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Dissecting the EU's Recent Anti-Tax Avoidance Measures: Merits and Problems

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1 Introduction

The profit-shifting activities of multinational enterprises (MNEs) have led to much discussion in various quarters. Whilst the media has largely concentrated on reporting cases where well-known large MNEs have engaged in aggressive tax-planning, the academic discussion has gone well beyond these individual cases by showing that profit-shifting is widespread among all types of MNEs and not solely a very large company phenomenon (although it is likely to be even more severe for these companies).

Even if it clearly takes both opportunity and willingness to engage in profit-shifting, academic scholars and policy makers seem to agree that such activity should mainly be reduced by diminishing the opportunities that exist in the international tax system. The source of companies' opportunities to engage in profit-shifting is widely seen in the disparity between globally operating MNEs and a disjointed international tax system composed of separate tax systems. The enduring nature of this disparity results from the key principles of the current international tax system: source-based taxation of active business income and residence-based taxation of passive income (in combination with a relatively formal residence doctrine); and a separate entity approach which requires arm's-length pricing for intra-MNE transactions. These principles maintain the status quo and provide MNEs with profit-shifting opportunities. In addition, they encourage countries to compete over the tax base by reducing their tax rates, by providing special tax regimes (e.g. patent boxes), or by making separate deals with MNEs.[2]

Due to the nature of the profit-shifting problem, individual countries are incapable of resolving it by themselves, and, therefore, a wider approach is needed. In response and in line with the long discussion on the need for tax coordination[3], both the OECD and the EU have taken an active role

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[2] See Devereux and Vella (2014).

[3] The need to coordinate corporate taxes in Europe has been a subject of discussion for decades. The issues have varied to some extent. The focus of the Ruding Committee (1992) and the European Commission (2001) was on reducing tax obstacles in the single market, while the Code of Conduct Group aimed to address revenue-eroding "harmful tax competition" (European Commission, 1998). More recently the G20/OECD and the EU have moved their focus to profit-shifting by large MNEs.

in the fight against profit-shifting. While the OECD in its Action Plan[4] on Base Erosion and Profit Shifting (BEPS) has provided recommendations on how individual countries should design their tax systems to make them more resilient against profit-shifting, the EU has legislated to reduce the scope for such activity. One central tool in the EU toolbox against profit-shifting activity is the Anti-Tax Avoidance Package (ATAP). In addition to this package the EU has also launched other initiatives including a proposal for a Common Consolidated Corporate Tax Base (CCCTB) and new rules for the taxation of digital services.[5]

The purpose of this report is to provide a dissection of the merits and problems of the recent EU anti-tax avoidance measures, especially those regarding the ATAP. Further, it discusses whether the measures are likely to succeed in their objective in the short or long term. Our findings cast doubt on the success of these measures. This report shows that even if the EU measures reduce the scope for some profit-shifting channels and outweigh the resulting costs for businesses in the form of compliance costs and increased uncertainty due to higher complexity, some problems remain. These can only be fixed by a reform of the key principles of the international tax system.

The report is composed of seven sections. After a discussion of the main profit-shifting channels and their causes in section 2, it provides an analysis of how well the EU measures are targeted in section 3. Section 4 discusses the compliance costs arising from the introduction of these measures and section 5 the stability of the tax system following their introduction. Section 6 provides a short review of alternative approaches and section 7 concludes.

2 Causes and Channels of Profit-Shifting

There are various ways for MNEs to shift profits from high-tax to low-tax jurisdictions. All of them exploit differences between national tax systems, either with respect to the tax rate for a particular type of income or definition differences. The latter allow companies to exploit mismatches in the interplay of separate tax legislations.

However, independently of the manner in which profit-shifting is exercised, it both reduces the overall tax burden of the MNE and redistributes tax revenue between jurisdictions, thereby also providing countries with the incentives to respond. In the following we describe some of the main profit-shifting channels.

Let us first consider two widely known profit-shifting channels that exploit tax rate differences between countries. One of these employs the mispricing of input factors or output within a corporate group. A company in a high-tax country may sell its commodities to another company in the same corporate group in a low-tax country at a price lower than would be the case between

[4] OECD (2013a)

[5] See EC 2016c,d and EC 2018a,b.

unrelated parties (so-called arm's-length pricing). As a result a larger share of profits accrues in the low tax country and the overall profits are taxed at a lower average rate. A particular challenge regarding *transfer (mis)pricing* is that it may be difficult to pinpoint. For instance, evaluating an arm's-length price is a difficult task for a tax authority if the only user of a patent owned by a company in a low-tax country is another company in the same corporate group.

Another widely-known profit-shifting channel is via corporate debt (*debt-shifting*). A company in a low-tax country provides debt to another company in the same corporate group in a high-tax country. Since interest payments can be deducted from the tax base in the high-tax country and are taxed at a lower rate in the low-tax country, the tax burden of the group and in particular of the company in the high-tax country decreases. The same result can also be achieved without internal debt financing by using more (less) external (e.g. bank) financing in the high-tax (low-tax) country.

Let us next focus on the channels that are based on location decisions. The *location of intangible assets* has important implications for the tax burden of the royalty payments and revenues of an MNE. Placing the intangible assets in a country with low tax rates instead of a high-tax country reduces the overall tax burden of the MNE by subjecting its royalty revenues to lower taxation.[6] Further, given the difficulty of determining arm's-length prices for royalties due to the very specific nature of intangible assets, mis-pricing may be a particularly severe problem in this area. While high statutory tax rate countries have not been part of this game, they recently joined in with the introduction of patent box regimes. In addition to the locations of intangible assets, the *headquarters location* also matters for the overall tax burden of an MNE. The lower the tax burden on (repatriated) foreign profits, the higher the incentive to locate in this country.[7]

While all the above profit-shifting means exploit tax rate differences, hybrid mismatch arrangements are another potential profit-shifting channel as they exploit the gaps in the interplay between separate national tax systems. One standard *hybrid mismatch arrangement* exploits the simultaneity of the deductibility of a payment in a payer country and the corresponding payment not being included in the tax base in the payee country (D/NI).[8] Due to this mismatch, the payment may induce double non-taxation, even if the rule (deductibility) that it employs was originally designed for a different purpose, namely to avoid double taxation.

[6] Note that this incentive arises even if the royalty payments are determined by arm's-length pricing.

[7] One particular way in which a special tax regime may arise is from a bilateral deal between an MNE and a government. Even if these arrangements are considered harmful tax practices (Action 5 in the OECD BEPS project; OECD 2015d), they have been observed in several EU countries and have been followed by both investigations and significant media attention: BBC (7.10.2014): Amazon faces European Union tax avoidance investigation; Atlantic (21.10.2015): "Illegal" Tax Deals in the EU: The European Commission says tax advantages the Netherlands gave Starbucks and Luxembourg gave Fiat artificially reduced their tax burdens; New York Times (3.12.2015): E.U. Investigates McDonald's Tax Deal With Luxembourg; Guardian (30.8.2016): Apple ordered to pay €13bn after EU rules Ireland broke state aid laws.

[8] For a more detailed discussion about mismatches, see section 3.1.4.

3 How Well Targeted are the EU Measures?

The ATAP has been designed by the European Commission to help Member States to take coordinated action against the tax avoidance behavior of MNEs and to better align tax payments with value added. A central element in this package is the proposal for the Anti-Tax Avoidance Directive (ATAD), which includes five anti-abuse measures, each of which is designed to tackle a particular observed problem in the current tax system.[9] Together these measures aim to create a minimum level of protection against corporate tax avoidance. In the following we introduce these measures and then discuss the merits and potential problems of each of these in turn.

Table 1 summarizes the design of the ATAP. In addition to separating each of the measures, it also gives the main objective that a particular measure is supposed to achieve.

Table 1: Summary of the Anti-Tax Avoidance Package (ATAP)

		Measure	Target
Anti-Tax Avoidance Package (ATAP)	Anti-Tax Avoidance Directive (ATAD)	Interest Limitation Rule (TCR/IB)	Reduce Debt Shifting Possibilities
		Controlled Foreign Company (CFC) Rule	Reduce Extent of Profit-Shifting Possibilities
		General Anti-Avoidance Rule (GAAR)	Discourage Artificial Arrangements
		Hybrid Mismatch Rule	Reduce Hybrid Mismatch Possibilities
		Exit Taxation	Prevent Valuable Assets from Exiting
	Other measures	Country-by-Country Reporting (CbCR)	Improve Transparency
		Recommendation on Tax Treaties	Address Treaty Abuses
		External Strategy	More Coherent Dealing with Third Countries
		Study on Aggressive Tax Planning	Improve Knowledge

The first measure in the table is the interest limitation rule, which is designed to prevent profit-shifting activities that take place via the debt-shifting channel. This rule restricts the deductibility of interest expenses and similar payments from the tax base and, therefore, reduces the benefit from debt-shifting and makes it less lucrative from the MNE's point of view. The second measure is the controlled foreign company (CFC) rule, which is designed to deter profit-shifting to low-tax countries by giving the right to tax company profits also outside a country's territory. This measure addresses the potential ways of re-allocating profits to low tax jurisdictions. The third ATAD measure may be considered a general backstop for profit-shifting. The general anti-avoidance rule (GAAR) allows EU countries to tackle artificial tax arrangements if they cannot be justified by economic reasons, and if other measures are not able to capture these. The fourth measure, the rule on hybrid mismatches, aims to limit cases where a payment would face double

[9] The ATAD was introduced in a number of steps. First, the Commission presented its proposal for an ATAD as part of the ATAP in January 2016 (European Commission 2016a). Then in June 2016 the Council adopted Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the single market. Following the adoption of the directive, the Commission presented its proposal to complement the existing rule on hybrid mismatches in October 2016 (European Commission 2016b). Council Directive 2017/952 further amended the hybrid mismatch rule to include third countries. There were originally six measures in the ATAD, but the switchover rule included in the original proposal was dropped in the process.

non-taxation resulting from a discontinuous interplay between separate tax systems in different jurisdictions. The remaining ATAD measure, exit taxation, deals with cases where the tax base is shifted within or outside the EU. It is designed to take effect before valuable assets, developed within one jurisdiction, are moved across borders.

