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| IU |
| International Taxation |
| DLMFAIT01 |

# Learning Objectives

Taxation is a very important issue for managers, businesses, organizations, governments, stakeholders, and society as a whole. Taxation also affects the size, location, organizational style (centralized versus decentralized), and form of businesses and organizations.

To successfully operate in a business environment, students must learn how businesses are taxed internationally and how to avoid the challenges of double taxation.

This course provides a comprehensive and distinct perspective of **international taxation,** both in theory and practice. Students will learn fundamental concepts and terms, such as residence, source, double taxation, taxation relief, double tax treaties, and active and passive sources of income.

The emphasis of this course is on direct taxation of income and corporate tax of multinational companies. The course aims to equip students with the necessary knowledge to navigate the current challenging international tax landscape by providing a deep understanding of difficulties in international tax coordination, tax issues in the age of digital economies, tax treaties and dispute resolution mechanisms.

Students will develop an in-depth understanding of both the practical aspects of international taxation and the theory behind it. They will distinguish between different types of tax, learn how individuals and businesses are taxed as well as the norms of international business taxation. In addition, students will gain expertise in various double taxation treaties, learn how cross-border business activities are taxed, and understand tax evasion and avoidance of double taxation.

Covered in the course will be institutional tax planning and management, rules of anti-avoidance, different tools of transfer pricing and controlled foreign company regimes, tax competition, the role of tax havens, and base erosion and profit shifting strategies (BEPS) from a globalization perspective. Students will also learn how to identify and critically evaluate the challenges of international taxation including the lack of international tax coordination, tax issues in the age of digital economies, tax treaties, and dispute resolution mechanisms.

# Unit 1 – Introduction

**Study Goals**

On completion of this unit, you will be able to …

… describe the special rules of international tax law within the general system of taxation.

… explain the basic idea and features of taxation.

… differentiate between the taxation of individuals and businesses.

… demonstrate a basic understanding of the relevant norms of international tax law.

# 1. Introduction

## Introduction

Note: some passages in this Chapter are a verbatim extract from Haase (2021).

The basic principle behind taxation is to generate revenue in order to finance a country’s domestic infrastructure. Therefore, taxpayers do not expect personal value in return for their tax payments.

The notion of taxation goes back a long way. For example, historically, taxes were often levied to finance wars or the reallocation of land. The basic issues and difficulties regarding the international allocation of taxes, as well as the need for the avoidance of double taxation, have theoretically been in existence since the middle of the 19th century.

Having said that, many years ago, the majority of countries did not levy personal income tax. The modern sense of taxation on an individual’s income is based on the economic ability to pay and also has a trans-territorial effect. The idea of the world-wide income principle is therefore relatively new.

Nowadays, despite differences in detail, many taxation systems around the world follow more or less the same basic rules, which are explained below. Most taxation systems rely on written, codified tax laws with a clear hierarchy of norms. In addition, most taxation systems have a clear definition of “the taxpayer” and differentiate between taxation of individuals and businesses. Taxation systems usually distinguish between different categories of tax.

These issues need to be evaluated in order to provide context to the present-day global tax environment, in which countries vie with one another to attract taxpayers and resulting revenue.

## 1.1 History of Taxation

As stated above, the basic issues and difficulties regarding the international allocation of taxes, as well as the need for the avoidance of double taxation, have theoretically been in existence since the middle of the 19th century. Nistotskaya and D’Arcy (2015) offer a detailed history of taxation.

Many years ago, the majority of countries did not levy personal income tax. The modern sense of taxation on an individual’s income is based on the economic ability to pay and also has a trans-territorial effect.

The idea of the world-wide income principle is relatively new. A system was crucial to determine in which circumstances double taxation could occur and how it could be avoided, leaving questions to arise only in exceptional cases (e.g., colonial states that were allowed to retain their own tax systems).

With the advent of industrialization, economic developments blazed a trail towards greater global integration. Industrialization brought about a major change for taxation (Hartwell, 1981). The increasing spread of technical innovations required a global sales market. For example, Great Britain, a central world power in its day, was a pioneer of the doctrine of free trade. The declared aim was to establish world-wide trade without trade barriers, in which countries outside of Europe (especially the Colonies) took on the role of both suppliers of raw materials and food and provided a market for sales.

By the start of the 20th century, economic structures had already consolidated. In some cases, such structures are still in existence today, such as in countries with a high dependency on exports. The attempt by these countries to build up their own industries as a counter-weight against Western Europe was only successful in a minority of countries, for instance Japan. The majority of states failed in such developments and ended up in debt traps, leading to even further dependency vis-à-vis Europe. Examples of such countries are Egypt and other North African countries.

This progression has not been without consequence. At the beginning of the 20th century there was indeed a lively trade between many countries. Around the year 1913, export quotas of the European countries were at a peak. By that time, the United States had developed into the world's largest industrial producer.

The League of Nations, founded in 1919, was a further sign of international, global networking of nation states. However, there were considerable economic differences between the regions of the world. This can be seen in the general differences between the wealthier industrialized countries on the one hand and the less wealthy developing countries on the other hand.

Following the First World War, Europe was highly dependent on the United States because the reconstruction was financed with American loans. The United States imposed very high tariffs on European imports as well. Indeed, this is a pattern seen in history time and time again.

However, this was a period when creation of industrial value was not only a challenge but also brought in some very substantial tax revenue for the industrialized countries. It was therefore no wonder that the right to tax and allocation issues began to abound more urgently than in previous decades.

A general, unilateral, and permanent abandonment of the right of taxation on income earned abroad would have led to a falling behind in pecuniary and economic terms on the part of certain states. As a result, countries started to cooperate with each other bilaterally and signed treaties to avoid, or at least mitigate, double taxation for their taxpayers.

The first confirmed double taxation treaty in which the basic structure of modern-day agreements can be seen was most likely the 1870 Domestic (German) Tax Agreement between Prussia and Saxony. The Agreement included components that were found in rudimentary form in contracts of the Northern German Confederation. The 1870 Agreement led to the conclusion of the first inter-governmental double taxation agreement between Prussia and Austria-Hungary, approximately twenty years later.

Immediately, this important development gained momentum. Further double taxation agreements between Austria-Hungary and the German States were put into force straight away.

However, the first truly systematic approach to the phenomenon of international double taxation did not begin until the League of Nations in September 1921 and the establishment of a panel. The panel comprised representatives from the Netherlands, the United States, Italy, and Great Britain. It published a comprehensive report on the causes, manifestations, and possibilities of avoiding international double taxation.

The panel issued its final **report** in April 1923. The panel report was divided into three parts. In the first part, the economic effects of double taxation were examined, while the second part explained general principles which were predominant in the international tax system at that time.

**Panel Report 1923**

The report outlined the basic principles that govern the rules of the international tax system to date.

The principle of the economic ability to pay taxes was assumed by the report as an inherent principle of taxation. For the allocation of two or more states to impose a tax, the guiding principle that was adopted was economic and, interestingly enough, not territorial affiliation.

In the third part of the report, possible methods for avoiding double taxation were discussed. The report, in that respect, distinguished four methods: (1) The deduction method (which corresponds to the current tax credit method in essence), (2) the exemption method for income earned abroad and rounding off (essentially corresponds to the current tax exemption method), (3) the method of a tax split, and (4) the method of the division according to source. The final two methods are no longer seen today.

The report thus proves itself as amazingly topical and far-sighted, even measured against current understanding and historical development over previous decades.

The Finance Committee of the League of Nations then commissioned senior tax officials from different states to address the problem of double taxation from a practical and fiscal perspective. The undertaking of the tax officials led to the development of the first model tax agreement aimed at avoiding double taxation, published in 1928. However, the officials’ report did not have a significant impact on the first double taxation agreements concluded in real terms, because the fiscal tendencies of those who prepared the report were one-sided. In contrast to the professors who had previously written reports, the tax officials were sent on behalf of the participating countries and this meant that the discussion was no longer objective and neutral. Unlike the preparation of previous reports, in this report states had their own agenda and increasingly tried to improve their economies and bring in unilateral fiscal interests. Nevertheless, the reports contained valuable details of the basic problems of international taxation, some of which are still relevant today. Friedlander and Wilkie (2006) document a good overview on the history of tax treaties.

### Self-Check Questions

1. Please mark the correct statement(s).
* *A basic feature of modern income tax is the economic ability to pay*.
* Modern income tax systems, as we know them today, have been in place since the 12th century.
* The first model treaty for double taxation agreements was influenced by China.
1. Please complete the following sentence.

The first confirmed double taxation treaty, which already showed the basic structure of the agreements used today, was probably the Domestic (German) Tax Agreement between Prussia and Saxony in the year 1870.

## 1.2 Basic Terms and Concepts of Taxation

First and foremost, taxes finance the infrastructure of a country. Therefore, taxpayers do not expect personal value in return for their tax payments.

Financial requirements, however, differ from country to country. One major issue is the structural and economic inequality between states. There are industrialized countries on the one hand and developing countries on the other. There is also a range of countries which fluctuate somewhere in the middle. This middle-range economy depends on various factors, including how it is defined.

Emerging markets have fundamentally different conditions, which in turn is the reason that there are different trade interests. The state of world trade and its appearance stem from this.

Developing countries export, if at all, mainly raw materials. In addition, such countries export technically simple, but relatively labor-intensive consumer goods (for example, textiles, toys, etc.). On the other hand, industrialized countries usually export technically sophisticated consumer goods (for example, medicines, cars, machinery, and more).

The greater industrialized countries are therefore dependent on imports of raw material from developing countries, while the latter preferably import capital goods to adapt their production technically to an acceptable level. This is often accompanied by the fact that the labor market and workforce in industrialized countries tends to be well-educated, academic, middle and upper class. Political, legal, social, and economic stability in these countries also tends to be guaranteed. Other positive factors make these locations an attraction. In contrast, the opposite is found in developing countries more often than not and there is a need to for these countries to “catch up” quickly.

Despite these obvious differences between industrialized and developing countries, there are also similarities. Companies from industrialized countries often have investments and are involved in developing and emerging countries through foreign direct investments, export and local investment companies, subsidiaries or permanent establishments. These companies make essential contributions for further local advancement of the developing country (“self-help assistance”), through the creation of jobs, the establishment and development of infrastructure and the transfer of know-how and technology. Today, many leaders and decision-makers in the industry recognize that an active role in the development of emerging markets unleashes potential innovation and ensures future success. Examples of such an active role are injections of capital or the allocation of licenses for the distribution of an asset.

In existence since approximately 1920, tax havens are situated “between these two worlds” to a certain extent. A tax haven is a non-technical term, not defined by law. It is a state which levies little or no income tax, namely, either on a flat-rate basis or only for certain sectors of the economy. Tax havens can be classified as both residence and source states. They are as old as taxes themselves, and are often in competition with one another.

When there are various providers offering similar products in a free economic area, prices usually drop. Tax havens try to circumvent this competition problem. It is notable that tax havens have emerged in the past and are still emerging today. They are seen within particular business models that specialize in certain activities, or have customers from specific countries or groups of countries. It is also seen that the Organization for Economic Co-operation and Development (OECD), other international organizations, and interest groups fight against tax havens. These organizations and interest groups place massive political and economic pressure on tax havens and work to ensure that the business model is abandoned or adapted. Only economically strong tax havens can resist this pressure. States that have a strong sovereign behind them and those states that focus their business on customers outside the territory are more likely to remain as tax havens.

This finding leads to the second problem which is that industrialized countries are more likely to be states of residence in global terms than developing countries, at least as far as prosperous companies are concerned. Typically, there are many companies which are subjected to an unlimited tax liability in industrialized countries, which according to the principles explained above, are taxed according to the world-wide income principle. Developing countries, on the other hand, are traditionally mostly source countries. They are countries within which many companies are invested but the companies are only subjected to limited tax liability, thereby simply generating too little tax revenue across the board.

**Residence versus source**

Traditionally, industrialized countries are likely to be residence states and developing countries are likely to be source states.

On the assumption that tax rates in developing countries are usually lower than tax rates in industrialized countries companies tend to be tempted to shift as much taxable earnings as possible to the country with a lower tax rate. However, this strategy alone does not lead to a reduction in the tax burden where it is not possible to associate a higher added value with the activity carried out in the developing country. The activities carried out by companies in developing countries were historically often routine activities. Companies that carry out routine activities or functions such as intra-group services, services provided within the group or simple sales functions, do not have any significant assets and bear only minor risks within a developing country. The profit attributed to these companies for tax purposes is therefore considerably lower than if the company were to function as what is called a strategy company.

A strategy company performs functions that are decisive for the success of the group, bears significant risks, and has essential materials, financial resources and intangible assets. It is a central enterprise in the group. Both terms - routine company and strategic player - are technical terms from the law of transfer pricing and serve the classification of companies in the economic value chain.

