineffective** instrument to suitably incentivise R&D. This is especially because they are seen as something that incentivises new ideas rather than the underlying research, and therefore they would not stimulate 'real' and 'structural' innovation[45]. In addition to that, patent box regimes are often considered ineffective because the granted preferential tax treatment accrues in essence from projects which most certainly involve and develop R&D, but that nevertheless are susceptible to being successful in any case, regardless of the applicable tax regime.

The patent box regimes constitute a significant opportunity for taxpayers and, due to circumstance that several Member States have them in force, others may *de facto* be obliged to align when they present themselves as **preferential locations for foreign investors**. This is making the presence of a patent box regime almost mandatory for any jurisdiction (both within and outside the Union) that wishes to attract foreign investment.

Intellectual property assets are, by definition, characterised by an extremely high level of mobility and, because of that, are the most **easily transferable** production factors. They can be effortlessly moved to a different jurisdiction offering a most convenient tax treatment.

The main distinction among the assets that usually fall within the scope of patent box regimes is between (i) the trade intangibles, and (ii) marketing-related intangibles. Good policies to encourage and incentivise investment in R&D and innovation activities, with a special focus on patents and intangible assets (and, generally, not intellectual property acquired from third parties, but solely what produced 'internally' by the beneficiary of the tax treatment), are usually seen as associated to the first category. Potential harm to tax competition within the EU has often been associated to the second category, which includes trademarks (e.g. Luxembourg and Italy) in addition to patents and patentable inventions. The reason is that this type of preferential regime has a strong tendency to attract income derived from intellectual property assets, but without any substantial requirement regarding the carrying out of R&D activities by the beneficiary. As a consequence, these regimes are **mainly regarded as a means of attracting highly mobile capital and relocating corporate income, rather than promoting innovation**.

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[44] For updated data, see also the Commission Staff Working Document titled Tax Policies in the European Union: 2020 Survey, Brussels, 30.1.2020 SWD(2020) 14 final.

[45] See, among others, S. Zucchetti, A. Pallotta, *Italian Patent Box Regime: Thinking Outside the Box or Just More Harmful Tax Competition?*, in International Transfer Pricing Journal, 2016, I, 68.

Table 2: Patent box regimes in Europe as of 2020

	Qualifying IP Assets			Tax Rate Under Patent Box Regime	Statutory Corporate Income Tax Rate
	Patents	Software	Other[1]		
Andorra	X	X		2%	10%
Belgium	X	X		4.44%	29.58%
Cyprus	X	X	X	2.5%	12.5%
France	X	X		10%	32.02%
Hungary	X	X		0% or 4.5%	9%
Ireland	X	X	X	6.25%	12.5%
Italy	X	X		13.95%	27.9%
Lithuania	X	X		5%	15%
Luxembourg	X	X		4.99%	24.94%
Malta	X	X		1.75%	35%
Netherlands	X	X	X	7%	16.5% to 25%
Poland	X	X		5%	19%
Portugal	X			10.5%	21%
San Marino	X	X		0% or 8.5%	17%
Slovakia	X	X		10.5%	21%
Spain: federal	X	X		10%	25%
Spain: Basque Country	X	X		7.2%	25%
Spain: Navarra	X	X		8.4%	25%
Switzerland	X			Varies from canton to canton, up to a 90% exemption from corporate tax	Varies from canton to canton; 11.9% to 21.6%
Turkey	X			11%	22%
United Kingdom	X			10%	19%

Source: The Tax Foundation, https://taxfoundation.org/patent-box-regimes-in-europe-2020/.

Action 5 of the OECD and G20 BEPS Project specifically suggests that there should be '**substantial research activity**' effectively and actually carried on in order to access the preferential patent box regimes. This contributes to one of the main ideas behind the BEPS, namely to align substance, and therefore income, with its relevant taxation, ensuring that taxable profits can no longer be artificially shifted away from the jurisdiction in which the value is originally created in favour of jurisdictions offering a preferential tax regime. This requirement put forward by the OECD is aimed at countering all those tax practices that would ultimately favour the relocation of the taxable base in a country other than the country of origin and the OECD Forum on Harmful Tax Practices has considered various approaches to verify its implementation. They are all aimed at identifying R&D expenditures that are

incurred by the taxpayer himself, not focusing on quantitative criteria, but rather on qualitative ones, as they constitute a measurement of the activity effectively carried out by the beneficial taxpayer[46].

The first of these approaches is the so-called **value creation approach**, requiring that taxpayers undertake a certain number of significant development activities. The second is the **transfer pricing approach**, under which tax benefits are granted to all the income generated by intellectual property assets, provided that the prospective beneficiary has located a certain degree of material functions in the jurisdiction providing the preferential treatment. This means that who benefits from the preferential tax treatment must be the legal owner and ultimate user of the benefited asset. Finally, there is the so-called **nexus approach**, according to which the preferential tax regime may apply as long as there is a direct nexus between the income for which the benefits are granted and the expenditures contributing to that income[47].

2.3. Shell companies

There is a lot of linguistic confusion about the meaning of the concept of a 'shell company'. Several different expressions are often used interchangeably. Under the EU law there is no legal definition of what a 'shell company' is, nor a legal definition of what constitutes a 'genuine' company while the OECD Glossary of Tax Terms provides the following definition: "*A paper company, shell company or money box company, i.e. a company which has complied only with the bare essentials for organisation and registration in a particular country. The actual commercial activities are carried out in another country*"[48].

For the purposes of this analysis, the following categories are employed[49]:

1) **Anonymous companies**: the key element of this type of companies is anonymity. This means that it is difficult to trace back precisely to the person in effective control of it. In practice, this happens where the ultimate beneficial owner of the company remains hidden behind it, or behind a chain of interconnecting shell companies, often in several jurisdictions. This type of structures has been at the very centre of several scandals occurred in recent times and is often juxtaposed with tax evasion, corruption, money laundering and even terrorist financing. They often consist of the true owner of the company hiding behind the anonymity provided by it while effectively controlling its activity and assets. This is likely to result in a threat to fair tax competition among Member States where it becomes impossible to trace back to the beneficial owner.

2) **Letterbox companies**: this expression refers to those companies that do not have any physical facility or infrastructure. It originates from the circumstance that they exist via mailing address only, with actual activities taking place in another Member State. These companies are sometimes used to circumvent labour laws and social contributions in the Member State in which the substantive economic activity is taking place. These 'letterbox' or 'mailbox' companies are generally mentioned in the context of circumvention of the Posting of Workers Directive. Some arrangements have led to a myriad of false letterbox companies which exist in paper terms only as a means of delivering a cheap workforce. Workers channelled through letterbox arrangements are often not declared to

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46 S. Zucchetti, A. Pallotta, *Italian Patent Box Regime: Thinking Outside the Box or Just More Harmful Tax Competition?*, in International Transfer Pricing Journal, 2016, 68.

47 S. Zucchetti, A. Pallotta, *Italian Patent Box Regime: Thinking Outside the Box or Just More Harmful Tax Competition?*, in International Transfer Pricing Journal, 2016, 69.

48 See also T. Hastings, J. Cremers, *Developing an Approach for Tackling Letterbox Companies, A learning resource from the Seminar of the European Platform Tackling Undeclared Work: How to identify and tackle fraudulent letterbox companies*, Brussels, 30 November 2017.

49 These categories are outlined in the following report: I. Kiendl Krišto and E. Thirion, *An overview of shell companies in the European Union*, EPRS Study, October 2018.

social security offices and/or tax departments, while under declared forms of work include failures to pay the minimum salary of the host Member State and/or failure to pay overtime.