In addition to the ATAD, the ATAP also includes the following other elements: (1) Country-by-Country Reporting (CbCR): This rule introduces a reporting requirement for the key tax-related information of MNEs, which aims to increase transparency and provide Member States with the necessary information to detect and prevent tax avoidance schemes. (2) Recommendation on tax treaties: This rule aims to provide Member States with information on how to design their tax treaties in order to restrain aggressive tax-planning in ways that are in line with EU laws. (3) External strategy: This rule aims to provide a coherent way for EU Member States to work with third countries, for instance by creating a common EU list of third countries for tax purposes. (4) Study on aggressive tax planning: This aspect aims to investigate corporate tax rules in Member States that may be prone to aggressive tax-planning strategies.

In the following section 3.1, we discuss each of the ATAD measures in more detail, section 3.2 discusses the CbCR, and section 3.3 provides a brief conclusion.

3.1 Evaluation of the Elements of the ATAD

3.1.1 Interest Limitation Rule

The proposed interest limitation rule in the ATAD, with its potential extensions, very much resembles the current interest limitation rule in Germany, introduced in 2008, which was also the leading model for the OECD proposal (OECD 2015c).

The general rule states that interest expenses in excess of interest income can only be deducted up to 30% of firms' earnings before interest, taxes, depreciation and amortizations (EBITDA). While this general rule has to be implemented in each EU Member State, some details are left to the EU Member States. These concern the introduction of exemptions for some firm types, different rules for corporate groups, rules regarding the transition and the intertemporal application of the rule, e.g. carry-forward and carry-back of financing costs that cannot be deducted and unused interest capacity. In the following, we focus on the main rule and the first two dimensions.

EU Member States may decide to mitigate the broadness of the rule by exempting stand-alone firms. These are firms that are either not part of a consolidated group for financial accounting purposes or corporate groups with less than 3 million euros in net interest expenses. Further, governments may decide to exempt firms that are part of a consolidated group for financial accounting purposes, if the firms' equity over total assets is not lower than the group's equity over total assets less 2 percentage points.

In addition, a firm that is part of a group may be allowed to deduct non-deductible *third party* interest payments in addition to the allowed 30%. The additional deductible financing costs are calculated by determining the ratio of non-deductible interest payments to third parties to the group's EBITDA, and by multiplying the ratio by the firms' EBITDA. This rule is usually referred to as the "group rule". In essence, it ensures that if a domestic corporate group is solely financed by external debt, all interest payments can be deducted.

Complexity of the Regulation due to the Inclusion of External Financing

Given the empirical evidence that multinational groups do not only use internal debt to reduce the tax base in high-tax countries but also proportionally more external debt (e.g. Moen et al. 2012: Buettner et al. 2012), it is reasonable that the proposed regulation focuses on internal as well as external interest payments.

However, while this is likely to increase the effectiveness of the regulation, it also comes at the cost of affecting purely domestic firms – if the regulation is introduced without any exemption for these firms. In the simplest scenario, this is likely to increase only compliance costs and borrowing costs for these firms. In the worst case, the regulation conflicts with national law by violating the so-called objective net principle. Such a case is currently pending before the German Federal Constitutional Court.[10]

Thus, depending on the status of the objective net principle in a particular country, the inclusion of exemptions is less of a choice and is rather mandatory in order to ensure that the regulation can be applied legally. Since an exemption cannot be granted conditionally on a firm being a domestic firm (group) as this would violate EU law, several exemption clauses have been proposed in the Directive. While the exemption of stand-alone companies and corporate groups with less than 3 million euros in net interest expenses does not imply high complexity or compliance costs, it also fails to ensure that all domestic firms with solely external financing can deduct their external interest expenses. Thus the rather complicated group rule has to be enacted as well.

Although the idea of the group rule is promising, it neglects differences in individual firms' debt capacity, which varies greatly by industry, for example. Thus, while the regulation is plausible for corporate groups operating in the same industry, it is less so for groups operating in different industries. While this might be acceptable for domestic groups for which the individual firm tax rates are similar, it opens up room for manoeuvre for international groups. For example, a multinational group has a clear advantage in locating a firm with high external debt capacity (due to it being low-risk, for example) in a low-tax country, and a firm with a low external debt capacity (due to it being high-risk, for example) in a high-tax country as this would ensure a higher amount of deductible external financing costs in the high-tax country.

[10] Press notice of German Supreme Tax Court of 11/02/2016.

Inflexible Fixed Ratio of 30% and De Minimis Threshold of 3 Million Euro

In the OECD proposal for an interest limitation rule, it is left to the introducing country which ratio of interest to EBITDA it chooses, as long as it is between 10 and 30%. While one could argue about the particular range, the focus on 30% seems even more debatable, in particular considering that certain details such as the inclusion of exemptions or the group rule are left to the Member States. Thus, while the OECD proposal acknowledges that the particular ratio is a choice variable which is influenced by the general design chosen (OECD 2015c), the Directive aims to reduce competition between countries with respect to the choice of the ratio but does not consider the exemption clauses to be potential ways for governments to introduce a lax interest limitation rule.

A nationwide ratio has also the disadvantage – even in the absence of competition between countries – that industries are very differently affected. While service industry firms and countries with a strong service industry are less likely to suffer, manufacturing firms and countries with a large manufacturing sector will be hurt more. This is important for a comparison of countries but also within countries as it is likely to affect the allocation of assets and workers across industries.

Related to the inflexible ratio is the optionality to exempt firms from the application of it by introducing a de minimis threshold. In principle, this is a reasonable idea as a de minimis threshold can avoid additional compliance costs for small and medium-sized firms. However, while it should be acknowledged that countries may choose a de minimis threshold of up to 3 million euro, it is unclear why 3 million euro is the upper limit. The optimal threshold depends on several aspects, in particular on the risk of creating a loophole in the rule, the additional compliance costs for businesses due to the rule as well as the costs to government of enforcing the regulation. While it may be the case that for some countries the optimal threshold is below 3 million, it may be above for other countries and would thus force them to make bad choices.

Definition of Group According to Financial Accounting Purposes

The last aspect concerns the definition of corporate groups for the application of the rule, which is based on financial accounting regulation. There are two main aspects: First, determining consolidated groups from a financial accounting perspective relies on the control of companies. While this is certainly a relevant criterion for financial accounting it is not necessarily the right criterion for tax purposes. For example, a parent company that owns less than 50% of the shares of a firm but is entitled to 100% of the firm's profits should probably be considered together with the subsidiary. If not, there is room for manoeuvre limiting the effectiveness of the rule.

Second, a consolidated group for accounting purposes can only exist if the subsidiaries are controlled by another company (or similar entity) and not by an individual or group of individuals. This means that corporate groups that are ultimately held by a few individuals may avoid being subject to the rule by restructuring their group such that either all of the companies within the group are stand-alone companies or the equity ratios are similar within subgroups of firms. The latter point may be avoided by not introducing the stand-alone escape but it would come at the expense of the group rule being the only exemption clause for domestic firms.

All in all, there is a trade-off, introducing more effective rules with a substantial increase of compliance costs and borrowing costs for domestic firms, or a less effective rule with only minor collateral damage. In some countries, this might be less of a choice for politicians as it is mandated by the legal system. Further, even without exemptions the rule is not bulletproof as it assumes that all firms have the same debt capacity. This weakness is bound to be exploited and this will distort the allocation of assets and labor within countries. Finally, while the flexibility of introducing exemptions allows countries to fit the rules into their own tax system, the limits to the flexibility may restrain countries from implementing their optimal choice. While this may be justified by limiting competition between countries, it remains to be seen whether the pure existence of these voluntary exemption clauses is not already enough to allow for competition between countries for the laxest interest limitation rule.

3.1.2 Controlled Foreign Company (CFC) Rule[11]

The final BEPS report on Action 3 did not produce a minimum standard for CFC rules as intended (OECD 2015b). This has been regarded as something of a failure. No consensus was reached and the report instead recommended common approaches and best practices structured in the six building blocks which could be configured to fit various tax systems with their own policy reasons for introducing, maintaining or strengthening CFC regimes, including (i) rules for defining a CFC (including definition of control); (ii) CFC exemptions and threshold requirements; (iii) definition of CFC income; (iv) rules for computing income; (v) rules for attributing income; and (vi) rules to prevent or eliminate double taxation. Following the publication of the OECD's report, there was no sense of major advancement towards a coordinated response in this sensitive area, nor did it create an expectation of a major global shift towards the introduction of CFC rules. A strong message coming from the Action 3 deliverable was quite the opposite. The report confirmed that a "one size fits all" approach to CFC rules may be counterproductive:

> *"Because each country prioritises policy objectives differently, the recommendations provide flexibility to implement CFC rules that combat BEPS in a manner consistent with the policy objectives of the overall tax system and the international legal obligations of the country concerned. In particular, this report recognises that the recommendations must be sufficiently adaptable to comply with EU law, and it sets out possible design options that could be implemented by EU Member States."12*

The EU's decision to press for the introduction of CFC rules by all Member States – where only approximately half of the 28 Member States had CFC rules – was ambitious. The rationale for a harmonized approach was to ensure that unilateral changes do not lead to distortions to the

[11] The authors thank Anzhela Cedelle for valuable comments and insight on this topic.