Around the year 1920, strategic players in traditional developing countries were almost never found. Moreover, tax shortfalls in the developing countries often resulted from what was usually an imperfect tax system, an inefficient tax administration, and the insufficient enforcement of tax claims. Due to a potentially high shadow economy, there was a high risk of an associated turnover and income tax loss.

Industrialized nations started to discuss allocation in the 1920s. In subsequent years, these nations referred to the classical arguments in favor of the world-wide income principle (use of local infrastructure, creation of valuable intangible assets, use of the high-level labor market, etc.). At the same time, developing countries were eager to explain the distribution of tax claims with the thesis that the capital injection or licensing in their economic area was to some extent additional income, and also exclusive. The industrialized nations argued that, in a market economy system most of the income comes from the expansion of existing markets or the development of new markets. However, this would apply to all sales markets and does not change anything with respect to the fact that the emphasis on generating income for income from capital assets and licensing to a certain extent is always with the “producer.” Against this background, the core question of any allocation of the right to tax between two states is to what extent the states wish to grant each other the withholding of the right to tax. A complete abandonment of the rules of unlimited tax liability is obviously not an option and never could be.

If a company is located within a state (due to the company’s registration, by virtue of the situation, or a similar or comparable reason), such a company will be subjected to a variation of unlimited tax liability by most countries that levy income tax. There is (and was) agreement in principle on this. The situation is different with regard to the withholding of tax rights. Where two industrialized nations are similar in terms of economic performance, and the structure of their economies is comparable, then the states involved will usually jointly promote the interest of a limitation of the withholding of tax, so that the participating countries will not unduly lose tax revenue.

On the other hand, in the case of developing countries there is a fundamental economic imbalance which is to their disadvantage. The import surplus of these countries creates a mutual surrender of withholding of tax rights only to the industrialized country. This is not to the benefit of the developing country and is to a certain extent the “root of all evil” in debates regarding global tax allocation. The interest of developing countries is to achieve the greatest possible maintenance or extension of the rights of withholding of tax, whereas it is the tax policy of the industrialized countries to reduce these rights in particular.

Having said this, in the 1920s, states around the world were in agreement bilaterally, implicitly or *de facto.* A compromise was accepted that the industrialized nations or residence states in principle should retain the full right of taxation for international tax issues and that therefore the international tax system should remain as it was.

As far as a company is concerned, there are only two exceptions to this. One exception is if the threshold for the creation of a permanent establishment at source is exceeded. The other exception is where direct investments are made through shareholdings, or through the granting of capital or licenses in the source state, and this demonstrates a certain participation in the market in the source country. In this respect, the right to tax at source can be restricted by giving the source state limits for determining the tax rate.

To sum up, the residence states should in principle be allowed to levy taxes on income, while the source states, as market states, have the privilege of turnover tax (as well as any customs duties and other import duties). This should cover the resident companies for their supplies and other benefits in the source state. These considerations led to the efforts of the OECD to develop a model tax convention on the avoidance of double taxation and this became successful around the world.

### Self-Check Questions

1. Please complete the following sentence.

Industrialized countries are more likely to be *states of residence* rather than states of source.

1. Find the correct opposites in international tax lingo (tick two answers):
* high-risk countries versus low-risk countries
* *industrialized countries versus developing countries*
* profitable taxpayers versus weak taxpayers
* unlimited tax liability versus limited tax liability

## 1.3 Types of Taxation

Most tax systems in the world differentiate between several types of taxation. These differentiations may refer to either the act that triggers the tax (basis of assessment), the way of levying the tax, or other parameters that determine the nature of such tax. A classical tax system would essentially distinguish between four different types of tax, as discussed below.

### Excise Taxes

These usually include taxes on spirits, coffee, tobacco, and mineral oil. Excise taxes are also levied on the purchase of food, beverages, and other goods.

### Transfer Taxes

In particular, these include sales tax (VAT) and real estate transfer tax. As a rule, VAT is levied on the company but borne by the consumer, the end user. In its current form, the VAT system in Europe today is referred to as an all-phase sales tax with input tax deduction. This means that taxation should occur at every stage of value creation. Since the seller cannot know whether the end of the value chain has been reached, VAT is reported in every case.

However, input tax deduction ensures that VAT is only paid in fact by the consumer, the end user. Input tax deduction thus determines the sales tax for the product as zero in each case. The tax payment does not remain in the treasury until an end user or entrepreneur who is not entitled to deduct input tax has purchased the product. Officially, sales tax is not constitute operating costs and therefore does not reduce the taxable income of a company.

Real estate transfer tax is levied on the acquisition of real estate. Transfer taxes are linked to the transfer of assets or rights. Accordingly, they usually include financial transaction taxes and insurance taxes.

### Taxes in Rem

These usually include land tax, trade tax and dog licenses. Personal circumstances are not a factor according to the rules in Germany. Respective municipalities levy property tax on the ownership of land. If a company is commercially active (as opposed to other self-employed activities in tax law) municipal trade tax is payable. This can vary from municipality to municipality, as each municipal authority can set its own rate of trade tax. Businesses use this variance as a factor to take into account when choosing a location for their business operations.

### Property Taxes

These traditionally include income tax, corporate income tax, and inheritance and gift tax. In the case of partnerships and sole proprietorships, the partners pay income tax on their share of the profits. On the other hand, corporate income tax is borne by a corporation. The dividends distributed by the corporation are in turn subject to the respective personal income tax of the shareholders. A solidarity surcharge is in principle also levied on income and corporation tax, provided certain low-income thresholds are exceeded. Inheritance tax and gift tax are levied when tangible assets, including companies or parts of companies, are bequeathed or given away.

According to the basis of assessment, two further classifications can be made in addition to this classification of taxes. First, there is a classification according to income sovereignty. Income sovereignty, also known as revenue sovereignty, is a term used in the levying of taxes. The sovereignty over a tax is vested in the local authority to which the tax revenue accrues. The second distinction is differentiation according to the procedure of tax collection. Most taxes are collected by way of a tax declaration procedure. In other words, a taxpayer files tax returns, receives tax assessments and then needs to pay the tax. The alternative is a withholding tax mechanism. This is usually easy to implement and therefore has advantages for the tax authorities in terms of administration. Particularly in cross-border scenarios, withholding tax mechanisms are often used in many countries.

### Self-Check Questions

1. Please mark the correct statement(s).
* *Income tax is an example of a property tax*.
* VAT is an example of an excise tax.
* Corporation tax is an example of a tax *in rem*.
1. Please complete the following sentence.

In a tax collection procedure, taxes are either determined through tax returns and subsequent tax assessments, or alternatively levied by way of withholding tax.

## 1.4 Taxation of Individuals and Businesses

Most tax systems in the world differentiate between the taxation of individuals and the taxation of businesses. The latter usually fit one of the legal alternatives for a business - (1) a corporation, (2) a partnership or (3) an individual entrepreneur.

In any of these situations, tax systems commonly differentiate between unlimited and limited liability with regard to taxation. A person or corporation with unlimited liability for taxation is usually subject to taxation on world-wide income. An individual usually has unlimited liability to taxation if the individual is resident or has a habitual abode in a particular country. The general rules are as follows: An individual is defined as resident if the individual maintains a dwelling under circumstances from which it may be inferred that the dwelling will continue to be maintained. A habitual abode is considered a place in which an individual is present and circumstances indicate that the stay in that place or area is not merely temporary.

For instance, in Germany when one has an unbroken stay of not less than six months, that place is invariably regarded as a habitual abode. The relevant periods differ from country to country. Ownership or leasing of a house or apartment, or physical presence in circumstances that suggest an intention to remain in Germany, are all indicators of residence or habitual abode status.

Relocation outside of Germany brings tax residence status to an end. For a non-resident, taxation of German-source income may continue and it may extend to non-resident taxation. Most countries have similar rules that are based on the residence principle, but there are also some countries where tax status is based on a blood relationship or purely on citizenship. The rules for corporations are much clearer: Corporations are usually considered tax-resident if the registered office or place of management and control is in a particular country.

Individuals who are not resident or do not have their habitual abode in Germany have limited liability for German taxation and only pay taxes on their German income source. The same applies for corporations which are neither situated in nor have a place of management in Germany.

**Tax transparency**

The difference between transparent and non-transparent entities is a standard question in international tax law, particularly for partnerships.

On a business level, most tax systems differentiate between transparent and non-transparent taxation. This is the case in Germany. Where an entity is treated as transparent, it is only liable for trade tax and value-added tax if it undertakes business activities. Profits of a transparent entity are taxed at the shareholder level. Thus, it is essential to determine whether an entity is transparent or not. This is a decision that has to be made for tax purposes under most tax systems in the world.

German corporate bodies are generally non-transparent, whereas German partnerships are treated as transparent for German tax purposes. Although Germany follows the registered office theory, a foreign entity is classified for German tax purposes through the “comparison by type procedure.” Entities established under foreign law are generally characterized by comparing their legal and economic characteristics to German entities through a comparison by type (“Rechtstypenvergleich”). The doctrine of the comparison by type was developed by case law. Most countries have a similar test, and some countries actually treat foreign entities differently from domestic ones.

### Self-Check Questions

1. Please complete the following sentence.

Under most tax systems, individuals are subject to an unlimited tax liability if they have either a residence or a place of habitual abode in a country.

1. Find legal forms through which businesses usually operate:
* work councils
* *corporations*
* consortiums
* partnerships

## 1.5 Norms of International Business Taxation

It should be noted that there is no codified “international tax law” that is applicable to all of the countries around the world. This is not even true amongst the European Union countries, where there is only a very restricted legal empowerment for the European Union as an institution to levy taxes. There is some harmonization with the European Union countries, but mainly with respect to indirect taxes such as VAT and certain excise taxes.

 Therefore, “international tax law” is a country’s national tax law in reality. Each country independently decides which rules apply in relation to cross-border cases and scenarios. The same applies to double taxation treaties, which are technically treaties of public international law between independent countries, but which have to be formally enacted by the national laws of most countries.

**Norm hierarchy**

International tax law is in fact national tax law of countries, and each country has its own norm hierarchy.

German international tax law, for instance, has a high degree of codification. Case law does not play an overly significant role in practice. One could initially assume that a high degree of codification is beneficial for taxpayers. The reasoning behind this is that it could lead to less discussion with the tax authorities as to “right” and “wrong” and fewer “grey areas.” However, this is not generally the situation in day to day practice regarding German tax law and international tax.

First, it needs to be understood that the degree of codification is high. The written laws are extensive, extremely complicated and detailed. They include long provisions that are difficult to read and understand. Some of the laws verge on the absurd and are almost incomprehensible. Despite this, taxpayers and their advisors must manage to work within the law.

To make matters worse, there are administrative circulars and guidelines of the German Ministry of Finance and the Finance Ministries of the German States which accompany the codified laws. There are thousands of such circulars and guidelines, and they are sometimes impossible to find.

There are helpful databases and computer programs, but there is no unified source of information where these circulars or guidelines can be found and are published. Some guidelines may not even be published at all, leading to an implausible situation in which only the tax authorities “know their own rules.” The German Ministry of Finance publishes an annual list of expired circulars. Many of these expired circulars will have gone unnoticed.

Nowadays, proper databases are essential for the practice of tax law in Germany at a high standard as well as in many other countries. In particular, small law firms are often unwilling or unable to spend money on such databases and so are at a disadvantage in that respect.

To make matters more complicated, the administrative circulars are often longer than the law which they accompany. One might question the quality of a law if it needs such a long explanation. Despite that fact, international tax law in general is technically of a very high standard.

The circulars and guidelines of the Ministry of Finance have a binding effect on the tax offices and members of the German tax authorities. Taxpayers and tax courts are not bound by them.

There is also extensive academic writing on the subject of tax law. A vast number of periodicals, journals, books and commentaries are published annually. To keep up with the material and to work with these sources of information, proper databases are needed. The German Income Tax Act has approximately ten available commentaries written by practitioners and academics. Some members of the German tax authority and some tax court judges also publish extensively.

Turning to case law, this is also very important in Germany. Some areas of tax law are even governed solely by case law. Surprisingly enough, this is also true for important areas like international tax law or corporate tax law. One such instance is the non-codified institute of hidden profit distributions (“verdeckte Gewinnausschüttung”). The number of cases that are published each year is also quite significant. Once again, practicing tax law without a proper database with respect to case law is, in principle, impossible.

The following is an outline of the tax courts in Germany that make rulings regarding norms in international tax law and the interpretation of such norms. There are currently eighteen Tax Courts (“Finanzgerichte”) in Germany: three in North Rhine-Westphalia; two in Bavaria, Berlin and Brandenburg (a joint tax court); and one in each of the other German States. The sole Court of Appeal is the German Federal Fiscal Court (“Bundesfinanzhof”) in Munich. The result of this rather small number of Tax Courts is that it takes time until a taxpayer’s case is heard and a judgment received. Depending on the court and the subject matter of the case, this may take between 5-25 months. When the matter is referred on appeal to the German Federal Fiscal Court, another two years can be expected.