3) **Special purpose entities**: this expression refers to entities whose core business consists of group financing or holding activities (often referred to 'holding companies'). These are entities with no or few employees, little or no physical presence in the host economy, and whose assets and liabilities represent investments in or from other countries. In this context, special purpose entities are usually mentioned with regard to their possible use in aggressive tax planning. For example, these types of entity may be established in a certain Member State (as well as in a third jurisdiction) to arbitrarily take advantage of the terms of a favourable provision present in either a directive or in a tax treaty which a Member State is part of (it is worth stressing that this example is not only applicable to this category of a shell company).

The main feature that is common to all these types of entities is the **absence of a real economic activity in the Member State of registration**. This generally means that such companies have no or few employees, no or little production and/or no or little physical presence in the Member State of registration.

Their use is **not illegal *per se***, but it becomes contrary to the law when they are misused, namely inserted into schemes aimed at circumventing the rationale behind the current legal framework (e.g. directive or treaty abuse). Where well-known brands buy property or land, for example, they may be legitimately willing to hide their identity behind a shell company, in order to avoid price increases by the seller. Moreover, it has to be underlined that they are usable for several different purposes, with the consequence that their misuse may not be aimed at paying a low amount of taxes, but, for example, at hiding the real identity of a beneficial owner. From a tax policy perspective, the presence of shell companies in the domestic legislation becomes a harmful tax competition practice where it causes an allocation of resources that do not respond to the real economic situation and thus undermines the proper functioning of the Single Market.

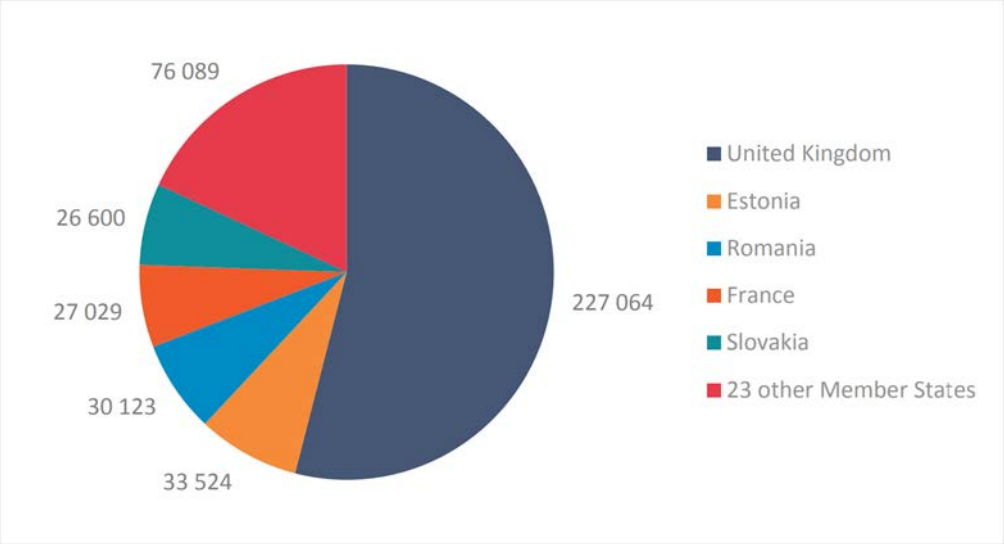
Also because of the difficulties in clearly defining what a shell company is, as well as the fact that the real issue is the use to which they are put, it is very **difficult to assess** their number within the EU. In order to evaluate whether a company is a shell company, most of the time it is necessary to take a close look at it. The procedure may imply to evaluate on a case-by-case basis whether the company has some economic substance or it exists only on paper. This may be done, for example, by assessing whether it is sufficiently staffed for its purposes. More in general, as to the magnitude of the presence of shell companies within the EU economy, a number of possible indicators has been elaborated over time. These **indicators** are, in particular, the number of foreign-owned companies in Member States. Although none of them is definitive in demonstrating the presence of shell companies, if considered together, they can contribute to the understanding of the phenomena and shed a light on its possible presence in one or more jurisdictions.

As to the first indicator, namely the **number of foreign-owned companies** in the EU, the most reliable data publicly available are to be found in a study for the European Commission on the Law Applicable to Companies[50]. Even if it is almost not worth remarking that not all foreign-owned companies are shell companies, their massive presence in a jurisdiction has been used as one indicator of aggressive tax

[50] LSE, *Study on the Law Applicable to Companies*, prepared for the European Commission, 2016. The data quoted in this paper are 2015 data and were already quoted in I. Kiendl Krišto and E. Thirion, *An overview of shell companies in the European Union*, EPRS Study, October 2018.

planning in general (at least when an unusually high number of foreign controlled companies cannot be explained by other factors)[51].

Figure 2: Estimated number of foreign-owned companies in the EU (pre-Brexit)



Source: LSE Study on the Law Applicable to Companies (June 2016).

The data clearly show that the UK was, at least in the pre-Brexit era, the most popular jurisdiction for foreign-owned companies. It is followed by three central and eastern EU Member States and France, but the study provides the possible explanation that these jurisdictions have very business-friendly company, tax and labour law in place.

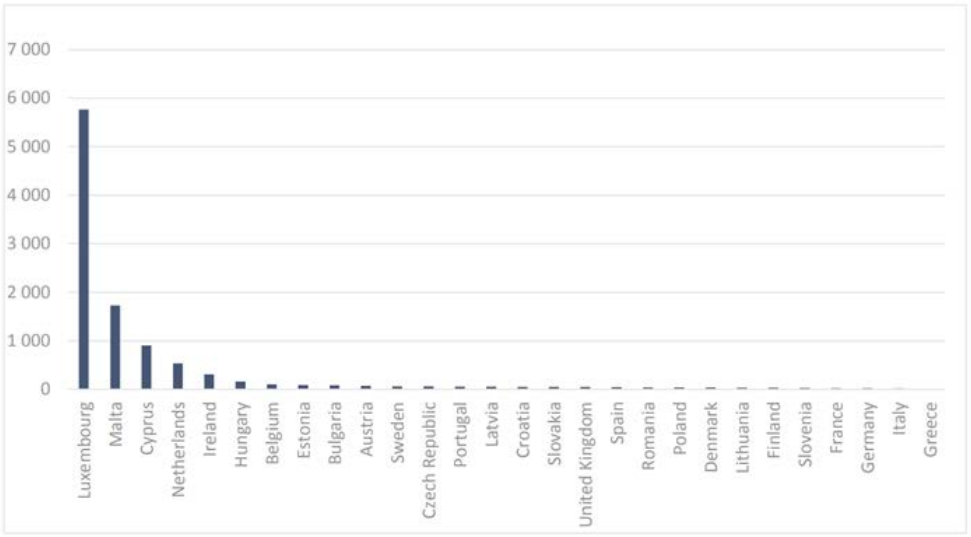
As to the second indicator, namely the **ratio of foreign direct investment in an EU Member State to the GDP of that Member State**, it consists of measuring the cross-border investment by a resident in one economy with an objective of establishing a lasting interest[52] in an enterprise that is resdient in an economy other than that of the direct investor.

The following data present the total inward and outward foreign direct investment stocks for each Member State in a percentage GDP. They are based on the European Commission data, in particular on the 2017 IHS Report on Aggressive Tax Planning Indicators and clearly show how some 'small economies' are within a major crossroads of inward and outward foreign investments (i.e. Luxembourg, Cyprus, Malta and the Netherlands).

[51] See for instance: Institute for Advanced Studies (IHS), *Aggressive tax planning indicators*, prepared for the European Commission, DG TAXUD Taxation papers, Working paper No 71, October 2017.