[12] http://www.oecd-ilibrary.org/docserver/download/2315301e.pdf?expires=1509532030&id=id&accname=guest&checksum=2406298920C34BE62E1EA19500AB97EB

Single Market. There was also a clear need to steer Member State towards a model which would comply with EU law. This point was hotly debated when the Action 3 report was prepared. Another reason for the presence of CFC rules in the ATAD was a competitiveness concern, traditionally amplified in the freedom of movement area, which facilitates transfers of a tax residence with the EU.

It did not come as a surprise that the scope of the CFC rules caused some of the most substantial disagreements between Member States at the stage of negotiations on the draft ATAD, which led to a number of changes being made in the original proposal. The kick-off point for CFC rules has been amended in the process of negotiations: a "low-taxed" status of a subsidiary (or a permanent establishment, PE) was defined with reference to the actual corporate tax paid (i.e. "the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment") and not the effective corporate tax rate as initially proposed by the European Commission.

In a nutshell, the EU CFC rules allow tackling base erosion and profit-shifting by reattributing the income of a low-taxed controlled foreign subsidiary (CFS) to its domestic parent company. The profits of a PE which are not subject to tax or are exempt from tax in the Member State are also within the reach of EU CFC rules. Article 7(2) of the ATAD introduces a general rule that the Member State of the taxpayer shall include in the tax base either:

- Option 1: certain predefined categories of non-distributed (passive) income of CFCs (e.g. interest, royalties, dividends). Option 1 is subject to a further substantive activity test. CFC rules will not apply if the CFC is undertaking "a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances". Member States may choose to refrain from applying the substantive activity test in a third-country context.
- Option 2: the non-distributed income of CFCs arising from "non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage".

A few additional qualifications that allow Member States to limit the scope of CFC rules can be found in Article 4(3)-(4) of the ATAD:

- Under Option 1, Member States may choose not to treat a subsidiary (or a PE) as a CFC if one third or less of its income belongs to the predefined (passive) income categories. Special rules are envisaged for financial undertakings. If one third or less of the predefined (passive) income categories derives from transactions with the taxpayer or its associated enterprises, the Member State may opt not to treat financial undertakings as CFCs.
- Under Option 2, Member States may exclude an entity (or a PE) with accounting profits (i) of no more than EUR 750,000, and non-trading income of no more than EUR 75,000; or (ii) amounting to no more than 10% of its operating costs for the tax period.

Incoherent Application and No Clear Answer to Double Taxation?

While the proposed CFC rules face no legal constraints regarding their application with respect to non-EU Member States, they may be seen as a challenge to the wide-spread belief that CFC rules can only apply between EU Member States as long as they target "wholly artificial arrangements" in order to comply with the landmark Cadbury Schweppes ruling delivered by the Court of Justice of the European Union in 2006.[13] Since the proposed rule seems to set broader parameters, it remains to be seen how these clauses will be interpreted and applied, and whether their application will be different for EU and non-EU Member States.

Further, the proposed rule also fails to deliver clear double-taxation safeguards, not even going as far as recommended by the OECD. This is a disappointing omission, given that whilst it sets rules against tax avoidance, the ATAD is also primarily an EU measure which has to be designed with the interest of the Single Market and the freedom of economic activity in mind.

Significant Variations in EU CFC Regimes Will Remain as Competitiveness Concerns

As to the actual design and reach of the CFC regime, the proposed regulation sets a very wide framework, allowing for significant variations between Member States. By signposting the main directions, it coordinates but cannot be expected to lead to uniform CFC regimes within the EU. From the outset, the Directive provides a choice between two options and then offers several additional optional ways for limiting the material and territorial application of the CFC rules. Since the Directive lays down a minimum standard, Member States are free to introduce a higher level of protection by, for instance, reducing the control threshold (set at 50%) or applying a higher threshold in comparing the actual corporate tax paid with the corporate tax that would have been paid in the Member State of the taxpayer. Further diluting a coordinated approach, the preamble also allows Member States to use "white, grey or black lists of third countries, which are compiled on the basis of certain criteria set out in this Directive and may include the corporate tax rate level, or use white lists of Member States compiled on that basis".

This flexibility in how the regulation will be implemented is a competitiveness concern. Thus, while one may argue for flexibility with respect to the interest limitation rule in order to ensure that states can find the right balance between preventing "harmful" debt financing of MNEs without affecting domestic firms too much, the proposed CFC clearly comes with too much flexibility as it has the advantage that only MNEs will be subject to the regulation.

3.1.3 General Anti-Avoidance Rule (GAAR)[14]

Article 6 of the ATAD provides that Member States should have a general anti-abuse rule (GAAR) "[f]or the purposes of calculating corporate tax liability".

[13] http://curia.europa.eu/juris/liste.jsf?language=fr&num=C-196/04

[14] The authors thank Judith Freedman for the valuable comments and insight on this topic and Alexander Kanishchev for the research assistance.

Most Member States already have either a statutory GAAR or a judicial doctrine or rule that might be thought to satisfy the ATAD GAAR requirements, but this provision brings in any outliers and attempts to create some uniformity of approach. Article 3 of the ATAD makes clear that the Directive does not preclude wider domestic provisions, but domestic provisions narrower than a cross–border GAAR would create problems because such a situation could lead to the cross-border provision being challenged as a restriction of a freedom, which would then have to be a justified and proportionate restriction.[15] At the same time, treating cross-border transactions more leniently than domestic ones could be challenged under State Aid rules.

Further, cross-border GAARs will need to be implemented in such a way that they do not go further than the ATAD GAAR. Treaty freedoms take priority over the Directive.[16] The ATAD GAAR is designed to be compliant with the freedoms by applying only to arrangements that are not genuine, consistent with the interpretation by the Court of Justice of the Treaty freedoms in the Cadbury Schweppes case.[17]

Clearly, despite the limits of the competence of the EU in tax matters, the ATAD GAAR has a potential impact on domestic GAARs. It is hard to imagine that Member States will relish the minefield that could be created if there are differences between their domestic and cross-border GAARs. This means that decisions by the Court of Justice on the application of GAARs are likely to influence decisions on domestic GAARs. In this way, avoidance concepts will be transplanted across the EU.[18] How well this process will work, given the different underlying systems in the various jurisdictions, remains to be seen.[19] Consistent application of GAARs can be difficult even at the domestic level, given the importance of details in these cases, so achieving consistency at EU level is likely to be challenging.

[15] Mitroyanni (2016).

[16] Curtin and Manucharyan (2015).

[17] C-196/04 *Cadbury Schweppes*

[18] On the concept of the "judicial transplant" in a tax avoidance connection, see Garbarino (2009).

[19] Freedman (2011).

Article 6 of the GAAR requires that

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

The wording echoes that in the Parent Subsidiary Directive as amended in January 2015.[20] Commentators have remarked that it is modeled on the abuse of law test developed by the Court of Justice in the *Halifax* case [21], but from a UK perspective the wording of the final ATAD GAAR looks very similar to that found in the UK GAAR, in particular the reference to the "main purpose or one of the main purposes".[22]

The shift from a test of a "sole purpose" or "essential purpose" test as found in the jurisprudence of the Court of Justice to the "main purpose or one of the main purposes" test now contained in the ATAD GAAR seems to have emerged via the OECD's BEPS Action 6, which adopted a principle purpose test.[23] A sole or essential purpose test is narrow and it does not take much ingenuity for a tax planner to find another purpose for transactions.[24] De Broe and Beckers express some concern about the relationship between this test and the Court of Justice jurisprudence on abuse of law, which continues to use the essential purpose test. This they consider more proportionate and presumably it will continue to be the test in cases involving areas other than corporate tax, VAT for example. This threatens the overall coherence of the ATAD GAAR and the general anti-abuse legislation and it will be interesting to see if the Court of Justice attempts any reconciliation.[25]

In the OECD Action 6 principle purpose test and the UK GAAR main objects test, the term is accompanied by a reference to what it is reasonable to conclude, making the test objective. There is no reference to reasonableness in the ATAD GAAR, and the jurisprudence of the Court of Justice suggests this test might introduce an element of subjectivity. If domestic GAARs have no subjectivity, it could be argued that they are wider than the ATAD GAAR, with consequent problems for the freedoms, or the European Court might introduce its own element of

[20] Council Directive 2015/121 of 27 Jan 2015 amending Directive 2011/96/EU

[21] C-255/02 *Halifax*; see de Broe and Beckers (2017).

[22] Part 5 Finance Act 2013

[23] OECD BEPS Action 6 Final; Report (2015).

[24] Freedman (2016).

[25] De Broe and Beckers (2017).

subjectivity as a matter of interpretation, though this would certainly not be in line with the intention of the UK legislation, for example.