The German Federal Fiscal Court is the final authority in tax matters in Germany. However, it should be noted that a specific court ruling only relates to and is binding on the individual taxpayer. The outcome for other taxpayers is not automatically the same, even when the cases are similar. In practice however, this is mitigated because the tax authorities usually come to a similar decision when there are similar cases and a precedent has been set. If the tax authorities explicitly agree with a judgment of the Federal Fiscal Court, they will publish the judgment in Part I of the Federal Fiscal Gazette (“Bundessteuerblatt”).

If taxpayers do not agree with a tax ruling, they can refer the matter to the Federal Constitutional Court (“Bundesverfassungsgericht”). A condition for this referral is that it can be proved that the taxation in the specific case infringes the German Constitution. This is only true on very rare occasions. In practice, most such cases in the Constitutional Court are lost. Moreover, the Constitutional Court very rarely accepts appeals from taxpayers in tax matters.

The second appeal option for taxpayers is to argue that a particular tax provision infringes upon European Community law. However, taxpayers are not able to refer a matter to the European Court of Justice (ECJ) directly. Only Tax Courts or the Federal Fiscal Court has such a right of referral. German courts, particularly the Federal Fiscal Court, Tax Court of Cologne, Tax Court of Hamburg, and the Tax Court of Muenster have a tendency to ask the ECJ for preliminary rulings more often than courts in other jurisdictions. The ECJ regularly deals with tax matters, thereby increasing the chances for a taxpayer’s case to be heard.

Tax Court rulings in Germany are usually of a very high technical standard, especially judgments of the German Federal Fiscal Court. There is some compensation in the fact that taxpayers must wait a long time until a final decision is received because the judgments are of a high standard.

The First Chamber of the Federal Fiscal Court primarily deals with corporate tax, international tax and double tax treaties. The Chamber comprises five judges, most of whom are former members of the German tax authorities.

Despite the fact that the First Chamber judges are usually former German tax authority members, the relationship between the German Federal Fiscal Court and the German Ministry of Finance has deteriorated over the last two years. The German Ministry of Finance has the power to issue non-application decrees (“Nichtanwendungserlasse”). These decrees declare one or more judgments of the Federal Fiscal Court to be non-binding on the tax authorities. In practice, this means that taxpayers who have a similar case to one which has already been decided by a Tax Court is required to go to court themselves, even when it is very clear or obvious that the case will be won.

The judgements of the German Federal Fiscal Court sometimes state that the tax authorities have misinterpreted the existing law or they criticize the Ministry of Finance or the legislation. Indeed, the actions of the German Ministry of Finance lend themselves to criticism at times. One example is with respect to European Community law. Members of the tax authorities have publicly stated that it is their intention to wait until a case is lost in front of the ECJ and that the law will not be changed proactively because they do not want to infringe upon EU law. This reasoning is not only contradictory to the notion of the EU, but also the reason why the “tax climate” between the tax authorities, the German Federal Fiscal Court and the taxpayers is not at its best.

### Self-Check Questions

1. Please mark the correct statement(s).
* Interpretation of tax law norms is carried out by the fiscal authorities only.
* International tax law is in most cases the national tax law of a specific country.
* Double taxation treaties are contracts under public international law.
1. Please complete the following sentence.

The EU only has a very restricted empowerment to levy taxes. Harmonization is accomplished mainly in the area of indirect taxes.

## 1.6 Global Tax Environment

It has never been easier than today to transfer substantial assets abroad within seconds. The mobility of taxpayers has also reached unprecedented levels. The combination of these two factors has led taxpayers, especially in the corporate sector, to look for ways to minimize taxes or to avoid payment altogether in extreme cases. Globalization, competition between companies, and the struggle to find qualified workers further aggravate this situation. There are various means in which taxpayers try to minimize or avoid tax - through transfer pricing, classic tax arbitrage, hybrid vehicles or instruments, base companies, trust constructions, and other similar methods. Naturally, this is a problem for the states involved, even if tax minimization or tax avoidance is expressly legal in many countries.

There is an additional complication here. States have entered into a competitive situation with each other that can be described as a “race to the bottom.” States compete with each other to lower corporate tax rates and offer tax concessions. This is still continuing today and there is no end in sight (Wildasin, 1988; Oates and Schwab, 1988). This ultimately leads to a situation in which states compete for economically active and financially strong taxpayers. Without these taxpayers it is not possible to adequately cover the steadily increasing demand for financial resources, particularly in light of the most recent COVID-19 crisis.

Welfare states are high tax countries and are especially dependent on competitive neutrality and extra tax incentives to attract taxpayers. This is demonstrated almost daily and probably explains the intensity with which countries like Germany or France have addressed these issues in the past, despite steadily rising domestic tax revenues.

Against this background, it is not surprising that international tax planning has become much more attractive and relevant in recent years. The increasing frequency of regulations, the coexistence of national tax jurisdictions, the allocation of tax claims between states through double taxation agreements, and purely practical difficulties such as language or cultural barriers have led to a complexity that is difficult to understand, even for professionals. In addition, the international mobility of taxpayers and sources of income has led to conflicting reactions on the part of tax authorities. Unfortunately, this has not brought about a simplification or more practical application of tax law.

**Tax planning is legal**

Tax planning is legal. However, it has become more and more difficult because countries are closing loopholes.

### Self-Check Questions

1. Please complete the following sentence.

In previous decades, countries entered into a “race to the bottom” mainly by gradually lowering their *corporate tax rates*.

1. Which are the two main driving forces of international tax competition as seen against the global tax environment?
* consolidation in the banking sector
* *mobility of taxpayers*
* transferability of assets
* weather conditions in tax havens

Summary

Many countries have a sophisticated tax system with codified laws and often specialized courts that deal with tax matters. This is not surprising, since taxes are a vital way for countries to generate revenue. On the whole, countries aim at creating consistent and efficient rules that ensure uniform tax collection across the spectrum. This is particularly true for international tax law, where the right to taxation is allocated between two or more countries.

The debate surrounding allocation in an international context can be traced back in time, as with many concepts in the field of taxation. Examples of concepts that still exist today are the concept of residence, source taxation, withholding tax regimes, and others. The same is true for unlimited and limited tax liability, different kinds of tax, and the differentiation between the taxation of individuals and businesses.

# Unit 2 – Double Taxation Treaties

**Study Goals**

On completion of this unit, you will be able to …

… describe how double taxation arises because of the rules that govern the taxation of cross-border activities.

… explain how taxation rights are allocated with respect to cross-border business activities and capital gains.

… apply methods to avoid double taxation in an international context.

… understand the phenomenon of tax evasion in the context of a tax treaty.

# 2. Double Taxation Treaties

## Introduction

Experts estimate that there are 2,500-3,000 tax treaties in the world. Probably most of the treaties rely on the OECD Model Tax Convention on Income and Capital (the OECD Model Convention). The Organization for Economic Cooperation and Development (OECD) elaborated on the OECD Model Convention in the 1950s. The OECD Model Convention is updated regularly. The most recent major update of the OECD Model Convention was in 2017.

The OECD Model Convention is without doubt the most important set of rules in international taxation. These rules express a broad consensus among the Member States as to how taxation rights should be allocated between countries and how international double taxation can be avoided. This is important because when international double taxation is not eliminated or at least mitigated, economies are harmed . The rules explained below are based on the OECD Model Convention 2017. Jogarajan (2018) offers more information regarding the history of these rules.

This Convention treats the most relevant kinds of income as follows:

* Business profits derived through a permanent establishment will be taxed in the country of source. Some tax treaties apply the credit method to income from foreign permanent establishment if the income is not active income.
* Dividends paid to corporations may be subject to a reduced withholding tax rate in the country of source. Generally, foreign taxes can be credited against the tax liability arising from this income. Since received dividends are tax-exempt, the withholding taxes are not creditable in most cases.
* Interest is exempt from tax under most tax treaties in the country of source and taxable in the country of residence.
* Royalties paid to foreign companies are usually subject to withholding taxes in the country of source.
* Capital gains are in most cases taxed in the country of residence.
* The right to tax income from immovable property, including capital gains from a sale, is in general allocated to the country where the real estate property is located. Income from foreign real estate property is in most cases exempt from tax in the state of residence.

## 2.1 Taxation Related to Cross-Board Business Activities

According to Article 7, Paragraph 1, Sentence 2 of the OECD Model Convention, a contracting state may tax the profits of an enterprise when and if the enterprise maintains a permanent establishment in that respective state. Internationally speaking, the “permanent establishment principle” is the most important factor when it comes to the taxation of business profits. This is not only true with respect to the aforementioned Article, but also with respect to Article 10, Paragraph 4 (dividends), Article 11, Paragraph 4 (interest), Article 12, Paragraph 2 (royalties), and Article 21, Paragraph 2 (all other income).

When it comes to the taxation of foreign entrepreneurs, whether single entrepreneurs, corporations, commercial or deemed-commercial partnerships, the existence of a permanent establishment is the most important requirement for a state´s right to taxation. Without a permanent establishment, or alternatively a permanent representative (“ständiger Vertreter”), there is usually no taxation right for commercial or business income. With a domestic permanent establishment or permanent representative, a foreign investor is subject to limited tax liability and is part of the normal tax assessment procedure.

**Permanent establishment principle**

The permanent establishment principle is the central topic in international business taxation. Without a permanent establishment there is usually no taxation right.

The profit of the entity as a whole, which is attributed to the head office or the permanent establishment, is determined according to national tax law. This is the case regardless of whether it concerns a domestic permanent establishment subject to non-resident taxation rules or a foreign permanent establishment subject to resident taxation rules. It also does not depend on the existence of a double taxation agreement. A double taxation agreement only regulates the assignment of a profit to the permanent establishment or the head office. It does not regulate how the profit is determined. This is decided according to the law of each state imposing the tax.

As a result, each taxpayer with a permanent establishment in another state is obligated to conduct a profit determination twice - one according to the law of the country in which the head office is located and one according to the law of the country of the permanent establishment. This violates the right of freedom of establishment according to Article 49 of the Treaty on the Functioning of the European Union (TFEU), since it creates higher costs in comparison to establishment in only one state. Given the lack of harmonization of the tax base within the European Union, it is legitimate for the Member State to exert its national regulations for the determination of the income of a permanent establishment, regardless of whether it is the state of source of the permanent establishment or the state of residence of the head office. In each case, determining profit according to domestic law is both necessary and appropriate.

When a commercial taxpayer maintains a permanent establishment in another state, the profit of this permanent establishment must be separated from the profit of the head office and the other permanent establishments of that taxpayer. This separation does not depend on a double taxation agreement. If there is a double taxation agreement, the profit of the permanent establishment is generally exempt from taxation in the state of the head office, with progression (the exemption method) according to the permanent establishment principle. In the state of the permanent establishment, the profit is subject to the non-resident taxation rules. The allocation of the permanent establishment’s profit ensures its correct determination in the state of the permanent establishment as well as the exemption of the correct amount and the enforcement of the exemption with progression in the state where the head office is located.

If there is no double taxation agreement, the profit of the permanent establishment is subject to non-resident taxation rules in the respective state as well. In the state of the head office, the profit will generally be assessed for tax based on the world-wide income principle, so that the tax imposed in the state of the permanent establishment is credited against the one imposed in the state of the head office. The accurate allocation of the profit of the permanent establishment is relevant both for the taxation in the state of the permanent establishment and the assessment of the maximum amount in the state of the head office.

### Self-Check Questions

1. Please complete the following sentence.

When it comes to the taxation of business profits in an international setting, the *permanent establishment* principle is the main rule that governs the allocation of tax rights between countries.

1. Which is the usual method that avoids double taxation for taxpayers with a foreign permanent establishment?
* tax credit method
* *tax exemption with progression*
* deduction method
* profit split method

## 2.2 Capital Gains

The taxation of capital gains under a tax treaty basically follows the taxation of ongoing income. For instance, if a country has the right to tax for specific rental income, it is extremely likely that this country can also tax the capital gain that may arise in connection with the sale of the relevant real estate property. The rules for capital gains are laid down in Article 13 of the OECD Model Convention. The following are the most relevant scenarios and can be differentiated.

* Gains derived by a resident of a contracting state from the alienation of immovable property situated in the other contracting state may be taxed in that other state (Article 13, Paragraph 1). The state of residence will usually apply the exemption method to avoid double taxation.
* Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a contracting state has in another contracting state, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other state (Article 13, Paragraph 2). The state of residence will usually apply the exemption method to avoid double taxation.
* Gains from the alienation of any property, other than that referred to in Paragraphs 1, 2, 3 and 4 of Article 13, are taxable only in the contracting state of which the alienator is a resident (Article 13, Paragraph 5). Therefore, the source country is not allowed to tax, and the state of residence does not need to apply a method of avoiding double taxation.