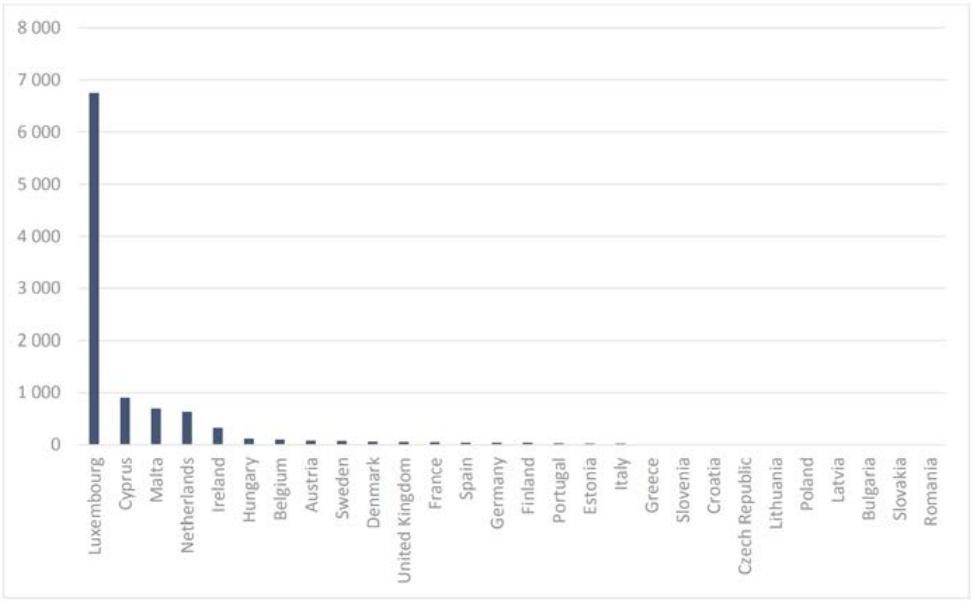
[52] The expression 'lasting interest' is intended as the direct investor owning at least 10% of the voting power of the direct investment enterprise.

Figure 3: Inward foreign direct investment as a percentage of the GDP in 2015



Source: Eurostat (2017).

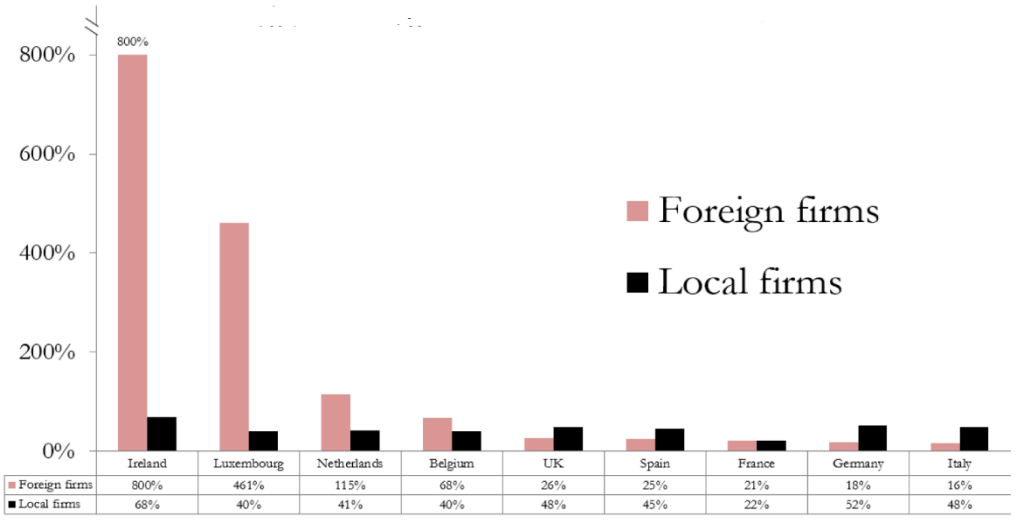
Figure 4: Outward foreign direct investment as a percentage of the GDP in 2015



Source: Eurostat (2017).

The third indicator consists of the **profitability gap between foreign and domestic companies** in a Member State. This shows how in certain jurisdictions the profitability of foreign-controlled companies is systematically higher than the locally-controlled ones.

Figure 5: Pre-tax corporate profits



	Ireland	Luxembourg	Netherlands	Belgium	UK	Spain	France	Germany	Italy
Foreign firms	800%	461%	115%	68%	26%	25%	21%	18%	16%
Local firms	68%	40%	41%	40%	48%	45%	22%	52%	48%

Source: T. Tørsløv, L. Wier and G. Zucman, *The Missing Profits of Nations*, Working paper, July 2018. Mentioned also in I. Kiendl Krišto and E. Thirion, *An overview of shell companies in the European Union*, EPRS Study, October 2018.

From a purely legal point of view, shell companies' users rely on EU fundamental freedoms to run them within the Single Market. In particular, they rely on the **Freedoms of Establishment and to Provide Services**. The first, under Article 52 of the EEC Treaty and Article 49 of the TFEU, facilitates the use of shell companies as it makes it possible to establish a legal entity in one Member State while pursuing economic activities in another Member State. In parallel, the Freedom to Provide Services under Article 56 TFEU makes it possible to carry out an economic activity in another Member State without having a principal or secondary place of business in that state.

These legal privisions are at the **very basis of the Single Market**, but make it possible to put forward false claims as to residence, with the purpose to avoid tax law, social securities and labour law requirements. Although there are several judgements of the European Court of Justice[53] that counter the use of *wholly artificial arrangements* and narrow the scope of application of fundamental freedoms where there is no real economic activity, the safeguard of the functioning of the Single Market is a pivotal point for EU institutions and is in general strongly protected, with the consequence that is often difficult to find a balance which is suitable for combating abuse.

2.4. Notional interest deduction regimes

The concept of notional interest deduction is designed to stimulate the use of equity. It consists of a fictional allowance granted in respect of equity capital that was developed in the 1980s by the Canadian economists Robin Boadway and Niel Bruce[54]. It is also commonly known as **allowance on corporate equity** and its ultimate purpose is to achieve neutrality between the tax treatment of equity and debt, with such fictitious allowance being deductible from the taxable income.

In practice, it allows the taxpayer to reduce his tax base by applying a deduction of **fictitious interest**, calculated on the basis of the share capital. Such deduction, however, does not increase the taxable

[53] The milestone case with regard to this standard is: CJEU, Case C-196/04, 12 September 2006, *Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*.

[54] K. Karainov, *Notional Interest Deduction Regimes in Europe: Through the Prism of ATAD 2 and Domestic Anti-Hybrid Mismatch Rules*, European Taxation, 2019, 479.

income of the shareholder[55]. The effect of a notional interest deduction regime is the reduction of debt financing vis-à-vis a higher equity financing. The mean to reach this result is a **lower effective tax rate**.

The notional interest deduction regimes became increasingly popular among Member States in recent years, in particular due to the ongoing efforts of the Union to limit the growth of the debt bias. They are seen as an efficient tool to increase the **tax competitiveness** of a jurisdiction, both at the European and global level.

To bring one concrete example, **Belgium** was one of the first EU Member States to introduce such a legislation. At the outset, the deemed interest rate was 6.5%, which corresponded to the interest rate of a 10-year government bond. Subsequently, due to the fact that its introduction was a success, the deemed interest to be deducted was constantly decreased. At current days, the fictitious interest rate is -0.092% for tax year 2021 (and even -0.160% for tax year 2022).