Paragraph 2 of the test applies a test that is familiar from Court of Justice case law. The reference to economic reality is considered to be an objective test.[26] Whether domestic provisions that define what may be considered to be abusive more precisely than this rather vague phrase - such as the UK GAAR - would be considered to have implemented this part of the Directive adequately remains to be seen.[27]

3.1.4 Measures Directed against Hybrid Mismatches

The measures directed against hybrid mismatches in the original version of the ATAD (or "ATAD I") are very brief (three lines in total) and are targeted at intra-EU situations. The rules provide that (1) to the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source, and (2) to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

On 29 May 2017, the Council of the European Union adopted Directive 2017/952/EU ("ATAD II") expanding the scope of ATAD I to deal with third countries (i.e. non-EU Member States). This expansion of ATAD II to third countries includes a broader definition of hybrid mismatches, with the result that the definition now covers hybrid permanent establishment ("PE") mismatches, hybrid transfers, imported mismatches, reverse hybrid mismatches as well as dual resident mismatches. Where such mismatches arise, ATAD II requires the Member State involved either to deny deduction of payments, expenses or losses or to include payments as taxable income. With ATAD II, the mismatch outcomes have been extended to include not only double deductions and deductions without inclusions but also non-taxation without inclusion as well as double tax relief at source.

Measures directed against hybrid mismatches raise a number of policy issues, but the discussion that follows below will focus on what are considered to be three matters of particular importance.

Complexity

Despite being the briefest measures in ATAD I, and notwithstanding the simplicity of the propositions reflected in the rules, the enactment of anti-hybrid rules in practice inevitably leads to inordinately complex rules. The position is reflected in the very lengthy (in excess of 450 pages) final report on hybrid mismatches in the OECD's BEPS project.[28] There are various sources of

[26] Moreno (2016).

[27] On the inadequacy of economic reality as a test, see Freedman (2016) above.

[28] OECD (2015a).

complexity in practice given that the application of the rule will typically depend on the treatment of payments in two (or more) jurisdictions and will require precise rules dealing with timing issues, the treatment of rules for taxing and relieving payments according to different bases, etc.

This complexity is significant for two main reasons. First, it is important as a stand-alone matter because of the number of difficult issues it raises. Second, it is important in the context of the two further issues that are raised below, given that the inordinate complexity of anti-hybrid rules adds additional weight to the significance of those two points.

On the first point, the deep complexity of the rules clearly raises questions about the ability of taxpayers to deliver, and tax authorities to police, full compliance with the rules. The inevitable complexity, coupled with the approach of ATAD of leaving enactment standards to Member States, also raises the further question of possible double taxation. It is expressly recognized in ATAD I that double tax creates an obstacle to the functioning of the market.[29] However, with highly complex rules such as those required to deal with hybrid mismatches, the risk of overlaps from one state to another is likely to be increased, potentially leading to such double taxation. A further difficulty with the approach of leaving highly complex rules to the individual Member States is that the intended uniformity of the response from state to state, which is emphasized as a major goal in ATAD I,[30] becomes appreciably harder to deliver in practice. This point is relevant to both the framing and scope of the rules and the arrangements and standards adopted to police the application of the rules.

Absence of Carve-out for Non-abuse

As the Directive rightly recognizes, hybrid mismatch arrangements are often adopted by taxpayers as a result of a desire to implement aggressive tax planning goals.[31] However, this is not the same as saying that hybrid mismatch arrangements are inevitably or always the product of such aggressive tax planning goals. In some cases, there might be entirely non-tax drivers to the use of such arrangements. In others, there may be tax objectives where tax avoidance is neither the goal nor the result. For example, in adopting a hybrid arrangement, a taxpayer may have the objective of ensuring the application of a single home tax regime under which all income is taxed and all costs are deductible and in such a case it might be that the hybrid arrangement has the effect of avoiding what might otherwise amount to stranded costs or income. There may also be cases where the hybrid arrangement is caused by the entirely legitimate policy choices of individual states and have nothing to do with individual taxpayers. For example, in dealing with substitute dividend payments that arise under stock loans, repos and similar arrangements, one

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[29] ATAD I, L193/2, recital (5)

[30] See for example, ATAD I, at L 193/2, recital (2) and L 193/5, recital (16).

[31] The role of hybrid mismatch arrangements has been discussed extensively in recent years. For example, it was a central theme of the European Commission consultation in 2012 on double non-taxation and the topic has also been considered on a number of occasions by the OECD – see, for example OECD (2010) and OECD (2011), leading to the report on hybrid mismatch arrangements, OECD (2012).

state may choose to assimilate payments and receipts of such payments to the treatment of the real dividends that have been foregone whilst another state may choose to treat such payments as simple compensation expenses. It is recognized that the incidence of such cases may be debated. However, the key point here is that whilst the Directive recognizes that hybrid mismatches are often the product of aggressive tax avoidance, it then proceeds as if this were always the case. It is not considered that this is correct for the reasons stated above. For that reason, it is considered that the absence of any carve-out from the rules in cases where it can be demonstrated that there is no aggressive tax avoidance objective is considered a policy failure of the hybrid mismatch rules.

Focus on Hybrid Mismatches in Concept

The exclusive focus of the hybrid mismatch proposals in ATAD I, and much of the discussion to date on the topic of hybrid mismatches, has been concerned with the two cases of hybrid arrangements involving deductible payments which are not taxed on the one hand and cases of double deductions on the other. In the case of the former (also referred to frequently as deduction/non-inclusion or "D/NI" cases), the hybridity is relevant precisely because it is assumed to deliver a non-taxable receipt. This suggests that the concept behind the D/NI approach is to deal with cases where there is a deduction but no corresponding taxation of the relevant income. However, there are - and will remain - very many cases where deductible payments are either not taxed at all or taxed at a very low rate in the hands of the recipient. Most obviously, a common example would be payments made to a company in a state subject to a no- or low-tax regime. It is not apparent what the conceptual rationale is for selecting hybrid mismatch D/NI arrangements for corrective tax treatment whilst not applying a similar approach to other cases which in effect also amount to D/NI outcomes. This point is all the more significant in the light of the two preceding points already mentioned above. A consequence of the situation is that it is to be expected that taxpayers wishing to achieve aggressive tax planning goals (and who have been using hybrid mismatch arrangements) are likely to migrate to alternative arrangements that avoid the now-specifically targeted hybrid mismatch rules. On the other hand, taxpayers who have been using hybrid mismatch arrangements other than for aggressive tax planning purposes may well find themselves inadvertently caught up in the application of these rules.[32]

3.1.5 Exit Tax[33]

The ATAD introduces a common minimum level of protection against the erosion of tax bases of EU Member States and the shifting of profits out of the Single Market. Although the Directive has been presented as an EU response to the OECD's BEPS Action Plan, the measures contained in it are not limited to implementing the outputs of the 15 Action Items. Article 5 of the ATAD that laid

[32] These comments are not relevant to cases of hybrid mismatches involving double deductions, though it may be observed that such cases could be addressed by specifically targeted measures and such measures might be considerably simpler than those proposed under the hybrid mismatch approach, as in the proposals of the OECD.

[33] The authors thank Anzhela Cedelle for the valuable comments and insight on this topic.

down common exit tax rules for EU Member States is one of two such extra measures – along with the GAAR (discussed in section 3.1.3 above) – implementing the EU's own policy measures.

The function of exit taxes is to ensure that if a taxpayer decides to move assets or its tax residence to another tax jurisdiction, the "home" state can tax the economic value of any unrealized capital gain generated within its tax jurisdiction. Already in 2006, the European Commission acknowledged that "[e]xit taxation is a prime example of an area where Member States could benefit from coordination at EU level" and expressed its willingness to assist Member States in developing a coordinated approach.[34] A non-binding Council resolution on co-ordinating exit taxation was adopted in 2008.[35] Exit tax provisions also appeared in the EU's proposal on the CCCTB.

Article 5 of the ATAD offers a co-ordinated EU approach and codifies a rich case law of the Court of Justice of the European Union that has evolved since the *National Grid Indus* ruling (2011).[36] The ATAD follows the Court's footsteps in its approach but covers a broader scope of circumstances. Many Member States already impose an exit charge along the lines of the rules proposed by the ATAD and therefore this new provision will trigger only small-scale adjustments. In those jurisdictions where more limited rules apply, the ATAD – once transposed – will introduce a lock-in effect which will bite particularly sharply if the transfer involves a non-EU/EEA country.[37]

Under the new rules, EU Member States will levy tax on certain cross-border transfers of assets, tax residence or business carried out by the permanent establishment (PE) within the EU or in the third-country context. A taxpayer becomes subject to exit tax when transferring (i) assets from its head office (HO) to a foreign PE; (ii) assets from a PE in a Member State to a foreign HO or PE; (iii) its tax residence to another country; or (iv) business carried on by its PE in a Member State to another country – all in so far as the Member State of exit loses the right to tax due to the transfer. Where no exit tax exists at the moment, it would have to be introduced to protect the tax bases of EU Member States from erosion. This also means creating an impediment to free movement within the Single Market. Certain concessions are made for intra-EU movements in order to respect freedom of movement under EU law.

[34] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52006DC0825

[35] http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2016412%202008%20INIT

[36] Case C-371/10 *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, ECLI:EU:C:2011:785); see also Case C-38/10 *Commission v Portugal*, ECLI:EU:C:2012:521; Case C-269/09 *Commission v Spain*, ECLI:EU:C:2012:439; Case C-301/11 *Commission v Netherlands*, ECLI:EU:C:2013:47; Case C-64/11 *Commission v Spain*, ECLI:EU:C:2013:264; Case C-261/11 *Commission v Denmark*, ECLI:EU:C:2013:480; Case C-164/12 *DMC*, ECLI:EU:C:2014:20; Case C-657/13 *Verder LabTec*, ECLI:EU:C:2015:331.