### Self-Check Questions

1. Please mark the correct statement(s).
* *The taxation of capital gains under the OECD Model Convention basically follows the taxation of the ongoing income regarding the allocation of taxing rights*.
* The OECD Model Convention does not contain any rules with respect to the taxation of capital gains.
* Article 13 of the OECD Model Convention governs the allocation of taxing rights with respect to capital gains.
1. Please complete the following sentence.

When a taxpayer of a state of residence sells real estate located in the state of source, the state of residence will usually apply the exemption method.

## 2.3 Double Taxation Issues and Double Tax Relief in Practice

Double taxation occurs when different national tax jurisdictions levy a tax on the same person in the same or similar manner on account of the same tax object for the same period. The taxation overlaps because one state taxes the total income of the resident taxpayer and the other state taxes the income originating from its domestic territory, including non-residents. The reason for this is the parallel taxation of an economic transaction, both according to the source principle in the country of the source of income and with the world-wide income in the country of residence of the taxpayer.

In addition to the same tax object, the concept of double taxation further requires that the same person is subject to a similar tax for the same tax period due to different national tax jurisdictions.

Therefore, the prerequisites for conceptual (so-called legal) double taxation are:

* different national tax jurisdictions
* identity of the taxpayer
* identity of the object of taxation
* identity of the type of tax
* identity of the tax period

In the context of legal double taxation, a distinction is further made between effective and virtual double taxation. Effective double taxation occurs when the same tax subject is actually claimed by several international tax authorities. Virtual double taxation occurs when such a claim is possible without actually taking place.

It is in the interest of states to avoid double taxation, as this can hinder international economic trade and development of economic prosperity in the states involved. On the other hand, care must be taken not to lose the tax entitlement of the individual state through ill-considered tax exemptions or uncoordinated standardization. This conflict of objectives must be solved by international tax law in the best possible way and preferably on the grounds of a broad international consensus.

The starting point is the principle of sovereignty that characterizes every independent state. Through national laws, each state determines the principles on which to base and regulate substantive international law and whether and how it enters into treaties with other states. There is no “international tax world order” that is binding for all countries around the world.

Many countries have included regulations in their national tax laws that aim at avoiding or at least mitigating double taxation. We call these measures unilateral measures. Apart from that, double taxation treaties always include specific rules on double taxation, which is not surprising because this is the first and foremost aim of such treaties. The treaties that follow the OECD Model Convention rely on the exemption method (Article 23A, OECD Model Convention) and the credit method (Article 23B, OECD Model Convention).

**Methods of avoiding double taxation**

Exemption and credit methods are the state-of-the-art methods that are generally used in double taxation treaties.

### Exemption Method

The exemption method results in a unilateral waiver of the respective national tax claim. Operating expenses, income related expenses or foreign taxes are not recognized by the country of residence when determining income. However, Article 23A (3) of the OECD Model Convention deals with the progression proviso. Many countries have agreed reversion clauses. According to these clauses, the right of taxation reverts back to the state of residence in the event of non-taxation by the other state (state of source). Some countries, including Germany, have included similar provisions in their national tax laws (called treaty override), even in the absence of an express agreement.

### Credit Method

Under the credit method, the state of residence includes the foreign income in the determination of income. However, the amount of tax already paid in the other state (state of source) is credited against the domestic tax attributable proportionately to the foreign income. This results in an increase in the tax level from the perspective of the state of residence. Credit can only be given for those types of tax that are levied in accordance with the respective tax treaty.

### Self-Check Questions

1. Please complete the following sentence.

Usually, the state of residence is obliged to avoid double taxation.

1. Which is not one of the widely accepted specific forms of double taxation?
* Legal double taxation
* Virtual double taxation
* Cash double taxation
* Effective double taxation

## 2.4 Tax Evasion and Avoidance of Double Taxation

The phenomenon of tax evasion is probably as old as taxation itself. (Pistone, in Dourado, ed., (2017)).

Tax evasion can occur in two different ways. First, there are physical tax evasions, meaning that assets and income-generating activities are shifted abroad. Second, tax evasion can occur as a result of paper transactions or of a treaty application that does not reflect the true intention of the treaty. The avoidance of double taxation is the primary goal of tax treaties. However, structures have developed in which the application of the methods to avoid double taxation have led to double non-taxation in practice.

To clarify that double taxation agreements are not used to bring about double non-taxation, the wording of the preamble of existing tax treaties is important. The OECD Model Convention was amended in 2017 in that respect. The abusive use of double taxation agreements to bring about complete non-taxation of income, or the reduction of tax profits is thereby prohibited. Examples are tax evasion, tax avoidance or treaty shopping. Treaty shopping is a strategy by which a non-resident of a state attempts to claim the benefits under a double tax treaty of that state.

It is useful to consider an example. A company with unlimited tax liability in state A receives income from state B. There is no double taxation treaty between the two states. However, a double taxation treaty exists between state B and state C. If the transactions are conducted via state C in order to claim the benefits of the tax treaty between states B and C, this constitutes treaty shopping.

In addition to the change to the preamble, the latest OECD Model Convention contains specific regulations that deny treaty benefits where the aim of a tax arrangement is to bring about a treaty benefit (principal purpose test).

### Self-Check Questions

1. Please complete the following sentence.

The avoidance of double taxation is the primary goal of tax treaties. However, in practice structures were developed in which the application of the methods of avoiding double taxation have led to double non-taxation.

1. What is the name of a specific tax treaty provision that aims at denying treaty benefits?
* evasion provision
* *principal purpose test*
* benefit test
* denial provision

## 2.5 Case Studies

The following two cases illustrate the complexity of international tax law in two scenarios, using Germany as an example. The complexity does not only result from the application of a tax treaty, but also the relationship between a treaty with national tax law rules of one or more countries.

### Case 1

Structure Chart I



2. Explanation

The structure is designed for international groups with a foreign parent company that maintains a German branch with one or more corporate subsidiaries allocated to that branch, and the latter is making a loss - current losses or losses carried forward. This is in fact the only situation in which a foreign corporation can be the head of a German tax consolidation group, i.e., the foreign head company needs to have a German permanent establishment and shareholdings in domestic corporations need to be allocated to the respective permanent establishment. This is done via the functional approach, which means that there must be a close link between the activity of the branch and the activity of the subsidiaries.

The structure allows for a direct allocation of positive and negative income to a parent company and unlimited offset against current income of that company. In order to achieve this goal, GmbH and the Foreign Co (acting through its German branch) need to conclude a profit-and-loss distribution agreement according to Section 14 of the German Corporate Tax Act. This is a peculiarity of German tax law. In fact, Germany remains the only country that requires this kind of corporate contract for a fiscal unity to become enforceable. The profit-and-loss distribution agreement is a corporate contract between a parent company and its subsidiary and, as a consequence, the parent company is obliged to bear all losses of the subsidiary in the event of such losses.

Under the fiscal unity rules, the losses of GmbH will be allocated to the German branch and may be offset there with income from other subsidiaries or with positive income of the branch. Except for the regular tax rules, the offset is unlimited. In other cases, the minimum taxation rule is applicable (see Section 10d, German Income Tax Act). This means that only losses of up to one million euros can be offset. As for any amount exceeding this, only 60 percent can be offset in a single fiscal year. Losses that are not used can be carried forward with no time limit.

There are two further issues in relation to this structure. First, the profit-and-loss distribution agreement needs to be applicable for at least five years. Any earlier termination results in retroactive taxation, unless the termination was for good cause, e.g. sale of the subsidiary.

It needs to be noted that the requirement of this corporate contract has been questioned under EU law, and only the future will reveal whether Germany will revise its fiscal unity rules. A revision has been announced, but the German tax authorities have postponed the reform due to complications in the international context. The authorities fear that a loss of imports would result if the fiscal unity rules were to be changed.

Second, the fiscal unity is only available for current and future losses of GmbH after establishing the tax consolidation group. Existing losses carried forward are frozen at the GmbH level and cannot be used while the fiscal unity is in place. In addition, the fiscal unity is regarded as one business under the interest barrier rule. Therefore, as regards the limitation on the deductibility of interest expense, only a single threshold in the amount of three million euros is granted to the group as a whole (Section 4h, German Income Tax Act). For groups with high debt-financing, this could be a structure or deal breaker.

### Case 2

Structure Chart II



2. Explanation

The structure is designed for foreign investors who wish to acquire a German corporation and need to debt-finance the acquisition. If planned carefully, the structure allows for a double dip regarding the deductibility of interest expenses.

In order to implement the structure, Foreign Co sets up a permanent establishment in the form of a registered branch. Foreign Co borrows money from a bank (or a related party) and funds the branch accordingly. The German permanent establishment uses the funds to acquire the participation in the German target (GmbH). Following this, the GmbH and the branch form a fiscal unity for income and trade tax purposes (tax consolidation).

As a consequence, Foreign Co is able to deduct the interest arising from the bank loan from the tax base of the foreign country in which Foreign Co is located. The tax base also includes the income from the German branch, provided that the applicable double tax treaty applies the credit method for foreign permanent establishment income, e.g., U.S.-German tax treaty. From a German perspective, the interest which is attributed to the German permanent establishment is fully deductible from the income of the fiscal unity. Under the limitations of the interest barrier rule, interest expenses are deductible to the extent that the branch generates interest income. For any exceeding interest expense, only 30 percent of the EBITDA (earnings before interest, taxes, depreciation, and amortization) is deductible. See above Case 1 for the general three million euro threshold.

Naturally, there are criteria relating to this structure which need to be addressed. First, the shares in GmbH must be functionally allocated to the German branch of Foreign Co. The branch must be working (personnel and office space) and ideally needs to be active in the same business as GmbH. Second, the (bank) loan granted to Foreign Co cannot be secured by a mortgage on land located in Germany. Otherwise, the German rules on withholding tax apply, and the German branch would be required to withhold tax at 25 percent on the interest paid (plus 5.5 percent solidarity surcharge thereon). Finally, the state of residence of Foreign Co must allow the double dip. At present, this is permitted in the United Kingdom, the United States, Belgium, Canada, Italy, Spain, Sweden, and Ireland.

### Self-Check Questions

1. Please mark the correct statement(s).
* *A profit-and-loss distribution agreement is essential for a German tax consolidation group.*
* A loss carried forward is restricted to one year in Germany.
* The general threshold for the German interest barrier rule is five million euros.
1. Please complete the following sentence.

The attribution of shareholdings to a permanent establishment is done by a functional approach.

Summary

Most of the existing double taxation treaties follow the OECD Model Convention. This Convention is revised every 3-5 years and contains general rules as to how taxing rights should ideally be allocated amongst two or more countries. The nature of such treaties is always a bilateral one, though the treaties also provide for the avoidance of double taxation vis-à-vis third party countries. The rules differ depending on the nature of the income in question, and taxing rights are either allocated to the state of residence or the state of source. The state of residence needs to choose a method to avoid double taxation. In a small minority of situations, the treaty determines that only one of the states has an exclusive taxing right (for instance, rental income). In practice, the most relevant methods are the exemption method and the credit method. These methods solve double taxation conflicts in most, but not all cases.

# Unit 3 – Institutional Tax Planning and Management

**Study Goals**

On completion of this unit, you will be able to …

… describe the general aim of anti-abuse rules in tax law and the consequences of such rules.

… explain the main methods in transfer pricing models.

… understand the ratio of Controlled Foreign Corporation Rules (CFC Rules).

# 3. Institutional Tax Planning and Management

## Introduction

The term “tax planning” is used in both a narrow and broad sense. According to the narrow interpretation, tax planning includes only the target-oriented influence of tax. In contrast, the broad interpretation of the term also includes the influence of taxation on the determination of possible entrepreneurial actions. The business analysis of the tax burden, with the help of state-of-the-art methods and tools, is necessary in view of the heavy weight of tax payments, complexity of tax laws and considerable scope to shape and maintain national and international competitiveness.

Tax planning contradicts the rules that try to prevent base erosion and profit shifting between companies or countries. Most countries have implemented anti-avoidance rules that make it more difficult for taxpayers to reach their goal of optimization. Most tax systems have a set of transfer pricing rules that govern the relationship between affiliated parties. Transactions between affiliated parties need to meet the arm´s length principle in order to be recognized from a tax perspective.

Importantly, states have enacted CFC Rules that hinder taxpayers to shift profits abroad into low-taxing countries. All of these instruments are explained in the following section.

## 3.1 Rules of Anti-Avoidance (Structure, Finance)

It is illegal for taxpayers to hide income, in part or in full, from the tax authorities or to try to obtain a tax refund that they are not entitled to by law. However, taxpayers do try to circumvent the law and this is tax fraud.

In contrast, anti-abuse rules take the legal structures into account. At times, these rules are structured in a general way and comprise catch-all provisions, known as GAAR (general anti-abuse rules). These rules sometimes address only specific situations. The rules are implemented in national law, double taxation treaties or European Union law.