Italy introduced such a regime for the first time back in 2011, to the benefit of resident companies and permanent establishments if non-resident companies, which were entitled to deduct from their net tax base a notional interest on newly injected equity. The deductible notional interest rate was set annually by the Ministry of Economics and Finance and was based on the average return on Italian public debt securities. For the period from 2011 to 2013, for example, the percentage was set at 3%. In 2014, it was increased to 4%; in 2015, to 4.5%; and, in 2016, to 4.75%. Finally, after having been cancelled, in 2021 at the rate of 1.5%.

On 25 November 2019, the **Code of Conduct Group (Business Taxation)** released a report to the Council[56], of which Annex II is titled **Guidance on notional interest deduction regimes**[57]. This guidance is based on the whole previous work of the Group and is intended, among others, to help Member States in identifying potentially harmful notional interest deduction regimes. It presents a non-exhaustive list of elements and characteristics which indicate that such a regime may be harmful (when assessed against the criteria of the Code of Conduct). This guidance on notional interest deduction regimes is aimed at assisting Member States that would wish to implement a similar regime to those already assessed as not harmful by the Group.

The notional interest deduction regimes implemented by Member States should have certain limitations in scope and be properly contained by appropriate anti-abuse measures in order to tackle tax-planning opportunities. The first (general) point is the **proportionality** of the measure: as these regimes may differ significantly with respect to the base, the incisiveness of related anti-abuse measures shall be proportional and tailored to the specific case.

More in details, the report provides suggestions on a number of limitations of the scope of these regimes that, if read *a contrario*, provide a (non-exhaustive) list of the characteristics that render them potentially harmful with respect to tax competition within the EU. The potential dangers to tax competition are listed hereinafter:

- the regime attracts equity that is created before the starting date of the regime itself, while its ultimate rational should be to incentivise the creation of additional equity;

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55 K. Karaianov, *Notional Interest Deduction Regimes in Europe: Through the Prism of ATAD 2 and Domestic Anti-Hybrid Mismatch Rules*, European Taxation, 2019, 479.

56 'I/A' ITEM NOTE, From: General Secretariat of the Council, To: Permanent Representatives Committee/Council, Brussels, 25 November 2019 (OR. en) 14114/19 FISC 444 ECOFIN 1005, 33, available at https://data.consilium.europa.eu/doc/document/ST-14114-2019-INIT/en/pdf.

57 See 'I/A' ITEM NOTE, From: General Secretariat of the Council, To: Permanent Representatives Committee/Council, Brussels, 25 November 2019 (OR. en) 14114/19 FISC 444 ECOFIN 1005, 33 etc., available at https://data.consilium.europa.eu/doc/document/ST-14114-2019-INIT/en/pdf.

- the regime does not prevent the possibility for a company to increase its equity and simultaneously subscribe the new shares;
- the regime does not exclude from its scope of applicability the shares held in other resident and non-resident legal persons, with the consequence that there is the possibility to create a cascade effect by 'fictitious' equity injections;
- the regime is applicable even if the deduction results in a tax loss which can be carried forward;
- the regime is applicable to assets that are not strictly necessary for the conduction of business, like for example, luxury goods and artworks; and
- the regime allows the deduction for capital which is allocated to permanent establishments where the profits attributable to permanent establishments are tax exempt.

2.5. Foreign source income exemption regimes

Under a foreign source exemption regime, certain types of income, usually derived from financial activities, like for example participations, are totally or partially exempted from domestic taxation. The ones known as **participation exemptions**, for example, are regimes under which dividends received from a company by shareholders, and potential capital gains arising on the sale of shares, are exempted from taxation.

Provided that the **EU Directive 2011/96/EU**[58] already exempts intra-EU dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes, in general it can be affirmed that the exemption of foreign source income enhances the attractiveness of a jurisdiction as a holding company location.

On 20 May 2019, the **Code of Conduct Group (Business Taxation)** agreed on an **approach to assess foreign source income exemption regimes**. It stated that foreign source income exemption regimes are not, in themselves, problematic[59]. On the contrary, they are even recommendable, in certain cases, to prevent double taxation. Problems arise when such regimes not only prevent double taxation, but also create situations of double-non taxation. This is particularly the case for regimes that have an overly broad definition of the income excluded from taxation, notably foreign source passive income without any conditions or safeguards.

Very little data is publicly available on the magnitude of tax competition based on these types of regime. In the Final Report on Aggressive Tax Planning Indicators[60], released by the European Commission in 2017, an **indicator on treaty shopping** is proposed. Although on the one hand, the attractiveness of a certain jurisdiction in terms of treaty shopping does not automatically result in harmful tax competition, on the other hand, it is an essential element for making a certain jurisdiction a holding company location. A high rate in terms of treaty shopping attractiveness, therefore, can be considered as an indicator of a possible risk that the jurisdiction has a foreign source income exemption regime in place. From the report, which is based on data dating back to the year 2013, the EU Member States with a higher attractiveness are Luxembourg (7.7), Estonia (6.7), the Netherlands (6.6), and Ireland (5.5). In conclusion, it has to be noted that, although these data are quite old, the tax treaty

[58] 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.

[59] 'I/A' ITEM NOTE, From: General Secretariat of the Council, To: Permanent Representatives Committee/Council Subject: *The EU list of non-cooperative jurisdictions for tax purposes*, Brussels, 4 October 2019 (OR. en) 12284/1/19 REV 1 FISC 367 ECOFIN 800.

[60] IHS In consortium with CPB DONDENA, Aggressive tax planning indicators, 2017 final report.

network of a country needs long years to be significantly changed, with the consequence that most of these data are likely to be, at least to a certain extent, still actual.

2.6. Special economic zones

Special economic zones, free trade zones, free zones, industrial parks/zones, and other similar terms are used to describe geographically limited and specially administered areas within a country that are established to attract local and foreign direct investment to enhance trade, employment, and industrial development[61].

The concept of 'free zones' is quite old and dates back to **ancient times**. Along history, several European cities have been 'free ports', like for example, Genoa, Bruges, Hamburg, etc. These were mainly free trade zones. In the second half of the twentieth century, another kind of zone developed: the service-based free economic zone. A free zone is a delimited area where special economic, administrative policy, and deregulation are applied, **which is not granted elsewhere in the jurisdiction**[62]. From 1993 onwards, there is a strong acceleration of the custom activities at the European level. The tax assessment and collection have been reduced, due to both the progressive expansion of the Community territory (because of the accession of new countries) and to the progressive reduction of duties on imports of goods from third countries with respect to the EU, as a result of a general liberalisation of world trade. At present time, the European Union has exclusive competence to legislate in matters of **common trade policy and customs**. This means that also the substantial regulation of the assumptions and methods of application of customs duties falls within the exclusive competence of the European Union[63].

In the EU, the terminology of special economic zones and free zones is also often used interchangeably, which can create some confusion, as free zones are subject to the Union Customs Code. According to the European Commission, free zones are "*enclosed areas within the customs territory of the Union where non-Union goods can be introduced free of import duty, other charges (i.e. taxes) and commercial policy measures*"[64]. According to December 2019 figures, there are more than 70 free zones in the EU, with Croatia having the most free zones[65].

The design of incentives and support instruments depends on the type of special economic zone within which they are developed[66]. They can be briefly divided into two groups:

- 'Classic' free zones: characterised by the exemption of customs duties and, sometimes, of indirect taxes; aimed mainly at promoting international trade.
- 'Exceptional' free zones: characterised by other types of tax relief (direct taxes, local taxes), financial and administrative advantages for companies, economic and social incentives, and institutional arrangements.