[37] European Economic Area, EEA.

Codification of Case Law with a Twist

The ATAD secures the right of a taxpayer to defer the payment of an exit tax for transfers within the EU or the EEA.[38] It is settled case law of the Court of Justice of the European Union that taxpayers should be provided with a choice to (i) either immediately pay the amount of tax due upon exit, or (ii) defer payment by paying it in instalments over a certain number of years. Such deferral may be subject to interest charges.[39] In certain circumstances, where there is "a demonstrable and actual risk of non-recovery", the provision of a guarantee may also be considered.

The ATAD provides for a five-year deferral. From the outset, this solution is consistent with existing case law where recovery of tax on unrealized capital gains spread over five annual instalments, instead of immediate recovery, was considered to be a proportionate measure.[40] The ATAD will thus ensure that the option of deferral is consistently offered through the EU, especially where Member States have been slow in amending their respective laws. However, the question arises as to whether Member States can be more generous and provide for a longer deferral. If Article 5(2) of the ATAD is interpreted against its declared protective objectives, it would seem to set the ceiling in that no more than five years should be given. If such an interpretation is adopted, the Directive will constrain the ability of governments to offer a more generous deferral within the EU and may – in certain circumstances – enhance fiscal barriers within the Single Market.

Solving a Double Tax Puzzle

The tax shall be levied at an amount equal to "the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes" (Article 5(1) ATAD). The "receiving" Member States must accept the value of the assets established by the "home" state for tax purposes unless this value does not reflect "market value" (i.e. "the amount for which an asset can be exchanged or mutual obligations can be settled between willing unrelated buyers and sellers in a direct transaction"). In the event of conflict, Member States could resort to existing dispute resolution mechanisms. Taxpayers therefore may face the risk of double taxation or at least a prolonged dispute on the value of assets.

Postponed Transposition Deadline

Article 11 of the ATAD sets out a general rule that Member States shall transpose the ATAD into their national laws, regulations and administrative provisions by 31 December 2018. Those

[38] If they have concluded an agreement with the Member State of the taxpayer or with the Union on mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Council Directive 2010/24/EU (14).

[39] Case C-371/10 *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, ECLI:EU:C:2011:785); see also Case C-38/10 *Commission v Portugal*, ECLI:EU:C:2012:521; Case C-269/09 *Commission v Spain*, ECLI:EU:C:2012:439; Case C-301/11 *Commission v Netherlands*, ECLI:EU:C:2013:47; Case C-64/11 *Commission v Spain*, ECLI:EU:C:2013:264; Case C-261/11 *Commission v Denmark*, ECLI:EU:C:2013:480; Case C-164/12 *DMC*, ECLI:EU:C:2014:20; Case C-657/13 *Verder LabTec*, ECLI:EU:C:2015:331.

[40] Case C-164/12 *DMC*, ECLI:EU:C:2014:20, paragraph 64.

provisions shall take effect from 1 January 2019. However, a special derogation is envisaged in relation to Article 5 of the ATAD: the transposition shall be completed by 31 December 2019, with the provisions entering into force by 1 January 2020. This delay may potentially undermine the effectiveness of the exit tax rule: it creates a generous window for taxpayers to adjust their corporate structures and location of assets.

3.2 Public Country-by-Country Reporting (CbCR)

The ATAP not only proposes the introduction of anti-avoidance rules but also aims to prevent profit-shifting by introducing public Country-by-Country Reporting (CbCR) through an amendment of the European Accounting Directive.[41] The proposal builds on Action plan 13 of the OECD initiative against BEPS (OECD 2015e) but goes beyond the initial OECD proposal in that it requires MNEs to publicly disclose the information rather than confidentially reporting it to national tax authorities. The current version of the Commission proposal, which was revised by the European Parliament in July 2017, requires all EU parent companies with a consolidated revenue of more than EUR 750 million as well as subsidiaries of non-EU companies with a consolidated revenue above this threshold to annually publish relevant information, both on their webpage and in a public register of the European Commission. The required information includes a list of all subsidiaries, the pre-tax profit, cash taxes paid, the amount of stated capital, the number of employees and several other details. All of these items have to be attributed to the individual taxing territories in which the reporting company is operating.

The proposal is motivated by recent revelations about tax planning strategies by MNEs, which has led to strong criticism on how these entities are monitored. A particular concern is that, while leading to potentially large losses of government revenue, many arrangements for tax avoidance may go unnoticed by the public. Increasing transparency is perceived as an apparent solution to this problem.

In order to assess the role of CbCR for the international tax system, it is helpful to compare the costs and benefits of such a proposal. The main benefit of CbCR that has been put forward by its proponents is that these reports may provide valuable information on corporate tax planning to tax authorities, the public and other market participants. CbCR does not need to be public in order to inform tax authorities. This is reflected in the proposal for confidential CbCR and the subsequent exchange of information of the reports between tax authorities according to the OECD BEPS Action 13 (OECD 2015e), which has already been implemented in the EU.[42] Mandatory exchange of tax information across borders could in fact help tax authorities to uncover dubious tax avoidance practices that may either be tackled by improving enforcement or by adjusting tax policy accordingly.

[41] See COM(2016) 198: Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches, 12 April 2016.

[42] Council Directive 2016/881 of May 2016, amending the Directive on Administrative Cooperation in the Field of Taxation (Directive 2011/16).

A potential benefit of informing the wider public about the tax-planning strategies of companies is that public scrutiny may induce MNEs to refrain from engaging in aggressive tax-planning, in particular those companies with a strong consumer orientation. In fact, empirical evidence suggests that public pressure may reduce corporate tax avoidance (Dyreng et al. 2016). However, it remains to be seen whether this immediate effect prevails in the long run. Experience from the publication of tax payments by large companies in Australia (documented in Hoopes et al. 2017) shows that public attention may quickly fade. Investors in the capital markets are likely to be a more rigorous audience. They dislike potential risks arising from questionable tax avoidance practices, and empirical evidence suggests that this is often reflected in the valuation of public companies (e.g. Hanlon and Slemrod 2009; Desai and Dharmapala 2009; Kim et al. 2011). However, more recent evidence also shows that investors may react positively to the revelation of corporate tax avoidance (e.g. Goh et al. 2016; Huesecken et al. 2017; Nesbitt et al. 2017), probably indicating that a company's tax-planning also bears fruit for its shareholders. Thus, while investors are likely to value additional information on corporate tax-planning, it is not certain that this necessarily incentivizes firms to reduce tax avoidance.

Further, even if additional information for the public and tax authorities reduces tax-planning incentives for MNEs, an important prerequisite for this would be that the information provided by public CbCR in the EU is actually timely and useful. This is questionable in the case of the current CbCR proposal. For instance, it requires firms to report cash taxes paid, which, on its own, is not informative about the company's actual tax liability in that year because firms may defer tax payments. Furthermore, the suggested CbCR items do not contain information on cross-border interest or royalty payments which would be important for identifying particular profit-shifting channels employed by the company such as debt-shifting or the reallocation of intangible assets. The existence of different tax accounting systems in the EU in combination with a substantial degree of discretion for firms with regard to the quality of the reports they submit further reduce the informational value of the proposed CbCR.[43] A general conceptual flaw of CbCR is that there is no benchmark against which to evaluate corporate tax payments in a particular jurisdiction (Evers et al. 2017; Schreiber and Voget 2017). The OECD argues that the level of taxation in a given location should be proportional to the economic activity there. However, in a world of increased atomization, complex international production chains and knowledge-intensive economies it is hard to pin down an exact definition of economic activity. In fact, various concepts coexist, referring, for instance, to the level of labor or capital employment, the value creation or the sales volume of a firm in a particular location. Thus, even if CbCR is informative, it leaves substantial room for interpretation as to whether the observed behavior constitutes tax avoidance.

When it comes to the costs side, two dimensions should be considered, and both of them are borne by MNEs. The first dimension captures compliance costs (e.g. the costs of preparing the

[43] In addition, the current proposal allows governments to temporarily exempt firms from reporting individual items upon application if the publication of this information would be "seriously prejudicial" to the commercial position of the firm. This may also decrease the overall usefulness of CbCR information.

required information). Overall, however, the magnitude is likely to be small as MNEs could usually rely on experienced accounting departments with international experience and draw on accounting information that already exists within the firm.

The second cost dimension captures unjustified reputation losses of firms that could arise from a misguided interpretation of the CbCR information. Given that CbCR is explicitly targeted at a wider public audience which may be unfamiliar with tax reporting standards, this concern appears realistic. However, for this to hurt the affected companies, there needs to be both a strong public reaction and a substantial impact of this reaction on firm valuation. As mentioned above, the empirical evidence for both aspects is mixed. With regard to the costs of CbCR, it appears that these are generally manageable. Substantiated empirical evidence is not available at this point, but previous implementations of CbCR for certain sectors (e.g. extractive industries) have not been reflected in conventional measures of the administrative burden of tax compliance (e.g. the World Bank's Doing Business Index). [44]

On the whole, there seems to be a range of problems with CbCR which have yet to be resolved. While the costs are likely to be limited, it is uncertain that the current EU proposal will actually generate benefits in the form of increased transparency and a decrease in corporate tax avoidance. Key challenges include the establishment of CbCR requirements leading to comparable reports across countries, the targeting of the required information towards well-known profit-shifting channels, and the development of a conceptual framework in which to evaluate the information obtained from CbCR. In the current version of the EU proposal, its main benefit may be that it incentivizes firms, which perceive it as a credible threat despite its problems, to adjust their behavior in order to avoid further scrutiny. However, this adjustment is unlikely to be sustainable if companies realize the deficiencies of the proposal.