Tax laws cannot be circumvented by the misuse of legal structuring options. If there is an abuse of law, the tax claim arises in the same manner as it would arise in a legal arrangement and one which is appropriate to the economic transaction. The application of the law as sought by the taxpayer is denied.

There is an abuse of tax law if the legal structuring is:

* inappropriate for achieving the desired objective;
* intended to reduce tax; and
* cannot be justified on the basis of economic or other considerable non-tax related reasons.

In the legal structuring of economic transactions, a taxpayer has freedom of choice within the framework of the law. From a tax law point of view, a chosen legal arrangement is recognized in principle. The motive to save taxes does not make a legal arrangement inappropriate *per se*.

An abusive arrangement is characterized by the fact that the taxpayer does not use the “appropriate” legal arrangement presupposed by the legislator in order to achieve certain economic goals, even though there are no significant non-tax related reasons for making such an arrangement. In other words, there is an abusive arrangement when a taxpayer chooses an unusual legal path, in which the goal of saving taxes is not supposed to be achievable according to the legislator's evaluations and underlying considerations. Therefore, an abuse of tax law exists if the taxpayer avoids an appropriate path and chooses a path that is also taxable according to the legislator's assessment, but as such does not trigger a taxable event.

Inappropriate legal arrangements are often referred to as cumbersome, complicated, uneconomical, artificial, unnatural, outlandish, superfluous, absurd or opaque, whereas appropriate arrangements are simple, expedient and clear.

It is interesting to note that recently, the EU legislator has attempted to define the abuse of tax law with binding effect for EU Member States. Many questions are raised by Article 6 of the Council Directive (EU) 2016/1164, 12 July 2016, which lays down rules to combat tax avoidance practices directly affecting the functioning of the internal market (hereinafter “ATAD 1”).

Article 6, ATAD 1 concerns an improper arrangement or an improper series of arrangements where the essential purpose or one of the essential purposes is to obtain a tax advantage. Thus, it concerns a purposeful action which contains a subjective element. Furthermore, the tax advantage must run counter to the objective or purpose of the applicable tax law. This means that the arrangement inappropriately prevents the tax-burdening provision from taking effect. The arrangement is considered unreasonable to the extent that it was not made for valid economic reasons reflecting economic reality. This raises the question of the burden of proof. In principle, according to tax law, the state always has the burden of proof unless the law or its interpretation indicates otherwise. Article 6, ATAD does not express otherwise and so the burden of proof is on the state to show that there were no valid economic reasons.

**ATAD**

The Anti-Tax-Avoidance Directive is the first substantial EU package that tackles abuse in tax law.

What is the significance of Article 6, ATAD 1 in respect of the national tax laws of Member States? ATAD 1 applies to all corporate taxpayers. The question here is whether ATAD 1 applies to all corporate taxes or only to corporate income tax. This is not entirely clear.

According to Article 3, ATAD 1, the directive only represents a minimum level of protection. However, it is questionable whether a different distribution of the burden of proof results in a higher level of protection. The distribution of the burden of proof is more about a procedural advantage than about a higher level of protection. The different distribution of the burden of proof of Article 6, ATAD 1 must therefore be observed and ATAD 1 takes precedence.

There is a questionable relationship between Article 6, ATAD 1 to the special abuse provisions in ATAD 1 and 2, other European Union directives, double taxation treaties, and national tax law. This relationship is relevant where a special abuse provision applies, but the requirements of the provision are not met in the specific individual case, and therefore no abuse can be assumed under the special abuse provision. Because Article 6 (1), ATAD 1 states that all relevant facts and circumstances are used to determine “inappropriateness,” there should also be no abuse within the meaning of this Article, regardless of the special provision.

The relationship between Article 6, ATAD 1 and the fundamental freedoms of the European Union is also interesting. In *Cadbury Schweppes* (12.9.2006 - C-196/04) and *GS* (14.6.2018 - C-440/17), the European Court of Justice assumed the possibility of the restriction of the EU fundamental freedoms was for purely artificial constructions devoid of any economic reality. What is the relationship between the principles in these cases and ATAD 1? Correctly, one must assume the primacy of the EU fundamental freedoms. Thus, even under ATAD 1, there should be no effect in case law on the relationship of the abuse provisions and EU fundamental freedoms, as seen in *Cadbury Schweppes*.

### Self-Check Questions

1. Please complete the following sentence.

The ATAD 1 Directive is only applicable to corporate taxpayers.

1. The abbreviation of general anti-abuse rules is…?
* GAR
* *GAAR*
* GARE
* GAP

## 3.2 Transfer Pricing Tools

Transfer pricing is one of the topical issues in international tax law. The rules of transfer pricing deal with transactions between related parties. In situations where the parties are related, there are many possible opportunities to shift profits, preferably into a low-taxing country.

For tax purposes, business dealings between affiliated parties must be evaluated according to whether those involved acted as unaffiliated third parties (arm’s length test). In this regard, free competition forms the standard. The underlying principle is that a normal degree of commercial prudence is exercised by a reasonable and prudent business manager in dealing with third parties.

The income allocation is generally based on each specific business transaction with the affiliated party. The facts and circumstances are decisive in accordance with the economic substance. The functions of the individual affiliated companies must be regarded for the income allocation.

Of particular importance are:

(1) the structure, organization, division of functions, and risk allocation within groups as well as allocation of assets;

(2) which companies fulfill individual functions such as production, assembly, research and development, administrative services, marketing, and other services;

(3) the capacity with which the companies perform these functions, e.g., as a fully-fledged distributor, an agent, an equal party or as agent of a pool.

In this context, the economic substance of the activity is the determining factor. Remuneration for services in respect of a company with no activity is not permitted. If a company carries out simple functions, then only the economic services actually rendered are taken into account, i.e., by means of a cost-plus method.

It is necessary to evaluate the remuneration that a third party would charge for supplies or services of the same kind (“arm’s length price”) and what income or expenses would have accrued to or been incurred by the taxpayer if a third party had conducted that same business. For this assessment, it is assumed that supplies and services are provided in the ordinary course of business between independent parties and are separate business transactions, i.e., separate agreements and invoices.

Package deals between affiliated parties are subject to an audit. It is not objectionable if a price is charged for a number of supplies or services as long as the overall remuneration can be split into specific partial transactions or third parties agree to such aggregate prices.

An arm’s length price is determined by evaluating the price of a comparable transaction between independent third parties, with reference to market data. The price which unaffiliated parties would negotiate in arm’s length business conditions is the determining factor. Accordingly, the following standards may be considered in determining arm’s length prices: (i) stock market prices, common trade prices that are determined in the relevant market, and other market information; (ii) prices which the taxpayer, the affiliated party or third parties have agreed for respective supplies or services in the relevant market; (iii) profit mark-ups, calculation methods or other business aspects which influence pricing in the free market (business data).

Where necessary, this data is adjusted according to divergent conditions of the relevant business. This step is important for the correct determination of an arm’s length price. For example, the market price for standard quality goods are usually recalculated to a customary commercial standard. Market prices based on cost, insurance, and freight (CIF) must be recalculated accordingly for freight on board (FOB) transactions. Discounts for bulk volume also need to be considered. An astute business manager arrives at a transfer price following careful consideration of all available and accessible data. The business manager has flexibility and choice in arriving at assessments. The same goes for other business decisions which are the result of experience in the trade with fluctuating market situations. On the other hand, managers of a taxable enterprise safeguard the interests of that business and the whole group towards affiliated parties in the same manner that is done towards third parties. Using such leeway presupposes that the total framework complies with the normal practice of the business, the industry, and general commercial dealings.

The following examples illustrate the application of these principles.

Example 1: In order to determine an arm’s length price, there is often only one price range available on the market for independent market participants to negotiate business transaction prices. Without any economically substantial reason, two affiliated companies set prices at the upper or lower limit within this range and the profit of the disadvantaged company is continuously reduced. A discerning business manager of the disadvantaged company would not accept such pricing. Instead, a manager would attempt to accomplish a more balanced pricing system for the benefit of the company. Therefore, the income of the disadvantaged company needs to be adjusted.

Example 2: A distribution company in a low-tax country is engaged in the export of goods of a German company. Leeway regarding the delivery of goods to this distribution company is designed in such a manner that it earns an unreasonably high profit which does not correlate with the function and role of the company. Again, the business manager of the disadvantaged German company would not accept such a situation and the income needs to be adjusted.

The standard methods described below give the most important guidelines for the transfer pricing examination.

* Comparable uncontrolled price method

Affiliated parties agree a comparable price to one which third parties would have agreed in the market for a similar transaction. This may be done by (i) an external price comparison (comparison with market prices determined according to price quotations, customary commercial prices or agreements concluded between independent third parties); or (ii) an internal price comparison. Preferably, the transactions should be as similar to one another as possible (direct price comparison). An inhomogeneous transaction can be considered if the influence of the divergent factors can be eliminated and the price agreed upon for the transaction is recalculated for a comparable transaction.

* Resale price method

This method begins with the price at which goods purchased from an affiliated party are sold to an independent purchaser. The resale price is then calculated back to the price that is applied to the transaction between the affiliated parties. Accordingly, the resale price is reduced by customary market discounts that reflect the function and risk of the reseller. If the reseller has processed or otherwise modified the goods, this must be reflected in an appropriate reduction. If goods pass through a chain of affiliated parties, it is possible to recalculate the price of the last delivery to an unaffiliated party across the chain back to its starting point. The same is applicable to services.

* Cost plus method

With regard to deliveries or services between affiliated parties, the starting point of this method is the manufacturer’s or service provider’s costs. These costs are calculated according to methods by which the manufacturer or supplier bases its pricing to third parties. Where there are no supplies or services to third parties, costs are calculated according to business management principles. Profit mark-ups that are customary for the company or the industry will then be added. Where goods or services are transferred through a chain of affiliates, this method is applied to each individual member consecutively, whereas the actual functions of the individual affiliated companies need to be regarded.

An adjustment between profitable and unprofitable transactions between a taxpayer and an affiliated party is only permissible where third parties would have made such an adjustment for their business transactions. Accordingly, the benefits must be set off if the taxpayer has accepted disadvantageous conditions in the transaction with the affiliated party.

The set off of benefits has a number of requirements. First, the transactions must be coherent and the taxpayer would have concluded the transaction with the same person under arm’s length conditions. Second, the benefits and disadvantages of the individual transaction are quantifiable with the care of a reasonable and prudent business manager. Third, the set off of benefits was agreed or had been part of the commercial motivation for the unprofitable transaction. If the disadvantageous conditions were not set off in the business year in which they took effect, a set off is only permitted if it is determined at the latest, by the end of the same business year. Then the disadvantages need to be off set within the following three business years. The set off is also achieved where the advantage has been capitalized.

There is no priority among the standard methods for the examination of transfer prices that applies in all cases. The examination is based on the transfer pricing determination that the company carries out. In verifying the appropriateness of that determination as regards method and application, it is assumed that a solid business manager:

(a) refers to the method closest to the circumstances under which arm’s length prices are formed in commercially comparable markets;

(b) refers, in case of doubt, to the method for which the most reliable and relevant pricing data is available from actual transactions of the participating affiliated companies with third parties. In this context, the circumstances of the individual case are the determining factor.

Market circumstances will often lead to the necessity to rely on several methods in order to determine transfer prices. It is therefore not objectionable if standard methods are specified, mixed or supplemented by other elements to meet market conditions. Several standard methods are used when analyzing transfer prices. Affiliated companies often determine their transfer prices based on costs, calculation and other computations of figures, or centrally collected data. The examination of income allocation may rely on such calculation systems if it leads to the same results as a business transaction between unaffiliated third parties with appropriate accuracy.

It is assumed that:

(a) the calculation systems are sufficiently differentiated and, with regard to system and application, the details are easily and completely verifiable;

(b) the calculation systems guarantee that domestically generated income is taken into account completely and accurately; and

(c) the standards and data contained in the computation are checked by the companies at appropriate intervals and adjusted according to changes in circumstances.

The calculation systems must be reviewed with regard to consistency and proper application to individual transactions.

In applying these principles:

(a) the starting point is the actual functions of the affiliated companies within the group;

(b) a company cannot refer to a standard method that deviates from the market conditions and those of the company;

(c) a company may only refer to a specific method in a case if it submits the documents required;

(d) a company may not depart arbitrarily from an appropriate method of determining its transfer prices or from appropriate calculation systems.

When applying the aforementioned principles, a tax audit can rely on the operating results that the taxpayer, affiliated parties, or third parties generated under comparable business conditions and in comparable transactions with unaffiliated parties. These results can be relied on to determine special audit fields, cross-check transfer prices, or to find other indications for income allocation. For these purposes, the total profits of connected business divisions and their allocation to the individual business divisions of an affiliated group can be referred to. The results may be taken alone as a basis for income allocation where the application of the standards methods does not lead to appropriate results because of special circumstances, e.g., when goods or a group of goods can, to a great extent, only be acquired or manufactured, processed, and distributed within a group of companies with a vertical organizational structure.