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61 See among others, R. De Luca, *Le Zone Economiche Speciali: caratteristiche, agevolazioni, opportunità e aspetti operativi*, Fondazione Nazionale Commercialisti, Roma, 31 gennaio 2017.

62 See also M. G. Vallespinos, *Can the WTO Stop the Race to the Bottom? Tax Competition and the WTO*, Virginia Tax Review, 2020, no. 1, 40, 93-174.

63 See also P. Barabino, *Le Zone Franche Urbane in Italia: un primo risultato dell'esperienza sarda*, Rivista trimestrale di diritto tributario, 2014, fascicolo IV.

64 European Commission, *Free zones*, available at https://ec.europa.eu/taxation_customs/business/customs-procedures/what-is-importation/free-zones_en.

65 Karakas, C., Stamegna, C., Zachariadis, I., *Public economic support in the EU State aid and special economic zones*, European Parliament, EPRS, 2020, available at (https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/646164/EPRS_BRI(2020)646164_EN.pdf).

66 See also I. Kiendl Krišto and E. Thirion, *An overview of shell companies in the European Union*, EPRS Study, October 2018.

These tax advantages were intended to offset the additional costs of carrying out the economic activity of the companies in that region resulting from its **structural disadvantages**[67]. If not properly limited and located, the special economic zones are likely to distort the competition within the Single Market, as the principle underlying economic zones is that they operate as offshore locations, separate from the host economy. This implies that the trade between companies located in the zones and others is 'substantially' treated like import and exports[68].

While state aid is generally prohibited on the basis of Article 107 (1) TFEU, under paragraph 2 of the same article the following 'aids' are to be considered compatible with EU law: (i) aids having a social character granted to individual consumers, provided that it is granted without discrimination derived from origin; and (ii) aids to make good the damage caused by natural disasters or exceptional occurrences. Furthermore, under paragraph 3, the following may be declared compatible with the internal market, among others: (i) measures to promote the economic development of regions where the standard of living is abnormally low or where there is serious underemployment, in view of their structural, economic and social situation (specifically, areas where per capita GDP is below 75% of the EU average); (ii) aids to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest; and (iii) remedies to a serious disturbance in the economy of a Member State[69].

2.7. Tax rulings

A 'tax ruling' can occur in the form of an advance tax ruling (ATR), an advance pricing agreement (APA) or any other 'tax arrangement'[70]. Tax rulings take a position on the divide between public and private law, a vertical and horizontal relationship, the public and individual interest. There is not such a thing as the system of 'tax rulings' within the EU. There are some trends, but in the end, all 'tax rulings' systems differ. Hereinafter, the main features of the different types of tax ruling are summarised[71].

Advance tax rulings within the EU Member States are normally issued either before the transaction has been undertaken, or before a tax return has been submitted for the period covering the transaction (pre-return) – possibly already carried out. They consist of a statement provided by the tax authorities, or an independent council, regarding the tax treatment of a taxpayer with respect to his future transactions and on which he is – to a certain extent – entitled to rely. In other words, an advance tax ruling is an – in principle – binding legal decision, given by the competent authority in accordance with the law, on the application of tax law in a specific situation before any tax consequences occur. The topics on which tax rulings can be delivered could be very broad (personal income tax, corporate income tax, value added tax, …) and for all kind of taxpayers (multinationals, small and medium-sized enterprises, natural persons) or very specific for multinationals only. Some excluded tax matters are tax rates and calculation of taxes, tax declaration, examination and control, evidence, tax assessment, terms, professional secrecy, administrative sanctions, tax increase, etc. Some of these tax matters

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67 For an example, see among others OECD, *Tracking Special Economic Zones in the Western Balkans: Objectives, Features and Key Challenges*, 2017.

68 Mena-OECD, Investment Programme, *Incentives and Free Zones in the MENA Region: A Preliminary Stocktaking*, Working Group 2, available at http://www.oecd.org/mena/competitiveness/36086747.pdf.

69 European Commission, *State Aid, Manual of Procedures*, Publications Office of the European Union, 2013, available at https://ec.europa.eu/competition/state_aid/studies_reports/sa_manproc_en.pdf.

70 E. Van de Velde, *Overview of Existing EU and National Legislation on Topics Covered by TAXE Mandate*, Study for the Directorate General for Internal Policies of the European Parliament, October 2015. See also E. Van de Velde, *The Future of Tax Rulings in the EU: Evaluation, Confrontation and Recommendations*, in J. Vella, E. Van de Velde, R. Luja, *International Taxation and Tax Rulings: Policy Issues at Challenging Times*, Compilation of Notes for the Directorate General for Internal Policies of the European Parliament, 2016.

71 E. Van de Velde, *Overview of Existing EU and National Legislation on Topics Covered by TAXE Mandate*, Study for the Directorate General for Internal Policies of the European Parliament, October 2015.

cannot be in 'advance' of a transaction; others would violate the principles of legality and equality. Moreover, neither exemptions nor reductions are allowed. No taxation, nor exemption or reduction without representation. Advance tax rulings can be cross-border or inbound and the competent authority could be the local or central tax administration.

Advance pricing agreements are arrangements that determine, in advance of controlled transactions**,** how transfer pricing rules will apply on that transaction. Therefore, an appropriate set of criteria for the determination of the transaction price will – according to the arm's length principle – be taken into account (for example method, comparable and appropriate adjustments thereto, critical assumptions as to future events). In other words, an advance pricing agreement will determine (in accordance with the law and the OECD Guidelines) if the transaction price between two related parties within a group is at arm's length compared to the transaction price with an unrelated party. An advance pricing agreement will in advance provide certainty concerning the transfer pricing methodology and therefore simplify or prevent costly and time-consuming tax examinations into the transactions included in the advance pricing agreement. The EU APA Guidelines prescribe the conduct of an advance pricing agreement process. According to these Guidelines, an advance pricing agreement application should typically have four distinct stages: a pre-filing stage/informal application, a formal application, an evaluation and negotiation of the advance pricing agreement and finally a formal agreement[72]. The documentation obligation is very extensive for the taxpayer when applying for an advance pricing agreement.

Other 'tax arrangements' are made – without any specific legal framework – between the taxpayer and the tax administration before a specific transaction takes place or before filing the tax return, or after a tax mediation process, or in court, or within a cooperative compliance procedure, or, within the context of a tax audit. These are the so-called 'informal tax rulings'.

In the past, many tax practitioners had limited consideration of the role of state aid rules, especially in direct taxation. However, the practice of tax rulings can represent harmful tax competition. In 2013, **the European Commission started to test national tax rulings against Article 107 TFEU**[73]. In doing so, the European Commission additionally targeted well-known names such as Apple and Starbucks. The Commission also opened an investigation into the Belgian Excess Profit Ruling system. The positions defended by the Commission gave rise to much discussion. It was argued that the Commission exceeded the limits of its powers. Questions were also raised about the use of the arm's length principle by the Commission in its decisions. Several recovery decisions by the Commission were consequently challenged in the EU courts. In 2019, the first judgments of the General Court appeared. Those judgments had a mixed outcome. In Starbucks[74], the General Court annulled the recovery decision. According to the General Court, the EC had not proven that the tax ruling in question conferred an advantage within the meaning of Article 107 (1) TFEU on Starbucks. On the other hand, the General Court rejected the appeal for annulment in Fiat. In line with the previous judgments, the General Court reiterated in the Apple case[75] that the Commission is competent to review a tax ruling on the basis of

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72 EU APA Guidelines, {SEC(2007) 246}, COM (2007) 71 final.