3.3 Conclusions

Summing up, all the measures have the potential to prevent profit-shifting opportunities for MNEs but they also have potentially substantial downsides. First, all of the proposed anti-avoidance regulations increase the complexity of the tax system and compliance costs for MNEs and potentially also for non-MNEs. Second, the regulations may lead to double taxation - this is particularly relevant for the CFC, GAAR and interest limitation rule, although it can be alleviated for the latter by allowing carry-forward and carry-back of non-deductible interest expenses. Third, while the CFC regulation leaves many important details to Member States, and thus may encourage harmful competition between countries, GAAR and the interest limitation rule seem to come with inadequate degrees of freedom. For the GAAR, this has implications for the application of domestic GAARs; for the interest limitation rule it may mean that the rule cannot be introduced such that it always creates a net benefit. Fourth, the rule on hybrid mismatches and the interest limitation rule have the potential to restrict non-harmful behavior, while the

[44] Somewhat related to reputation losses due to misguided interpretation is whether the publication of the required information constitutes a violation of trade secrecy that effectively harms a company's competitiveness (see Cockfield and MacArthur 2015).

interest limitation rule may be introduced with several additional exemptions for some firm types; this is not possible for hybrid mismatches.

Overall, it thus comes down to whether the benefits of introducing these measures exceed their costs. While some cost elements cannot be quantified at all, others, such as compliance costs, can. The next section aims to provide some evidence of their role. Further, besides the current benefits, the question remains whether the ATAP is capable of providing a tax system that is stable in the long run. This question is considered in section 5.

4 Compliance Cost

All the measures in the ATAD are anti-avoidance rules and thus share the feature that they would not replace existing rules in the international tax system but rather complement them. It is thus not only important to assess whether the proposed rules do prevent harmful tax avoidance but also at what cost, and to recognize that costs also arise for non-targeted companies. While purely domestic companies are not subject to some rules due to their nature, e.g. transfer pricing or CFC rules, others such as the interest limitation rule, which focuses on internal and external interest payments, do affect domestic companies as well. Further, these rules are becoming increasingly complex. In the UK, for example, the interest limitation rule based on the OECD proposal was implemented by adding 156 pages of primary legislation and almost 500 pages of guidance (Collier 2017). Introducing an interest limitation rule is thus very likely to increase tax compliance costs for domestic firms and, due to the increase in the complexity of the tax code, uncertainty about taxation.[45] Both tax complexity and tax uncertainty depress economic activity and may thus outweigh the benefit of less tax avoidance.[46]

Due to a lack of reliable firm-specific information on compliance costs, quantifying these costs is challenging.[47] Probably the most accurate data on compliance costs for companies on a country level is the time in hours per year spent to prepare the tax returns for a fictive, standardized, mid-sized company in a particular country, which is provided by the World Bank.[48] The tax returns include corporate income tax, sales tax and labor taxes (including payroll taxes and social security contributions). Importantly, due to the nature of the company, the company does not

[45] The underlying argument is that administrative costs and compliance costs are lower if the tax system is simpler (see for example Shaw et al. 2008, page 20).

[46] Edminston et al. (2003) study the impact of complexity and tax uncertainty on FDI for 25 transition countries between 1993 and 2008 and find a negative correlation with FDI inflow. They measure tax complexity by the number of tax rates and the number of lines used for describing the tax base. Djankov et al. (2010) and Mueller and Voget (2012) both use the World Bank measure. Djankov et al. (2010) investigate the impact of tax complexity on country-level FDI in 2004, while Mueller and Voget (2012) investigate its impact on firm-level FDI, exploiting variation over time. This allows other time-invariant country characteristics to be controlled for. Mueller and Voget (2012) find a negative and statistically significant impact of tax complexity on firm-level FDI.

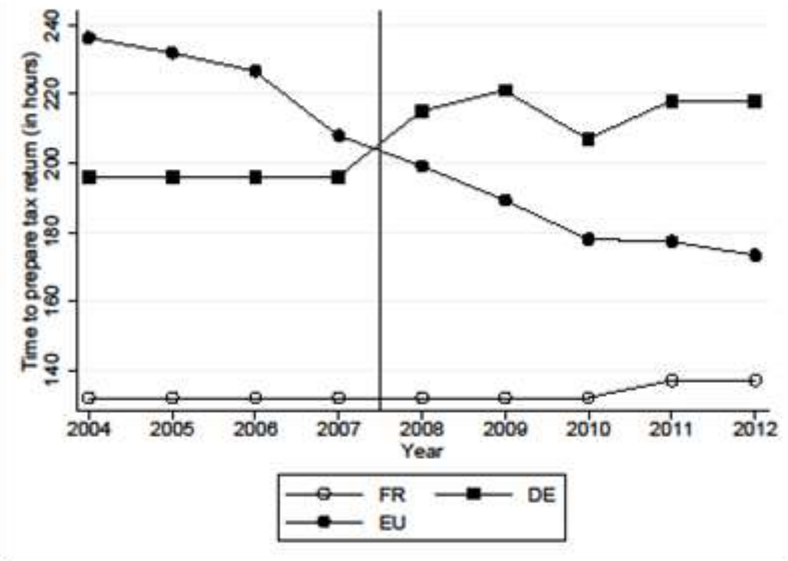
[47] For a recent overview of different methodologies, see European Commission (2013).

[48] The financial statements of the fictive company are handed to tax experts in each country, who compute the taxes and mandatory contributions, report the time spent as well as some survey questions. For more information see http://www.doingbusiness.org/methodology/paying-taxes and Djankov et al. (2010).

engage in profit-shifting activities and thus represents a non-targeted business. The reader should be aware that the compliance cost measure does not include the one-off time of getting familiar with the tax code but only the burden of preparing and submitting the information requested by tax authorities. Figure 1 shows the evolution of the average time to prepare tax returns for the EU 27 Member States (black dots). Further, it plots the average time for Germany (black rectangle) and France (dots). The average time to prepare tax returns in Germany increases after 2007, while it decreases in the EU on average and stays constant for France. The increase in Germany coincides with the implementation of the corporate tax reform in 2008, which introduced several anti-avoidance measures such as the well-known German interest limitation rule, which is very similar to both the OECD and the EU proposals.

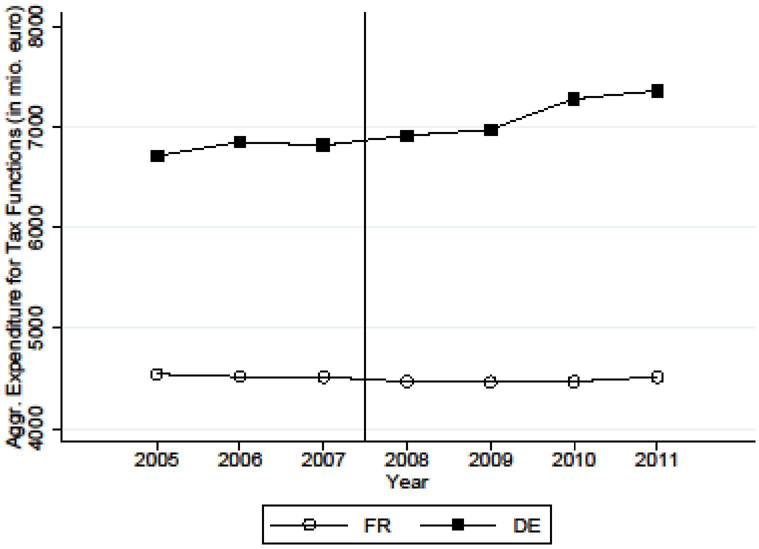
A very similar picture emerges when looking at aggregated expenditures on tax collection (not only for businesses but in general) in Germany compared to France. The data is provided by the OECD (2013) and is shown in Figure 2. Aggregated expenditures remained fairly constant in

Figure 1 Time to Prepare Corporate Tax Return in Germany, France and the EU Member States



France, while expenditures increased in Germany after 2008 but with a delay, which is nonetheless not implausible given that tax returns are submitted the following year. Although there are several other factors which may explain the increase in compliance costs and the costs of tax collection, part of the increase in compliance costs is likely to result from the introduction of anti-avoidance rules.