In special cases it may not be possible to compare the actual circumstances with similar situations between unaffiliated parties, especially where business relations of the same kind would not have been concluded between unaffiliated parties or would only have come about in an essentially different commercial context. In such cases, income allocation must be based on an appropriate allocation of income from business relations, as a good business manager would have agreed.

### Self-Check Questions

1. Please complete the following sentence.

Transfer pricing rules in general only apply to transactions between affiliated parties.

1. Which is not a widely recognized transfer pricing method?
* comparable uncontrolled price method
* cost plus method
* profit and loss split method
* resale price method

## 3.3 Controlled Foreign Company Regimes

An old theory of entrepreneurs is to maintain residence and live in a country with high social standards, but to make use of companies that are registered and operate in low-tax countries. To make matters worse, entrepreneurs often have the know-how and pull the strings behind the operations of the companies in low-tax countries, while the successes are not reflected in the overall taxation of the companies nor the entrepreneurs. A company in a situation such as the above is known as a controlled foreign company/corporation (CFC). Most countries have special CFC regimes in their national tax laws to tackle problems surrounding such companies and the base erosion that is associated with them. The following is an overview of the German CFC rules, as an example.

As part of the German anti-abuse regulations, the German Foreign Transaction Tax Law contains special CFC provisions. According to the German Foreign Tax Act, a foreign company is any company that has neither its seat nor its place of management in Germany. This foreign company is a controlled foreign company if one or more German taxpayers hold the majority of the shares in the company. The shares of related parties are also taken into account. A taxpayer in this context can be a German corporation, a partnership, or an individual. A controlled foreign company is an intermediary company for low-taxed passive income.

**US rules as role model**

The German CFC rules and many CFC rules in the world rely on the United States Sub-Part F Legislation.

### Passive Income

Passive income is all income, except income from the following sources:

* agriculture and forestry;
* manufacture, machining, processing, or assembly of tangible property, the generation of energy, and the exploration for and extraction of mineral resources;
* the operation of banks and insurance companies that, for business purposes, maintain an organization that is equipped in a commercial manner, provided such business is not transacted predominantly with resident taxpayers holding ownership interests in the foreign company or with parties that are related to such taxpayers;
* trade, but not to the extent that
* a resident taxpayer holding an ownership interest in the foreign company, or a party related to such a taxpayer that is liable to tax in the territory to which this tax law applies on its income therefrom provides the foreign company with control over the traded goods or merchandise, or
* the foreign company provides control over the goods or merchandise to a resident taxpayer holding an interest in the company or to such a related party,

unless the taxpayer proves that the foreign company maintains a business organization that is equipped in a commercial manner for such merchandising transactions, participates in general commerce, and carries out the activities associated with preparing, entering into, and performing the transactions without the involvement of a resident taxpayer or any such related party;

• services, but not to the extent that

* the foreign company, in performing the services, relies on a resident taxpayer that holds an ownership interest in it or on a party that is related to such a taxpayer and taxable in the territory to which this Law applies on its income from the functions it performs, or
* the foreign company renders the service to such a taxpayer or such a related party, unless the taxpayer proves that the foreign company maintains a business organization that is equipped to render such services, participates in general commerce, and carries out the activities associated with the service without the involvement of any resident taxpayer holding an interest in the company or any such related party;
* rental and usufruct leasing, excluding
* licensing the use of rights, plans, samples, procedures, experience, and knowledge, unless the taxpayer proves that the foreign company is exploiting the results of its own research and development work which was carried out without the involvement of a resident taxpayer that holds an ownership interest in it or a party that is related to such a taxpayer,
* the rental or usufruct lease of parcels of land, unless the taxpayer proves that the income therefrom would be exempt under the terms of a convention for the avoidance of double taxation if it had been directly derived by the resident taxpayers that hold ownership interests in the foreign company, and
* the rental or usufruct lease of tangible moveable property, unless the taxpayer proves that the foreign company maintains a commercial rental or usufruct lease organization, participates in general commerce, and carries out all activities associated with such commercial rental and usufruct leasing without the involvement of a resident taxpayer that holds an ownership interest in the foreign company or of a party that is related to such a taxpayer;

• raising and lending capital, if the taxpayer proves that such capital is raised solely on foreign capital markets and not from a party that is related to the taxpayer or the foreign company, and that such capital is provided either to business entities or permanent establishments located outside the territory to which this Law applies that derive their gross revenue exclusively or almost exclusively from the business activities listed above, or to business entities or permanent establishments located within Germany;

• profit distributions of corporations (under certain circumstances);

• the sale of a share in another company, the liquidation of another company, or the reduction of another company’s capital under certain circumstances.

### Low Taxation

A low rate of taxation within the meaning of the Foreign Tax Act exists if the income of the foreign company is subject to the burden of tax on income of less than 15 percent, unless this results from an offset against income from other sources. Where taxes on income of at least 15 percent are owed *de jure*, but are not levied in fact, the definition of low taxation is also fulfilled.

### Escape for EU Companies

Following the decision in *Marks & Spencer* made by the European Court of Justice, the German legislature had to amend its rules regarding controlled foreign companies in order to allow for an “escape rule” for European companies. According to the current Foreign Tax Act regulations, a company with its registered office or management in a Member State of the European Union or in a treaty country of the European Economic Area Agreement (the EEA Agreement) is not an intermediary company. This is with respect to income for which resident taxpayers hold majority ownership interests in the said company insofar as the company carries out genuine economic activities in the country in question.

A further requirement is that the Federal Republic of Germany and the country in question provide each other with necessary information to carry out taxation. This is pursuant to Council Directive 77/799/EEC of 19 December 1977, concerning mutual assistance by the competent authorities of Member States in the field of direct taxation and value added taxation, or pursuant to a comparable bilateral or multilateral agreement.

The escape clause does not apply for income of a lower tier company that is attributable to that company if neither its registered office nor its management are situated in a Member State of the European Union or a treaty country of the EEA Agreement. The same exclusion applies with respect to intermediary income attributable to a permanent establishment of the company that is located outside the European Union or a treaty country of the EEA Agreement.

The core requirements of this escape clause are that the registered office or management of the foreign controlled company is situated in a Member State of the European Union or an EEA country and the company carries on genuine economic activity in the country in question.

### Determination of a Tax Base

Taxable passive income is taxed at the level of the resident taxpayer. The imputed income amount is the amount that results after deduction of taxes levied against the foreign company on this income and on the property underlying this income. To the extent that the taxes to be deducted have not yet been paid at the time at which the income is deemed to have been received, the taxes will be deducted from the taxable income in the years in which they are paid. If the resulting amount is negative, no income is imputed.

The imputed income amount constitutes dividend income and is deemed to have been received immediately within the foreign company’s relevant financial year. The dividend is taxed according to normal tax rules in Germany, but without any benefits that are usually associated with dividend income.

The income underlying the imputed amount of income is determined by applying the provisions of German tax law analogously. Tax preferences that are conditioned on liability to tax as a resident or on the existence of a domestic business or a domestic permanent establishment and the provisions of the thin capitalization rules are not applicable and are disregarded. Losses incurred with respect to income for which the foreign company is an intermediary company may be deducted to the extent that they exceed the income, which is disregarded under the *de-minimis* threshold, by applying the German loss deductions provision analogously. To determine the income for which the foreign company is an intermediary company, only those business expenses which are economically related to such income are deductible.

### Self-Check Questions

1. Please complete the following sentence.

The imputed CFC income under German rules is treated as a fictitious dividend.

1. Which is the relevant threshold for low taxation within the German CFC system?
* 25 percent
* 20 percent
* 15 percent
* 10 percent

Summary

Tax planning can contradict rules that try to prevent base erosion and profit shifting between companies or countries. Most countries have implemented anti-avoidance rules that make it more difficult for taxpayers to reach their goal of optimization. Such rules have a general structure in the sense of catch-all provisions. General rules are called GAAR (general anti-abuse rules). Alternatively, rules may address specific situations only. Rules are implemented in national law, double taxation treaties or European Union law. Tax laws cannot be circumvented by misuse of legal structuring options. If there is an abuse, the tax claim arises in the same way as it would in the case of a legal arrangement and appropriate to the economic transactions.

In addition to these rules, most tax systems have a set of transfer pricing rules that govern the relationship between affiliated parties. Transactions between affiliated parties need to meet the arm´s length principle in order to be recognized from a tax perspective.

The final important instrument that states have enacted in practice are CFC rules that hinder taxpayers to shift profits abroad into low-tax countries. If companies in these countries earn passive income, the income is added back on the shareholder level as a fictitious dividend to which the normal tax benefits of dividend taxation do not apply.

# Unit 4 – Taxation and Globalization

**Study Goals**

On completion of this unit, you will be able to …

… describe the latest trends and developments in international tax law.

… explain the inter-dependencies between tax law and globalization.

… give a definition of a tax haven and classify countries and companies and their role in global tax competition.

# 4. Taxation and Globalization

## Introduction

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When business goes global, taxes don´t stay local. This old saying is truer than ever today. Tax competition has increased significantly in the last few decades, as more and more countries entice taxpayers across the globe. Tax competition has also increased amongst taxpayers. In particular, large enterprises are at an advantage in terms of economic competition because they try to keep their overall tax burden to a minimum.

In the past, companies often aimed at tax havens with little or no income taxation, but these tax havens have recently become problematic. The business model has become more and more obsolete in light of increased tax transparency rules. The OECD’s base erosion and profit shifting rules (BEPS) are the peak of this development, with tighter rules on transparency and taxation alongside the value creation chain.

## 4.1 Tax Competition

It is not surprising that international tax planning has recently become more popular and relevant today. However, there is also a complexity that is not easy to comprehend, even for experts. There is an increasing density of regulations, coexistence of national tax jurisdictions, allocation of taxation claims between states through double taxation agreements, as well as purely factual difficulties such as language barriers or different cultures. In addition, the international mobility of taxpayers and sources of income has led to conflicting reactions on the part of tax authorities, which in turn has not brought about a simplification of tax law or a more practical application.

The competition by states for taxpayers is understandable but this is only one part of the picture. If the totality of a government’s measures reaches an intensity that is capable of deliberately preventing taxpayers from investing in other countries, this causes harmful tax competition. This is undesirable from the point of view of the community of states and the OECD. Only in extreme cases are the countries addressed typical tax havens. Within the European Union, the OECD has already identified a whole series of harmful tax practices by Member States recently. For , see().

The OECD and the EU Commission have addressed the economically undesirable problem of harmful tax competition by implementing different approaches. In the past, the focus of attention and criticism was solely on a national level. As early as 1998, the OECD issued its report “Harmful Tax Competition - An Emerging Global Issue,” in which it sought for the first time to record the harmful elements of international tax competition in a truly systematic way. To this end, guidelines were issued that provided for the fundamental elimination of harmful tax practices by 2005 at the latest. In addition, the “Forum on Harmful Tax Practices” was founded as an OECD working group. It is to this group that we owe the preliminary work on co-operation between tax authorities in tax matters, which now extends from general legal and administrative assistance to joint audits.

**The direction of tax competition**

The discussion about tax competition has evolved over time. At first, states were the focus but later large companies were focused on.

However, recently the discussion has taken on a different tone. Rather than the focus being on the states, the focus has turned to multinational companies. These companies, especially through transfer pricing and preferential tax regimes, have achieved almost “indecent” corporate tax rates in the low single-digit range. Spurred on by dubious media reporting, it was primarily American multimedia groups that first brought this to the public's attention. As a result, from approximately 2013 onwards, the EU Commission re-issued the legal institution of prohibited state aid for tax law and this has been successfully used since then. From the point of view of illegal subsidies under EU law, intellectual property boxes (IP) and other preferential tax regimes, and most importantly the advance rulings associated with them, will soon be a thing of the past in Europe. At the very least, their effect will be significantly reduced.

On 6 December 2012, the EU Commission launched an action plan to strengthen the fight against tax fraud and tax evasion. This plan contains 34 individual proposals. For the full text of the action plan, see <https://eur-lex.europa.eu/legal-content/EN/LSU/?uri=CELEX:32012H0772>. The plan is supplemented by a recommendation from the same date on aggressive tax planning. This focuses in particular on the revision of income tax directives and the inclusion of general and special anti-abuse clauses in double tax treaties.

Another Commission recommendation from the same date deals with the good governance of non-EU countries and aims to encourage them to adopt minimum standards in the field of tax. For example, the recommendation encourages non-EU countries to adopt the criteria of the EU in the Code of Conduct on Unfair Tax Competition and the Global Forum on Transparency and Exchange of Information, to draw up a “blacklist” of tax havens, and more.

This was the environment in which the OECD found itself when it began work on a truly ground-breaking project in 2013, namely the action plan against BEPS (base erosion and profit shifting). It was initiated with the aim of combating harmful tax competition between states and aggressive tax planning by internationally active corporations. The BEPS project builds a bridge between the above-mentioned approach of the last three decades, where the interests of the states are taken into account on the one hand, and multinational companies’ interests are taken into account on the other.