73 For the following paragraph, see J. Leroy, *Staatssteun en tax rulings: wie ziet nog het bos door de bomen?*, Tijdschrift voor Fiscaal recht 2020, n° 592.

74 Cases T-760/15 and T-636/16, available at https://curia.europa.eu/juris/document/document.jsf?text=starbucks&docid=218101&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=6041272#ctx1.

75 Cases T-778/16 and T-892/16, available at https://curia.europa.eu/juris/document/document.jsf?text=apple&docid=228621&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=6041272#ctx1; Appeal by the European Commission, Case C-465/20 P, available at https://curia.europa.eu/juris/document/document.jsf?text=apple&docid=237178&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=6041272#ctx1.

Article 107 (1) TFEU and can use the arm's length principle in doing so. However, as in the Starbucks case, the Commission failed in fulfilling its heavy burden of proof. The Commission could not prove that the disputed tax rulings conferred an advantage within the meaning of Article 107 (1) TFEU on Apple. Finally, the recovery decision in the Excess Profit Rulings case was also annulled by the General Court. The Commission failed to substantiate its view that the system is an aid scheme.

More recently, the Court also rejected the annulment of the tax rulings granted by Luxembourg to companies in the Engie group[76]. The case relates to the tax advantages granted to some companies within a complex infra-group financing structure. In particular, the Court found that the Commission did not err in law by looking at the combined effect, at the level of the holding companies, of the deductibility of income at the level of a subsidiary and the subsequent exemption of that income at the level of its parent company.

Apart from the state aid procedures of the European Commission, the EU adopted the **Directive on the exchange of information of cross-border tax rulings** in 2015[77]. Does this initiative work in practice and does it reduce harmful tax competition by tax rulings? A very interesting study has been conducted by the **Belgian Court of Audit** ('Rekenhof'). The Belgian Court of Audit reported to the House of Representatives on the audit related to the international automatic exchange of tax information with respect to tax rulings and the country by country reporting[78]. Concerning the exchange of information of cross-border tax rulings, the Court of Audit points out that the main problem with the use of exchanged rulings is that the risk analysis is hampered by the fact that the summaries of the rulings do not contain sufficient qualitative data. In this context, efficient risk analysis remains a difficult task. There are still many working points at the international level to increase data quality. As risk analysis still involves a lot of (time-consuming) manual work, the possibility of using artificial intelligence could be explored. The current risk analysis should therefore be seen as a learning process that is still in full development. In many cases, the summary is insufficiently clear or structured for a proper risk assessment. To overcome this problem, the Court of Audit mentions that a solution must be found at the international level, such as easier access to the full text of the ruling, the use of artificial intelligence, and the development of a search engine. Even if risk analysis is still in its infancy, it should be emphasised that the mere knowledge of the existence of a ruling can in itself constitute very valuable information for the control services. For the time being, there is no central monitoring of the results, which means, among other things, that it is not possible to check whether risk analysis is achieving its objective.

[76] Cases T-516/18 and T-525/18, available at https://curia.europa.eu/juris/document/document.jsf?text=&docid=241187&pageIndex=0&doclang=FR&mode=req&dir=&occ=first&part=1&cid=6041272.

[77] Council Directive (EU) 2015/2376 of 8 December 2015 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, OJ L 332, 18.12.2015.

[78] Court of Audit, Report on the International Exchange of Tax Information, 12 November 2020, available at https://www.ccrek.be/EN/Publications/Fiche.html?id=b45d4d34-391c-4fb2-af2b-0cd4977f4acd, 59-60.

3. GENERAL RECOMMENDATIONS

KEY FINDINGS

This section presents some recommendations to counteract harmful tax competition, dealing with recent challenges. In addition to mainly technical aspects, it also emphasises that an effective policy against such conduct cannot be achieved without a broad political consensus within the European Union.

For some of the proposed solutions, a broad political consensus would also be needed, because their implementation would require changes to the fundamental rules underpinning the European legal order.

3.1. The legal (and political) basis to counter harmful tax competition

It emerged clearly in the previous pages how direct **taxation remains one of the main prerogatives of Member States**. In parallel, it emerged equally clearly how the current EU legal framework is not fully capable to prevent tax competition among Member States that is harmful and distortive.

It seems that the time has come to give the Union stronger powers to combat this phenomenon. On the one hand, therefore, on the basis of the subsidiarity principle it is necessary to leave the Member States free to shape their tax systems according to their needs, economic and social structures, and traditions. On the other hand, there is a need for the European Commission to equip itself to prevent tax measures that could damage the Single Market and, ultimately, **European cohesion**. In fact, the Commission has already a wide experience in challenging harmful tax competition under the state aid rules[79].

From a political point of view, the strategy announced by the European Commission under the Ursula von der Leyen Presidency for the period 2019-2024 includes a number of points which are strictly related to taxation. In particular, the European Green Deal, the building of an economy that works for people and the promotion of the European way of life, are political objectives that cannot be pursued in presence of domestic tax systems that compete with each other unfairly. In fact, the building of the European Union like the one described in this strategy implies the presence of Member States that occupy a central role in public life and have **sufficient funding** to pursue these general interest objectives.

All of which, as already mentioned, seems to have increased dramatically following the crisis caused by the Covid-19 pandemic. The big issues of the economic and social consequences of the pandemic will begin to arise. It is therefore reasonable to expect that preserving our European way of life and values will require a central role for the state in the coming years, starting with good management of European funds from the Recovery Plan, which requires **modern, efficient and well-structured public structures**.

While the philosophical basis for imagining decisive action against harmful tax competition between European Member States seems to be clear and well founded, the same cannot be said for the legal basis. Turning what we have identified above into an acceptable and sound legal standard will be very

[79] See also P. Lampreave, *Harmful Tax Competition and Fiscal State Aid: Two Sides of the Same Coin?*, European Taxation, May 2019, 197.

difficult. **Politically**, this would run up against the objection (of which the analysis is outside the scope of this study) that Member States may currently be the most appropriate dimension to deal with post-pandemic challenges. On the other hand, from a **legal point of view**, even if it is acknowledged that this could be just the right opportunity to bring the European Union to the centre of European citizens' lives, the problem is that the rules governing the European Commission's intervention powers in this field are contained in the Treaties, and therefore difficultly amendable. However, as mentioned in Section 1 of this study, many initiatives have been taken by Directives as secondary EU legislation as well, preliminary announced in Tax Packages and Action Plans, and by monitoring work and follow-up initiatives by the Code of Conduct Group for Business Taxation.

In the conclusive part of the present study, the authors gather some of the most suitable proposals that have been put forward in this field and add some own proposals to consider. The debate around these issues is certainly not new, and there have been discussions for many years, both at academic and civil society level, on how to deal with the issues presented herein.

3.2. Some proposals for post-pandemic sustainable taxation within the EU

3.2.1. The use of Article 116 TFEU to counter market distortions

Article 116 TFEU empowers the European Commission, in cooperation with the Member States involved, to eliminate existing **market distortions**. In May 2017, President Juncker of the EC committed before the Parliament to using Article 116 TFEU to overcome difficulties in achieving unanimity on certain tax files in the Council. Many are stalled there, in particular the proposals for a digital services tax and a common consolidated corporate tax base. In its communication of 15 January 2019, entitled 'Towards a more efficient and democratic decision-making in EU tax policy', the Commission mentioned Article 116, stating that qualified majority voting under the ordinary legislative procedure was possible in order to eliminate distortions of competition due to different tax rules and that the Commission was ready to employ it, should the specific necessity arise[80].