Figure 2: Aggregated Expenditures on Tax Collection in Germany and France

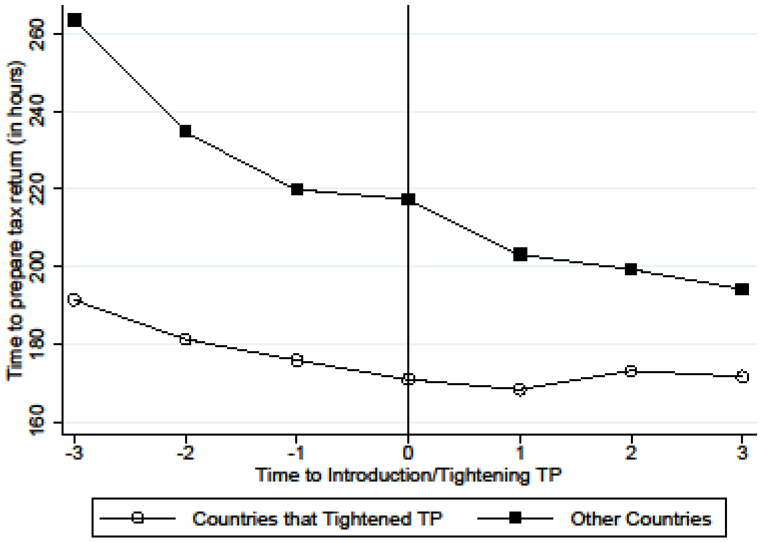


To illustrate the differences between anti-avoidance rules that are also likely to affect non-targeted companies and more targeted rules, we inspect whether introducing or tightening transfer-pricing rules has a similar effect on the time taken to prepare tax returns.[49] Several EU countries have either introduced explicit transfer-pricing rules or tightened them.[50] Since the date of introduction differs, Figure 3 plots the average time taken to prepare tax returns for countries that tightened their transfer pricing regulations with respect to the year of introduction. Other countries serve as a counterfactual. There is no obvious spike in the time taken to prepare returns in counties after they tightened their transfer-pricing rules. This is not surprising as transfer-pricing rules only affect companies that engage in cross-border trade with related parties, which is less likely to be relevant for the hypothetical, mid-sized company.

[49] These countries are Croatia, Denmark, Finland, Greece, Ireland, Luxembourg, Slovenia and Spain.

[50] The data was provided by Lohse and Riedel (2013) and Mescall and Klassen (2014). We defined tightening of a transfer-pricing rule as meaning that the transfer-pricing indicator developed by Mescall and Klassen (2014) increased by more than 1.

Figure 3: Time Taken to Prepare Corporate Tax Return in Countries that Tightened their Transfer-Pricing Rules

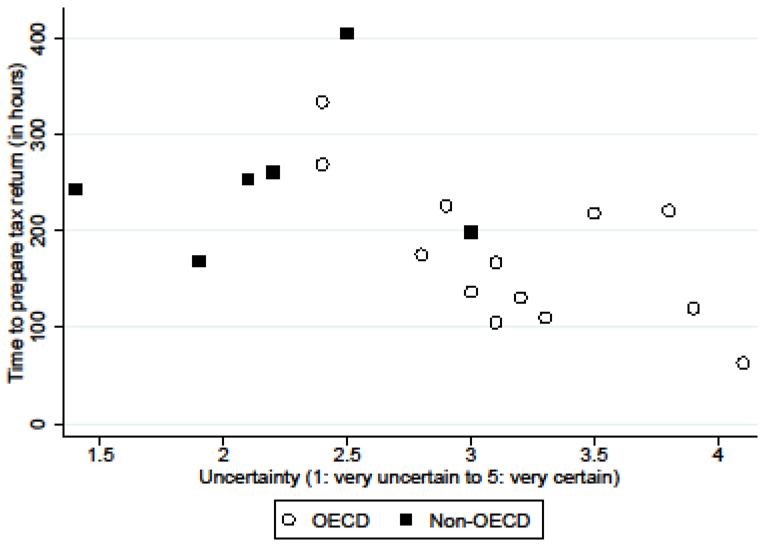


As well as the increase in compliance costs, rather general anti-avoidance rules may increase tax uncertainty. Figure 4 illustrates the relationship between tax uncertainty and time taken to prepare tax returns. The tax uncertainty measure stems from a survey of senior tax professionals in large businesses and professional firms.[51] Roughly 90 respondents answered questions about tax uncertainty in 25 major countries. While there is no clear relationship between tax uncertainty and the time taken to prepare tax returns in non-OECD countries, there is a negative relationship for OECD countries. Thus, less time taken to prepare tax returns is associated with lower uncertainty about tax in a particular country.

To conclude, even if the proposed rules are effective in preventing base erosion they might not be beneficial for the whole economy if the collateral damage in the form of increased compliance costs and tax uncertainty for non-targeted companies outweighs the benefits.

[51] For more information, see Devereux (2016).

Figure 4: Tax Uncertainty and Time to Prepare Tax Returns in Selected Countries



5 Stability of the Post-ATAP Corporate Tax System

Although the benefits and costs associated with ATAP are important for how we assess its success, there are also other relevant issues. One important one is whether the anti-tax avoidance measures introduced in the ATAP will be able to provide the EU with a stable corporate tax system. By stability we mean a tax system that gives neither firms nor countries harmful incentives which would require continuous adjustments to keep the rules competitive and functional and to avoid the erosion of national tax revenues.

Such stability is most likely to be achieved if the system is based on consistent principles that do not give rise to such eroding effects. As discussed in section 1, some scholars have seen that the current principles of the international tax system are not satisfactory in this respect. They have traced the causes of base erosion and tax competition observed in recent years to the following key principles of the current system: source-based taxation of active business income and residence-based taxation of passive income (in combination with a relatively formal residence doctrine) and a separate entity approach (which requires arm's-length pricing for intra-MNE transactions). The first principle generates incentives and opportunities for firms to locate profits and investments to low-tax jurisdictions. The second principle lays the system open to mispricing of internal trade in goods and services. These aspects of the prevailing tax system make it attractive for countries to lower their corporate tax rates and introduce special low-tax regimes for particularly mobile activities.

It is important to observe that both the G20/OECD BEPS and the EU ATAP aim at strengthening these principles. They do not seriously consider alternative approaches but rather put all their efforts into ensuring that taxes are paid to the jurisdiction where profits are generated. They attempt to achieve this goal mainly by introducing new anti-tax avoidance rules.

As our analysis in section 3 implies, the ATAP creates new standards and sets certain minimum requirements for various anti-avoidance measures. Some Member States have already introduced most of the measures in recent years, while many others have much work ahead before the Directives are fully enforced. Generally, the Directives will indeed strengthen anti-tax avoidance measures in the EU. For example, the new rules for preventing hybrid mismatch arrangements, while complex and open to criticism in certain respects, will probably be able to reduce many forms of tax-planning.

However, the new rules still leave scope for profit-shifting activities. For example, the ATAP does not solve the problems concerning the mispricing of internal transactions or the opportunities to game with intellectual property rights such as patents and trademarks. Nor do the new rules provide any solution to cost contribution agreements or to agreements which allocate risk within a corporate group.

The problems are likely to become more severe with the increasing role of digitalization in businesses. It will become increasingly difficult to find appropriate prices for intra-group transactions when trade is in digital services and intellectual property rights. Similarly, it will be easier for firms to serve customers in a jurisdiction with no physical presence there. This makes it possible to locate marketing and shipment activities so that taxes are minimized.

What is equally important from the stability point of view is that the anti-tax avoidance measures will not reduce the incentives to relocate investment and other key activities of MNEs to low-tax countries. Some have argued that they may even lead to the opposite outcome. When profit-shifting becomes more difficult, for example through eliminating tax havens or special tax regimes, the efforts of MNEs will turn to optimizing the location of real economic activities (Hong and Smart, 2010; Dharmapala, 2008). And when countries cannot use special regimes in their attempts to attract tax bases, they may focus on general corporate tax rates (Keen, 2001).

The problems are aggravated by the natural attempts of national governments to attract investment and tax bases by reducing tax rates, introducing special regimes and avoiding overly strict anti-tax avoidance rules. Due to competitive pressures, differences in tax rates and opportunities for tax planning are likely to remain or even become greater in Europe.

In sum, building on the work in OECD/G20 BEPS, the ATAP is likely to further reduce the profit-shifting activities of MNEs but does not solve the inherent incentive problems of the cross-border corporate tax system in Europe. Therefore the post-ATAP corporate tax system is unlikely to be stable in the long run.

6 Alternative Approaches

The OECD's and the EU's anti-tax avoidance projects aim to repair the existing rules of the international tax system by patching up the loopholes, which permit MNEs to shift profits from high- to low-tax jurisdictions. As this approach has some apparent drawbacks, as discussed above, it may be useful to provide a brief review of alternative means discussed in recent debate.

We start from the attempt to strengthen the source principle by introducing withholding tax on intra-group interest and royalties (I&R), which was ignored by the OECD and the EU as a potential short-term measure. Then we consider two more fundamental reform proposals, the CCCTB and the destination-based cash flow tax (DBCFT).

6.1 Withholding Tax on Intra-Group Interest and Royalties?

As discussed above, arrangements involving debt transactions and intellectual property rights (IP) play an important role in the tax-planning activities of MNEs. Tax relief on intra-group interest and royalty (I&R) payments makes it profitable to launch external debt issues in high-tax countries and locate intra-firm financing services and IP holdings in jurisdictions with a low tax rate.

However, the deductibility of I&R costs is not the only tax factor relevant for the existence of incentives and opportunities for such profit-shifting. An equally important issue is whether the source country collects withholding taxes on intra-group I&R payments.

The OECD model convention permits source countries to levy withholding taxes on I&R. These taxes will be credited against the corporate taxes of the recipient company in its residence country. This crediting procedure aims to eliminate any resulting double taxation. However, since January 2004, after the introduction of the Interest and Royalty Directive (2003/49/EC), the EU Member States can no longer levy withholding taxes on intra-group I&R payments. The Directive effectively gave the taxation right entirely to the residence country and mandated residence countries to design their tax systems to be attractive for MNEs.