### Self-Check Questions

1. Please complete the following sentence.

In the past, countries have entered into a “race to the bottom” by gradually lowering their *corporate tax rates*.

1. Which are the two main driving forces of international tax competition as seen against the global tax environment?
* consolidation in the banking sector
* *mobility of taxpayers*
* transferability of assets
* weather conditions in tax havens

## 4.2 Tax Havens

The term “tax haven” is not a technical term. It is a term that describes countries where tax levels are low. These countries impose no taxes or impose very low taxes or other levies. Examples are the Bermuda Islands and the Bahamas. The list also includes Liechtenstein, Monaco, and Switzerland, with certain limitations. The low tax levels are due to either a generally low maximum tax burden or special tax and duty privileges for certain tax subjects and taxpayers. Some of these countries try to compensate for the lack of tax and duty revenues with other revenues (special stamps, concessions, etc.).

From the taxpayer’s point of view, the attraction of tax havens has been considerably restricted, and in some cases reversed, by the CFC rules. Moreover, since the mid-1990s, tax havens have also come under strong pressure to refrain from what is perceived as unfair tax competition. This pressure comes from coordinated defensive measures by OECD countries. As a result of these measures, legal forms of tax reduction through dealings with tax havens now promise only minor benefits. The appeal of tax havens has narrowed mainly to activities in which taxpayers from a high (or normally high) taxing country invest capital in tax havens and conceal its existence from tax authorities in their home country.

Tax administrations have recently increased their efforts to obtain information from tax haven countries regarding capital investors and the existence and amount of capital investments and income in their countries. The OECD has established standards for cross-border exchange of information. High and normal tax countries also require tax havens to comply. Seer and Kargitta (2020) provide a comprehensive overview of the exchange of information in direct taxation and also the development of the DAC.

The plan to impose massive and coordinated economic and tax sanctions on tax haven countries has caused numerous tax haven countries to express their willingness to provide cross-border information on capital investments and income in order to escape such sanctions. This is an unexpectedly far-reaching concession by the tax haven countries vis-à-vis the industrialized countries.

It has therefore become conceivable that tax havens will no longer be able to assert themselves in the long term as a place of investment to conceal funds from the tax authorities. However, it remains to be seen whether the tax haven countries will actually sufficiently comply in practice with the obligations that they have entered into and cooperate fiscally in the exchange of information.

### Self-Check Questions

1. Please complete the following sentence.

The OECD has established standards for cross-border exchange of information, and high and normal tax countries also require tax havens to comply with these standards.

1. How is the term “tax haven” used in tax law in general?
* In many written tax statutes.
* In many administrative circulars of the tax authorities.
* In a non-technical, merely descriptive way.
* In a clear, judicially enforceable way.

## 4.3 BEPS Measures

The OECD presented a comprehensive report to the G20 Finance Ministers and Central Bank Governors’ Meeting in February 2013 on the causes and effects of base erosion and profit shifting (BEPS) by multinational companies. Based on this report, the G20 gave the OECD a mandate to develop a comprehensive action plan. Germany and the German Federal Ministry of Finance played a key role (and probably also financed) the preparation of the action plan, which was approved by the G20 in Moscow on 20 July 2013.

At the outset, 62 countries participated in the BEPS project and the concrete development of the action plan. These included all of the OECD and G20 countries, as well as developing and emerging countries. International organizations such as the United Nations, the International Monetary Fund, the World Bank and the European Union were also involved, as were regional tax organizations. The action plan is to be understood as a catalogue of measures against base erosion and profit shifting. Internationally coordinated regulations against profit reduction and profit shifting were to be developed by the end of 2015 based on this catalogue of measures.

**Broad international consensus**

The BEPS project was the largest international consensus in the history of international taxation.

The BEPS action plan included the following 15 measures or action items:

Action Item 1: Addressing the Tax Challenges of the Digital Economy

Action Item 2: Neutralizing the Effects of Hybrid Mismatch Arrangements

Action Item 3: Designing Effective Controlled Foreign Company Rules

Action Item 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Action Item 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Action Item 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Action Item 7: Preventing the Artificial Avoidance of Permanent Establishment Status

Action Items 8-10: Aligning Transfer Pricing Outcomes with Value Creation

Action Item 11: Measuring and Monitoring BEPS

Action Item 12: Mandatory Disclosure Rules (See Haase, 2021 for more information).

Action Item 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

Action Item 14: Making Dispute Resolution Mechanisms More Effective

Action Item 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

In this way, the international community of states responded in a broad international consensus to the observation that multinational companies were increasingly reducing their tax burden to a minimum by taking advantage of different tax systems compared with companies operating predominantly nationally. The aims of the BEPS project therefore were to reduce information deficits of tax administrations, link the extent and place of taxation more closely to actual economic substance, increase coherence of individual national tax systems of the states, and curb unfair tax competition.

These goals are necessary for several reasons. The primary negative consequence of BEPS on the treasury is that harmful tax competition and aggressive tax structuring lead to tax losses that countries can hardly afford, especially in times of budget consolidation. However, there are also other disadvantages. For example, the competitiveness of companies that do not use such tax arrangements and therefore bear a higher tax burden is reduced. This affects small and medium-sized companies. In addition, the overarching principle of fair taxation is affected when only a few companies reduce their tax burden to a minimum through complex constructions and others are taxed at the standard statutory rate.

### Self-Check Questions

1. Please complete the following sentence.

The BEPS action plan is to be understood as a catalogue of measures against base erosion and profit shifting.

1. How many Action Items did the BEPS report comprise?
* 10
* 20
* 15
* 5

Summary

In the last few decades, tax competition has increased significantly amongst countries as well as taxpayers. It is therefore not surprising that the OECD and the EU Commission both combat tax competition, in particular when competition borders on unfair tax competition. In the past, states were the main focus of public debate and tax competition. However, the taxpayers have come into play more recently.

Tax havens - a non-technical term - have also been the focus of public debate concerning tax competition and tax fraud. The attraction of tax havens from the point of view of taxpayers has been considerably restricted and, in some cases, reversed by CFC rules. Moreover, since the mid-1990s, tax havens have also come under strong pressure from coordinated defensive measures by OECD countries to refrain from what is perceived as unfair tax competition. The tax haven business model has become more and more obsolete in light of increased tax transparency rules. The BEPS rules of the OECD are the peak of this development, with tighter rules on transparency and taxation alongside the value creation chain.

# Unit 5 – Challenges of International Taxation

**Study Goals**

On completion of this unit, you will be able to …

… outline the current trends and perspectives in international taxation.

… explain the specific problems of taxation of the digital economy.

… describe the general principles of EU taxation law.

# 5. Challenges of International Taxation

## Introduction

Some passages in this Chapter are a verbatim extract from Haase (2021).

It is no exaggeration that international tax law, as known for decades, is at a turning point. International tax law is entering an entirely new era. There are four recent, international developments that support this statement. First, the OECD has introduced the Multilateral Instrument. This is a multilateral tax treaty, the purpose of which is to uniformly amend as many as 2,000 existing bilateral tax treaties around the globe, almost simultaneously. This Multilateral Instrument will implement central results from the landmark BEPS project of the OECD into tax treaty law.

Second, the United States brought forward a proposal to change the current system of international tax law towards a destination-based cash flow taxation, instead of excise taxes or VAT, for example. Although the United States stepped back virtually at the last minute and did not proceed further with this idea, it shows that international tax law is gradually forming an important part of trade policy, at least for economically strong countries.

Third, digitalization and digitalized businesses raise the question of whether the traditional nexus for taxation of business income - the permanent establishment - should be amended.

The fourth development is that the OECD put forward a proposal for a global minimum taxation.

Each of these developments alone has the potential of being ‘disruptive’ to the traditional world of international tax law, but together they will change the current international tax system drastically.

Additional developments come into play in Europe in particular. In the last three years, the European Commission revised the Council Directives to harmonize certain areas in direct taxation matters. Whereas the existing, well-established Directives from 1990 and 2003 were, by and large, beneficial to the taxpayer, these recent directives (e.g., the Anti-Tax Avoidance Directive and the Mandatory Disclosure Directive) are clearly detrimental. There are a further two Directives which have been proposed but, as yet not adopted, which would also be detrimental to the taxpayer. These pertain to a significant digital presence and the EU Digital Services Tax. Moreover, while the Directives pursue similar aims to those of the OECD, they convey the impression that both organizations, the OECD and the EU, do not seem to fully coordinate their measures.

Brexit also raises questions with respect to international tax law that are far from being solved.

## 5.1 The Future Global Tax Environment

On an international level, digitization of the economy has posed tax challenges and solutions are constantly being fine-tuned. According to the final report of the BEPS project adopted in 2015, given the digitization of the entire economy, the “digital economy” cannot be isolated for tax purposes. As a result, the OECD’s G20 Inclusive Framework on BEPS, established in 2016, began to develop standards on BEPS-related issues. The OECD is mandated by the G20 countries to develop a global consensus and a solution to the tax challenges posed by the digitization of the economy. The original deadline to reach a solution was the end of 2020. This was extended to mid-2021 as a result of the COVID-19 pandemic and further extended into 2022.

The basis for the current negotiations is a two-pillar proposal from the OECD. This proposal envisages a redistribution of taxation rights on corporate profits (Pillar 1) and the introduction of an effective global minimum tax on corporate profits (Pillar 2). The proposal is based on the recognition that “ring-fencing” the digitized economy is not expedient. In October 2020, the OECD published outlines of both Pillars and technical work has progressed since then. The outlines contain essential concretizations on the technical design of both Pillars.

On a political level, 2021 brought new momentum to the negotiations. Prior to 2021, the talks had stalled under then U.S. President Donald Trump. He had demanded a safe harbor arrangement for the U.S. and expressed a preference for Pillar 1. However, with the change of administration in Washington, the U.S. moved away from this approach. Under President Joe Biden, the commitment of the new U.S. administration to a compromise solution has significantly increased the chances of an international agreement within the OECD by mid-2022.

A potential turning point came at the G20 Finance Ministers and Central Bank Governors’ Meeting on 6 April 2021, at which the U.S. presented a new proposal to base the redistribution of tax revenues on quantitative criteria such as revenue and profitability. The proposal also called for the abandonment of the restriction of the scope of Automated Digital Services (ADS) and Consumer-Facing Businesses (CFB). Under the provisions of the proposal, the 100 largest and most profitable corporations will be targeted - regardless of industry affiliation or business model. In view of the consequences of these recent developments, it is already clear that the years 2021-2023 will be decisive for the “reform of the world tax order.”

The latest move by the U.S. to base the distribution of tax revenues on quantitative criteria such as sales and profitability is supported by many EU countries. This is because examining qualitative criteria on the basis of internet or consumer transactions involves a great deal of administrative effort on the part of companies. In its initial response, the EU Commission announced that it would closely examine the proposals. However, on the grounds that the latest U.S. proposal would affect “only five or six digital companies,” the EU Commission clarified shortly thereafter that it would continue to adhere to its plans to submit a proposal for a European digital levy.

The role of the EU Commission should be to anticipate international developments and support an international agreement that is almost within reach, thereby refraining from unilateral proposals. This is especially so, since the plan to introduce a European digital tax has already failed once before - in the spring of 2019 - due to a lack of unity among the EU Member States. Parallel to international negotiations, the EU Commission was correctly committed to the work at OECD level at first and prepared a possible implementation of the OECD specifications in the EU. In contrast, the presentation of its own European initiatives to tax the digitalization of the economy was considered primarily as an alternative measure in the event of failure at the OECD level. This was the reasoning until the summer of 2020.

The recent push by the U.S. to limit the scope of Pillar 1 should in no way be taken by the EU Commission as an opportunity to vigorously move forward with the work on introducing a European digital levy. Instead, it is important to advocate and push for a comprehensive international agreement.

The planned reform of the EU's resource system marked a turning point in the European debate in 2020. During the course of this debate, the concept of a European digital levy found its way into the conclusions of the European Council of 17-21 July 2020. The conclusions were confirmed in the Declaration of the European Council of 25 March 2021. The conclusions provide for the presentation of a legislative proposal for a European digital levy. It is to be introduced by 2023 at the latest, as a new EU resource to finance the 750 billion euro reconstruction fund.

The EU Commission is taking this mandate from the heads of state and government as an opportunity to prepare the introduction of a European digital levy, parallel with international negotiations. Several options are being considered, including:

* an additional surcharge on corporate income tax for companies that carry out certain digital activities in the EU;
* a tax on revenues generated by certain digital activities in the EU;
* a tax on B2B digital transactions within the EU.

A corresponding proposal for an EU directive was presented in the spring of 2022. Some countries expressed their concern that the European plans would run counter to the OECD's goal of creating a globally uniform playing field. It was argued that as well as further fragmentation of the international tax system, there could also be an increase in international trade conflict. This is especially true since the U.S. emphasized in its most recent initiative at the OECD level that it would not accept “any outcome that discriminates against U.S. companies.”