If the European Commission finds that the Market is unduly distorted, it must, in principle, consult the Member State concerned to balance the different interests at stake carefully. If this consultation procedure does not result in the removal of the distortion, and the European Commission is still convinced the distortion needs to be eliminated, the European Commission must submit a **proposal for a directive** (or for any other appropriate measure) under the ordinary legislative procedure (Article 294 TFEU) to the European Parliament and the Council. The use of Article 116 TFEU would be a so-called 'hard law' instrument to counter market distortions.

This procedure requires a **qualified majority**, rather than unanimity which is normally required for decision-making in the field of taxation. In general, this may be seen as a significant advantage in procedural terms, although there seems to be the concrete risk that Member States vote against a Commission anti-distortion proposal requiring elimination of the fiscal regime or a tax rate increase, not because of disagreement with its content, but to avoid the anti-distortion weapon to be turned against themselves in future. The fight against harmful tax competition within the EU would then

[80] European Parliament, Parliamentary question E-001797/2019, available at https://www.europarl.europa.eu/doceo/document/E-8-2019-001797-ASW_EN.html.

become a political battleground and be used as a bargaining chip in relation to other matters of EU competence[81].

Recently, Nouwen described why this market distortion rule does *not* seem appropriate for any far-reaching EU tax integration initiatives, but, according to this author, **it could complement** the diplomatic EU Code of Conduct Group's work, as well as the Commission's use of the state aid rules, in addressing national internal market distorting tax measures and tax ruling practices of Member States[82]. In Nouwen's opinion, Article 116 TFEU is a subsidiary 'safety valve' where other Treaty provisions prove to be inadequate to take away the market distortion, namely Articles 113, 114(2) and 115 TFEU. It affirms that **Article 116 TFEU was never meant to encroach upon the predominance of the Treaty provisions for harmonising national legal and tax systems** which, in most cases, should be used to overcome distortions caused by disparities through EU-wide tax integration[83]. On the contrary: Article 116 TFEU would amount to a residual provision if the possibilities of all other provisions have been exhausted and still market distortions remain which need to be eliminated. He concludes: "*Where a market distortion is too generic in nature, for example, where it is caused by low statuary corporate tax rates, the resulting fiscal disparity will often be too unspecific to be addressed under the market distortion rules (the lex specialis), and can only be addressed under the Treaty harmonisation provisions for harmonising national legal systems (Articles 113, 114 and 115 TFEU; the lex generalis).*"[84]

3.2.2. Reliance on the state aid rules

Where tax competition is implemented by Member States through measures that can be classified as **state aid**, the European Commission already has considerable power to tackle such conducts (as mentioned in Section 2 of this study). The European Commission has strong investigative and decision-making powers. At the heart of these powers lies the **notification** procedure which - except in certain instances - the Member States have to follow.

As this instrument is already in place, it is considered appropriate to suggest that the European Commission makes use of it where circumstances permit. Although the competence for its use lies exclusively with the Commission, it is considered that a **strong political consensus** around its possible action is indispensable and can have positive effects. Member States that affected by harmful tax competition should therefore work to build such a consensus around Commission's actions. The reliance on the state aid rules would be a 'hard law' instrument too. Therefore, it is very important here that the state aid rules are used in the way for which they are actually intended.

3.2.3. Rethinking business taxation in a global and digital economy

It is better to think pre-emptively about adjustments to business taxation. Several initiatives have been launched, but the Corporate Consolidated Corporate Tax Base (CCCTB) is the most famous. This is a project that was re-launched several times by the European Commission. It consists of the establishment of a **single set of rules to calculate companies' taxable profits** in the EU. This project is currently blocked, as there seems to be no political consensus around this initiative.

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81 E. Rivoli, *Harmful Tax Competition – Overcoming Unfair Frugality*, Notre Europe, European Labour and Social Affairs, Policy Paper 225, September 2020.

82 For a deep description of this procedure and an opinion that is contrary to the possibility of relying on this legal basis, see M. Nouwen, *The Market Distortion Provisions of Articles 116-117 TFEU: An Alternative Route to Qualified Majority Voting in Tax Matters?*, Intertax, 2021, 14-28.

83 M. Nouwen, *The Market Distortion Provisions of Articles 116-117 TFEU: An Alternative Route to Qualified Majority Voting in Tax Matters?*, Intertax, 2021, 14.

84 M. Nouwen, *The Market Distortion Provisions of Articles 116-117 TFEU: An Alternative Route to Qualified Majority Voting in Tax Matters?*, Intertax, 2021, 18.

With the CCCTB, cross-border companies would only have to comply with one single EU system for computing their taxable income, rather than many different national rulebooks. Companies may be entitled to file **one single tax return** for all of their EU activities, and offset losses in one Member State against profits in another. The consolidated taxable profits would be shared between the Member States in which the group is active, using an apportionment formula. **Each Member State would tax its share of the profits at its own national tax rate**.

Although a CCCTB would have no impact, for example, on the race to the bottom regarding corporate tax rates, it would eliminate mismatches between national systems, preferential regimes and hidden tax rulings. In addition to an overall reduction of compliance costs, a common set of rules would also allow companies' ability to carry their losses and reduce the distortion caused by the deductibility of interest payments[85]. The adoption of a CCCTB would also give to EU Member States the opportunity to elaborate and include **common and robust anti-abuse measures**, to defend against base erosion and profit shifting to non-EU countries[86].

Another rethinking initiative that is worth mentioning is the in January 2021 published report of the Oxford International Tax Group, entitled **Taxing Profit in a Global Economy**[87]. This book undertakes a fundamental review of the existing international system of taxing business profit. The report evaluates the existing system and a number of alternatives that have been proposed. It argues that the existing system is fundamentally flawed, and that there is a need for radical reform. The key conclusion from the analysis is that there would be significant gains from a reform that moved the system towards taxing profit in the country in which a business made its sales to third parties. That conclusion informs two proposals that are put forward in detail and evaluated: the Residual Profit Allocation by Income and the Destination-based Cash Flow Tax[88].

Finally, reference can be made to the announcement of the **reform of the Code of Conduct for Business Taxation** in the Communication from the EC to the EP and the Council on **Tax Good Governance in the EU and Beyond** of 15 July 2020, and in particular, to a minimum taxation as EU standard embedded in a reformed Code of Conduct: "*The timing of the Code reform must be carefully considered, to ensure that the result is as ambitious and effective as possible. The ongoing international discussions on the reform of corporate taxation, steered by the OECD, could have a major impact on the accepted* ***limits of tax competition in the future****. In particular, if minimum effective taxation becomes a global standard, there will be a new floor on how low countries can go in using their tax rates to attract foreign businesses and investment. This will clearly have to be integrated into the* ***EU's actions on fair tax competition****,* ***within a reformed Code of Conduct****. At the same time, if there is no consensus on* ***minimum taxation*** *at global level, this concept* ***needs to be introduced in the Code as an EU standard, to modernise and clarify the concept of harmful tax competition*** *and to ensure that all businesses pay their fair amount of tax when they generate profits in the Single Market.*"[89]

3.2.4. Rethinking the Code of Conduct in a global and digital economy

It may be clear that the role of the Code of Conduct and the Code of Conduct Group will be important in reducing future harmful (or unfair) tax competition. The work of the Code of Conduct Group has

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85 A. Bénassy-Quéré, A. Trannoy, G. Wolff, *Renforcer l'harmonisation fiscale en Europe*, Notes du conseil d'analyse économique 2014/4 (No 14), 1-12.

86 See also Norad and Open Society Foundations, *Tax Games: the Race to the Bottom*, 2017.

87 M.P. Devereux, A.J. Auerbach, M. Keen, P. Oosterhuis, W. Schön, J. Vella, *Taxing Profit in a Global Economy*, Oxford University Press, 2021.