Indeed, an authoritative text book on European tax law by Ben Terra and Peter Wattel assessed the future implications of the I&R Directive soon after its adoption as follows (Terra and Wattel, 2005, pp. 639-640):

> *"It is not easy to see why the I&R Directive was included in the 'package to tackle harmful tax competition,' as it is difficult to see what connection it has with the curbing of harmful tax competition. It rather encourages such competition. … Abolishing withholding taxes on those payments means that the source country (the debtor State) receives no tax revenue whatsoever. This implies tax planning opportunities … . …*

We are tempted to predict that … either this directive will lead to a huge stream of deductible interest and royalties from the high tax jurisdictions into the low tax jurisdictions within the EC, or to EC-wide application of very strict thin capitalization rules, … and other anti-base erosion rules … .”

The predictions seem to have been fulfilled. This begs the question whether repealing the I&R Directive and relaunching coordinated withholding taxes on I&R income for intra-group payments would not have been a well-targeted way of reducing tax-motivated profit-shifting within the EU, rather than many elements of the ATAP, which tend to be complex and still lack convincing efficiency.

The wide BEPS debate has been surprisingly silent on withholding taxes as a potential measure to mitigate profit-shifting. There have been some exceptions, however: Cnossen (2004, 2017) discusses withholding taxes on I&R payments as a first step towards full source-based taxation of profits. Fuest et al. (2013) raises withholding taxes as a potential way to counter international tax-planning. Vleggeert and Vording (2017) propose conditional withholding taxes on such payments to serve the same goals. The key property of their proposal is that the tax is only levied if the payments are not taxed at a corresponding rate in the recipient's residence state. [52]

One of the reasons for repealing withholding taxes has been that the rules for crediting varied between bilateral agreements, which led to variation in effective tax rates (Terra and Wattel 2005). Further, there has been the concern that withholding charges are taxes on gross income, and thus have no direct link to economic profit. The crediting procedures would also be cumbersome both for tax administrations and taxpayers. However, in a well-organized coordination process, such as the one that has been able to produce the recent anti-tax avoidance Directives, the challenge of implementing a sufficiently uniform withholding tax with relatively simple crediting procedures should not have been too difficult.

Withholding taxes could have several benefits in the present framework. They effectively narrow the tax rate gap between high- and low-tax countries, and therefore reduce the incentive to shift profits. Withholding taxes automatically focus on intra-group cross-border situations, while interest limitation rules must also be applied to domestic groups. The mandatory tax credit in the recipient's home country automatically eliminates any double taxation, while CFC or the interest limitation rules proposed in ATAD do not necessarily preclude double taxation. Finally, as they move the principal right to tax intra-group I&R to the source country, withholding taxes are in line with the goals of the OECD BEPS project.

There are limitations as well, of course. Withholding taxes would only address certain forms of profit-shifting. They clearly would not solve the mispricing of intra-company transactions other than those related to debt and IP and do not solve hybrid mismatch and treaty misuse situations.

[52] See also Baez and Brauner (2015).

Finally, the system would still be grounded on source-based taxation, and therefore it would not create a stable tax system for the long run.

But introducing withholding taxes would establish a way to enforce source-based taxation in a way that is well rooted in the principles of current international tax rules. While the EU appears to have taken its approach to tackling debt-shifting from the interest limitation rules of the ATAD, profit-shifting via IP location has not yet been addressed. A (conditional) withholding tax on intra-group royalty payments could still serve as a complement to the measures already adopted.[53]

6.2 The EU CCCTB Reform Proposal

In October 2016, the European Commission put forward its revised plan for a common consolidated corporate tax base (CCCTB) in the EU (European Commission, 2016c, 2016d). The original proposal was launched in 2011.

The CCCTB would harmonize the tax base of large multinational companies in Europe. These companies would be taxed as single units, and the group-level tax base would be attributed to the Member States using a formula which aims to measure how the activities of the group are distributed across the Member States.

The main novelty of the 2016 draft is that the CCCTB would be implemented in two steps. In the first stage only the standardized rules to calculate a firm's taxable profit would be established. Taxation would still follow the separate entity approach. The second phase, which would be started only after the first phase was enacted, would include the consolidation of taxable profits and the apportionment of this aggregated taxable profit.

Two other new elements are the inclusion of a generous R&D tax allowance and an equity allowance, which aim at encouraging investment (both allowances) and eliminating the tax bias towards debt (equity allowance).

The well-known key benefit of the unitary approach to taxing MNEs is that intra-group transactions do not affect where taxable profit is allocated. This implies that opportunities for tax-minimizing profit-shifting, e.g. using mispricing of intra-group trade, vanish.[54]

The main problem of the unitary approach, however, is that the apportionment rules, which aim to allocate the tax bases to the Member States, create new opportunities for tax-planning. In fact, the formula effectively transforms corporate taxes into excise taxes on the factors in the formula. If corporate tax rates differ between countries, as they do strongly in Europe, the variation in

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[53] To minimize potential unintended consequences, it could be advisable to pursue the selective operation of a withholding tax, for example in designated situations where there are concerns about the substance or location of the payee.

[54] The other favorable features of the CCCTB are that it simplifies the tax rules for cross-border activities and strengthens the investment incentives.

these “excise taxes” encourages firms to locate capital and labor in low-tax countries. This incentive further encourages countries to engage in tax competition.

While the CCCTB proposal clearly has some advantages, the incentives it produces to locate production in a particular country as well the still inherent incentive for tax competition between countries calls into question the long-run stability of the tax system. In principle, this problem could be alleviated by heavily weighting destination-based sales in the formula. This would tie the place where (a large share of) taxes are levied to the location of consumers, who should be relatively immobile. Whether the EU will utilize this device remains to be seen.

6.3 Destination-based Cash Flow Tax (DBCFT)

While having been subject to discussion for several years among academic experts (Bond and Devereux 2002, Devereux and Sørensen 2006, Auerbach et al. 2010), a version of a destination-based cash flow tax was proposed by the US House of Representatives in their report “A Better Way for a Tax Reform” in June 2016 (Ways and Means Committee of the House of Representatives 2016) bringing much new attention to the tax system.[55]

The idea of the DBCFT is to tax corporate cash flow in the location of the final consumer. While the cash flow part means that the tax is levied on a base that is calculated by deducting all expenses, including capital expenditure, from accrued revenue, the destination element implies that the tax is only levied in the place of sales, ultimately in the location of the final consumer. The latter principle is implemented by exempting exports and taxing imports, as under value-added tax (VAT).

The benefits of the cash flow tax element are that the tax falls on economic rent independently of the form of finance. Therefore the tax stops favoring debt over equity and does not distort the scale of investment.

The benefit of the destination basis is that tax is levied not in a location of the MNE’s mobile activities, but rather in the place of the final consumer, which should be seen as relatively immobile. This property reduces the effects of the DBCFT on location decisions compared to the conventional CIT and most its alternatives.

The DBCFT also has strong merits in addressing international tax-planning. Profit-shifting using mispricing of intra-group trade becomes useless. This is because the tax base is effectively revenue minus expenses incurred in the destination country. The pricing of cross-border transactions has no effect on the base.

[55] In the final tax bill the key elements of the DBCFT were dropped, however.

The tax model also eliminates debt-shifting. In an R-based cash flow tax, which ignores financial transactions, there is no interest relief and no tax on interest income. Therefore it provides no opportunities for debt-shifting.[56]

While issues have been raised concerning the US proposal as well as the practical implementation of a pure DBCFT,[57] the experiences of running VAT, which closely resembles it, provide an encouraging perspective. In particular, in an international context it mitigates the key problems of the current corporate tax, e.g. the incentives to relocate profits and business activities of MNEs due to tax incentives and tax competition between countries.

[56] The same conclusion applies to the broader version of a cash flow tax, which includes all financial transactions.

[57] Auerbach et al. (2017) discusses some of the criticism.

7 Conclusions

The European Union moved quickly to implement key anti-avoidance practices in the G20/OECD BEPS actions after they were published in October 2015. The first draft Directive was issued in January 2016 and key elements of it were enacted as EU law in July 2016. The measures were later amended and augmented.

Our analysis in this report implies that while elements of the ATAP are likely to raise the minimum standards of anti-tax avoidance measures in Europe, they still leave scope for tax-planning. The standards adopted also tend to increase the complexity of the tax code and cause costs for both taxpayers and tax administrations. The evidence concerning the impact on enforcement costs is still incomplete due to scarce data, but this should not be a reason for neglecting this worry. A considerable influx of complex new legislation with some variation in concepts and structures between countries inevitably leads to increased costs and reduced economic activity.

In some cases the new measures are likely to lead to double taxation and in some others they will produce new distortions to the decisions of corporate groups. One example of the latter is the interest limitation rules. They will most likely affect different sectors differently, and provide incentives for multi-sectoral MNEs to locate their activities in a tax-optimal manner. While some of the new rules seem to be overly rigid, some others are more lax and will be sensitive to the strategic behaviour of countries.

Even more importantly, the new anti-tax avoidance standards do not mitigate the incentives inherent in the current international tax system due to disjointed national tax systems. Since tax-planning opportunities will not be curtailed substantially and the incentives to relocate real economic operations to low-tax countries are hardly touched at all, the anti-tax avoidance instruments of the ATAP appear inadequate in creating a stable corporate tax system in the long run. Therefore, the EU should keep on searching for a truly viable approach.

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