88 See also J. Vella, *Are we Moving in the Right Direction? Public Disclosure of Information & Other EC/EP Proposals to Reduce Aggressive Tax Planning*, in J. Vella, E. Van de Velde, R. Luja, *International Taxation and Tax Rulings: Policy Issues at Challenging Times*, Compilation of Notes for the Directorate General for Internal Policies of the European Parliament, 2016, 17.

89 Communication from the Commission to the European Parliament and the Council – Communication on Tax Good Governance in the EU and Beyond, Brussels, 15.7.2020 COM(2020) 313 final, 3-4.

been successful and is still desirable in the future. As mentioned, there are plans to reform the Code to be prepared for the future.

The Code is a soft law instrument, that operates on the basis of peer review and peer pressure between Member States. If the tax measure is found to be harmful, the Member State in question must amend or abolish it. Since the Code was established, over 400 tax regimes have been assessed in the EU and around 100 of these were found to be harmful[90]. It has been the basis for assessing third countries in the context of the EU list of non-cooperative tax jurisdictions. Another initiative that has been mentioned in this study is the guidance on notional interest deduction regimes, aimed at assisting Member States that would wish to implement a similar regime to those already assessed as not harmful by the Group. These and other initiatives should be encouraged.

However, **globalisation, digitalisation, the growing role of multinationals in the world economy, the increased importance of intangible assets, and the reduction of barriers for business have all intensified the pressure on states to use taxation to compete for foreign investment**. This has prompted tax competition to escalate and evolve, testing the very parameters of fairness. In this context, both Member States and the European Parliament have questioned rightfully the ability of the Code to tackle contemporary forms of harmful tax competition[91].

3.2.5. Special and urgent attention for the impact of digitalisation

As mentioned in the recommendations above, we are living now in not only a globalised but also digitalised economy. Experts who drafted the Reflections on the EU objectives in addressing aggressive tax planning and harmful tax practices in 2019[92], stressed that a **common EU approach to digital taxation** would address the main gaps identified by several stakeholders. It might also contribute to more uniform tax rules across Member States, as currently several of them have decided to implement their own digital tax, thus creating potential distortions to the functioning of the Single Market.

3.2.6. Enabling administrative capacity building and common supervision

In the past, a strong emphasis has been placed on the relationship between the **enforcement of anti-avoidance rules and a fully administrative capacity**, which is one of the fundamental elements to make them effective. It has been underlined[93] that the EU could provide targeted **technical assistance** based on a detailed assessment of relevant capacity constraints at the national level. Capacity building may for example rely on the **Fiscalis 2020 Programme**, which aims to support administrative cooperation and enhance the administrative capacity of participating countries, as necessary.

In parallel to this capacity building activity, it also seems conceivable to **organise supervision** of the activities of Member States' tax administrations. Without in any way interfering with their decision-making autonomy or the performance of their public functions, one could imagine the presence of European staff in the national tax offices in an advisory and supervisory capacity. A direct relationship with European staff would not only provide a certain moral suasion, but would also allow these staff members to **study and constantly monitor the operational dynamics** of the financial administrations without any mediation (e.g. the criteria for selecting taxpayers to be audited, etc.). This

[90] Communication from the Commission to the European Parliament and the Council – Communication on Tax Good Governance in the EU and Beyond, Brussels, 15.7.2020 COM(2020) 313 final, 3.

[91] Communication from the Commission to the European Parliament and the Council – Communication on Tax Good Governance in the EU and Beyond, Brussels, 15.7.2020 COM(2020) 313 final, 3.

[92] *Reflections on the EU objectives in addressing aggressive tax planning and harmful tax practices* Final Report, written by CEPS for the European Commission, November 2019, 65.

[93] *Reflections on the EU objectives in addressing aggressive tax planning and harmful tax practices* Final Report, written by CEPS for the European Commission, November 2019, 66.

would also allow the EU to collect an invaluable set of data for the development of future tax policies to support the administrative work of the Member States. This recommendation is an administrative tool.

3.2.7. Enhancing and monitoring tax transparency of tax rulings

Tax transparency of tax rulings should be achieved at three levels.

Firstly, over the past few years, more and more EU jurisdictions reformed their **tax rulings procedures** into a more transparent procedure (for example the Netherlands and Luxembourg followed the Belgian example). It should be recommended that more jurisdictions should follow these examples. Of course, the establishment of a common framework at EU level for tax rulings procedures is the ultimate recommendation[94].

Secondly, anonymised summaries of tax rulings should be **publicly available**.

Thirdly, using artificial intelligence should be explored with respect to risk analysis of exchanged cross-border tax rulings between tax administrations. In many cases the summary is insufficiently clear or structured for a proper risk assessment. To overcome this problem, the Belgian Court of Audit for example mentioned that a solution must be found at the EU level, such as easier access to the full text of the ruling, the use of artificial intelligence and the development of a search engine[95]. Hence, a **central monitoring** of an initiative on more transparency of tax rulings that has already been taken on the EU level, is still crucial to push back harmful tax competition by tax rulings.

3.2.8. Providing guidance on Cooperative Compliance Programmes

Combatting harmful tax practices of multinationals by **providing guidance on Cooperative Tax Compliance Programmes** is a final recommendation in this study. The hypothesis reads the more **tax certainty** in the relation between the tax administration and the taxpayer by cooperative tax compliance procedures, the lower the risk on using the 'escape button' of a harmful tax practice.

Since the early 2000s, **Cooperative Compliance Programmes** have emerged through the years in various forms worldwide[96]. Although these programmes generally exhibit comparable characteristics and are built on similar pillars, the precise modalities depend greatly on various factors, such as the organisation of the tax administration, the legal or cultural context, resistance to taxation, etc. This makes for a number of varieties of Cooperative Compliance Programmes, both in guidelines and in practice.

Since the legal underpinning of Cooperative Compliance Programmes will always remain a **Member States' prerogative**, it is the authors' opinion that **a soft law instrument on the EU level** may grant an appreciable level of guidance on a solid framework for cooperative compliance programmes. For example, for the sake of taxpayers' protection, a paragraph could be added in the European Taxpayer's Code. A set of basic rights and obligations may be inserted into this soft law instrument, in order to set

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94 E. Van de Velde, *The Future of Tax Rulings in the EU: Evaluation, Confrontation and Recommendations*, in J. Vella, E. Van de Velde, R. Luja, *International Taxation and Tax Rulings: Policy Issues at Challenging Times*, Compilation of Notes for the Directorate General for Internal Policies of the European Parliament, 2016.

95 Court of Audit, Report on the International Exchange of Tax Information, 12 November 2020, available at https://www.ccrek.be/EN/Publications/Fiche.html?id=b45d4d34-391c-4fb2-af2b-0cd4977f4acd, 59-60.

96 OECD (2013). Co-operative Compliance: A framework – From Enhanced Relationship to Cooperative Compliance, OECD Publishing; J. Leigh Pemberton, A. Majdanska, *Creating a positive Tax Climate for Complex Multijurisdictional Investment Projects* in M. Lang and J. Owens (eds.), *Removing Tax Barriers to China's Belt and Road Initiative*, Alphen aan den Rijn, Kluwer Law International, 2018.

a standard homogeneously endorsed at EU level. Another initiative could be the publication of a for example 'Guidelines on the procedural aspects of Cooperative Compliance Programmes within the EU'.

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The purpose of the present study is to provide a tool for understanding the phenomenon of harmful tax competition within the EU, as well as making an in-depth assessment and proposing solutions. It contains policy recommendations for future EU standards.

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