There is no doubt that a global solution is needed to tackle the taxation of the digitized economy. This requires an international consensus, which is currently within reach. The EU Commission should be part of this. It is crucial for companies that the new global rules do not result in multiple taxation of corporate profits while the administrative burden of implementation needs to be limited.

### Self-Check Questions

1. Please complete the following sentence.

Many EU countries support the latest move by the U.S. to base the distribution of tax revenues on quantitative criteria such as sales and profitability.

1. Which is not an option for an EU digital levy?
* An additional surcharge on corporate income tax for companies that carry out certain digital activities in the EU
* a tax on revenues generated by certain digital activities in the EU
* a tax on B2B digital transactions within the EU
* a consumption tax on sea food and meat

## 5.2 International Tax Coordination

The term “tax coordination” - understood in the sense of substantive tax law and with respect to harmonization initiatives - has been discussed in other Chapters of this Unit. However, the term has a relatively new and procedural feature on the part of the tax authorities as well. This aspect is explained below.

The international coordination of tax authorities is best described when it comes to “joint audits.” Joint audits are coordinated bilateral and multilateral external tax audits. Joint audits are carried out within the framework of inter-governmental administrative assistance. There is an exchange of information upon request leading to the spontaneous and automatic exchange of information. In such a coordinated international external audit, at least two states participate in order to conduct an audit in the field of direct taxation regarding the tax circumstances or cross-border business relations of companies simultaneously or jointly. Internationally, the terms “multilateral control” (MLC) or joint audit have become established in common parlance for such procedures.

**Joint audit**

Joint audits have become rather popular in recent years. However, taxpayers and tax authorities are still in a trial period in practice.

The legal basis for joint audits within the EU is the EU Mutual Assistance Directive (Council Directive 2011/16/EU of 15 February 2011) and the basis for its implementation in national law is in the EU Mutual Assistance Act of 26 June 2013. In addition, cooperation with almost all third countries is now possible within the framework of a joint audit via Article 26 of the respective double taxation treaty and the Convention on mutual administrative assistance in tax matters of 16 July 2015.

In respect of a national audit, auditors only perform sovereign activities in their own country. In the case of a joint audit, foreign auditors may be actively or passively present in the country while domestic auditors may actively or passively participate in the audit activities abroad. “Active” in this context means that foreign auditors, provided the taxpayer gives consent, may perform certain investigative actions in the presence of domestic officials, such as examining records and questioning persons (an active audit right). The information obtained during the joint external tax audit is exchanged directly insofar as it is likely to be relevant for taxation in the other EU Member State.

The foreign auditor must observe the restrictions or obligations arising from the national regulations of the other EU Member State or third country as well as national procedural regulations. Conversely, an examiner sent to a foreign country is only entitled to the powers that arise under domestic and national law of the requested country. If the law of the requested EU Member State or third country provides for more extensive possibilities of investigation or rights than domestic law, the seconded employee cannot take advantage of such privileges.

At the end of the joint external tax audit, the domestic and foreign officials involved in the audit prepare a coordinated protocol of their results. This protocol contains the jointly determined facts and a legal assessment based on the respective national tax laws, taking into account the applicable double taxation treaty. The protocol serves as a basis for the implementation of the ascertained facts in the form of tax audit reports in the respective national law of the countries involved. If a mutual agreement procedure follows, it can be completed faster and more efficiently on the basis of the facts determined in the joint external tax audit.

If the joint audit leads to different assessments of the facts and their evaluation with regard to the applicable double taxation treaty by the auditors involved leads to double taxation, the taxpayer has the option of applying for a mutual agreement procedure as long as the legal requirements are met. Since the facts of the case will have already been jointly determined by the countries involved in the joint audit, the duration of the mutual agreement procedure can be shortened.

### Self-Check Questions

1. Please complete the following sentence.

The legal basis for a joint audit in the EU is the EU Mutual Assistance Directive.

1. What happens at the end of a joint audit?
* There is an exchange of various e-mails.
* *A coordinated protocol of the results of the audit is prepared.*
* There is a final video conference.
* There is a referral to the tax courts.

## 5.3 European Union and Taxation

This Section is based on a Paper published by the European Parliament “Direct Taxation: Personal and Company Taxation“ (2021).

The area of direct taxation is not precisely regulated by European Union legislation. Nevertheless, harmonized standards for the taxation of companies and individuals are established within the framework of several directives and the case law of the European Court of Justice (ECJ). In addition, measures have been taken to avoid tax evasion and double taxation.

The EU Treaty does not contain explicit provisions for legislative powers in the area of direct taxation. Legislation on company taxation is usually based on Article 115 of the Treaty on the Functioning of the European Union (TFEU). This Treaty allows the EU to adopt directives for the approximation of the laws, regulations, and administrative provisions of the Member States that have a direct impact on the internal market. Unanimity and the use of the consultation procedure are required for this purpose.

Article 65 of the TFEU, free movement of capital, allows Member States to treat taxpayers differently if they are not in the same situation with respect to their residence or the place where their capital is invested. However, in 1995, the ECJ ruled (Case C-279/93) that Article 45 of the TFEU is directly applicable in the field of taxation and social security. The Article states that the free movement of workers includes “the abolition of any difference in treatment based on nationality [...] as regards employment, remuneration and other conditions of work.”

Articles 110-113 of the TFEU require Member States to eliminate double taxation within the EU through negotiations. Article 55 of the TFEU prohibits discrimination between nationals of Member States with respect to participation in the capital of companies. However, most agreements in the area of direct taxation are outside the scope of EU law. An extensive network of bilateral tax treaties, applicable to both Member States and third countries, covers the taxation of cross-border income flow.

Proposals to harmonize corporate income tax have been discussed over several decades. In 1980, the Commission advised that attempts at harmonization were likely to be futile (COM (80) 139) and instead focused on measures to complete the internal market. Three proposals were adopted in the 1990 “Guidelines on Company Taxation” (SEC (90) 601). These are the Merger Directive (90/434/EEC, now Directive 2009/133/EC), the Parent-Subsidiary Directive (90/435/EEC, now Directive 2011/96/EU), and the Arbitration Convention (90/436/EEC).

An example of the tough wrangling in negotiations with Member States is the 1991 proposed directive on a common tax regime for interest and royalty payments between parent companies and subsidiaries in different Member States. Despite an amendment, and notwithstanding the positive opinion of Parliament, the Commission withdrew the proposal due to lack of agreement in the Council. As part of the “Monti Package,” a new version was presented in 1998, which was subsequently adopted as Directive 2003/49/EC.

The Independent Expert Committee (Ruding Committee) was established in 1991. The report of this Committee recommended a program to eliminate double taxation, harmonize corporate tax rates, and ensure full transparency in tax relief offered by Member States for the purpose of promoting investment. The Commission made a number of proposals that were later withdrawn.

In 1996, the Commission established a new approach to taxation. In the area of business taxation, the most important outcome has been the Code of Conduct for Business Taxation, adopted as a resolution by the Council in 1998. A good review of the results of the Code are presented by Nouwen (2020). The Council also established a Code of Conduct Group (“Primarolo Group”) to examine cases of unfair business taxation. In 2001, the Commission prepared an “Analytical Study of Company Taxation in the European Community” (SEC (2001) 1681). The Commission's complementary Communication (COM (2001) 582) noted that most of the problems encountered by companies stem from the fact that they have to adapt to different sets of national rules in the Internal Market.

The Commission proposed various approaches to create a consolidated tax base for business activities in the EU. Among these approaches are home state taxation, an optional consolidated common tax base (CCTB), a European corporate income tax, and a mandatory, fully harmonized tax base. A working group was set up in 2004, the results of which were incorporated into the Commission proposal (COM (2011) 121). The proposed “common consolidated corporate tax base” (CCCTB) means that companies benefit from a one-stop shop system where tax refund claims are submitted. All profits and losses incurred in the EU can also be consolidated. Member States regain all responsibility for setting their own corporate tax rates. In April 2012, the European Parliament adopted the relevant legislative resolution for this proposal. To relaunch negotiations in the Council, the Commission presented a strategy in June 2015 to relaunch the CCCTB proposal the following year.

**Ongoing CCCTB Discussion**

The discussion about a CCCTB in Europe has been going on for about 20 years, but all former ideas did not reach the necessary unanimous consent.

The Commission opted for a two-step process, addressing the common base and elements of consolidation separately. The two related legislative proposals were a common corporate tax base (CCTB) and a common consolidated corporate tax base (CCCTB). The future proposal would include a mandatory CCCTB, to be phased in. This improved proposal, aligned with the work of the OECD, also addressed tax avoidance by removing regulatory loopholes between national systems, thereby curbing common tax avoidance schemes.

In March 2018, the Commission presented a proposal for two Council Directives aimed at ensuring fair taxation of companies providing digital services. The EU continues to advocate for a global solution to tax the digital economy in the G20/OECD framework.

In the wake of the 2008 financial crisis, the focus shifted to combating tax avoidance and the fair taxation of companies. One of the ways to achieve these goals is through greater transparency, as reflected in the March 2015 package of measures on tax transparency. The package included the Council Directive on the automatic exchange of information in the field of taxation between Member States (Directive (EU) 2015/2376) and the Communication on tax transparency as a means of combating tax evasion and tax avoidance (COM (2015) 136).

In 2015, the Commission adopted an Action Plan for fair and efficient business taxation in the European Union (COM (2015) 302). This envisaged a reform of the corporate taxation framework to combat tax abuse, ensure sustainable revenues and support a better business environment in the single market.

In January 2016, the Commission proposed a package of measures to combat tax avoidance. The measures included a proposal for rules to combat tax avoidance practices with a direct impact on the functioning of the internal market. This was adopted in July 2016.

In April 2016, the Commission proposed an amendment to Directive 2013/34/EU with regard to the disclosure of income tax information by certain companies and branches. The proposal requires multinational companies to disclose certain information that has been submitted to the tax authorities.

The Commission presented a proposal in June 2017 on new transparency rules for intermediaries (consulting firms, banks, lawyers, tax advisors, and others) that design or trade in potentially harmful tax arrangements. This was in response to a call for a legislative proposal in a Parliament Resolution (TAXE 2). This proposal was subsequently adopted in the Council in May 2018.

In December 2017, the Council published the first-ever EU list of non-cooperative countries and territories. The list is updated on a regular basis.

### Self-Check Questions

1. Please complete the following sentence.

Legislation on company taxation is usually based on Article 115 of the Treaty on the Functioning of the European Union (TFEU).

1. Which directive was not part of the 1990 “Guidelines on Company Taxation”?
* parent-subsidiary directive
* arbitration convention
* interest directive
* merger directive

## 5.4 Tax Issues in the Age of Digital Economies

In the last two decades, information and communication technology has developed rapidly. Computing power and storage capacities have increased exponentially, the production costs for computers have fallen, telecommunications networks and the internet have spread, and software and data use have been optimized. As a result of this development and the associated transformation process, companies have adapted their existing business models and established new models.

As already mentioned, the resulting digital economy has produced the following business models, among others, as stated in the OECD study on BEPS in Action Item 1 (Addressing the Tax Challenges of the Digital Economy). (1) E-commerce was “the” buzzword in the 1990s. This is when goods or services are offered via digital networks and then sold online or offline. For example, Alibaba or Amazon sell as online traders while Apple sells its goods online and in retail outlets. (2) In the online advertising business, goods or services are advertised via the internet. Website operators generate advertising revenue or receive a fee for the sale of user data (e.g., Google and Facebook). (3) In the sharing economy, goods or services are exchanged via an internet platform and the intermediary platform receives a commission (e.g., Airbnb and Uber). (4) In cloud computing, computer services such as computing power, storage or software are offered via the internet (e.g., Amazon Web Services, Google, and Microsoft).

The digital economy is characterized by several key features that are relevant from a tax perspective. Goods and services can be offered across borders, easily and quickly in different countries. Companies can carry out business functions from a central location, with little or no presence of personnel in the sales market (mobility of taxation of the digital economy business functions). With a small increase in staff, companies can increase and maximize the size and scope of their business (scale without mass). Users, for their part, can carry out business transactions globally with comparative ease (mobility of users).

The development and use of intellectual property rights and the resulting dependence on them plays a major role. Digital companies are often dependent on IP and software and invest in the development of new software products. In addition, the collection and processing of data, especially so-called big data, is a decisive factor in the digital economy. Customer data is evaluated to personalize advertising and improve the product range.

The impact of a particular network is of great importance for companies in the digital economy. The more users there are in a network, the greater the value for advertisers and companies (e.g., social networks and media sharing sites).

Due to the above-mentioned characteristics of the digital economy, the following tax problems and questions have arisen. First, there is the question of how value creation is determined in the business models of the digital economy. Are users and data to be regarded as part of the value creation chain? And if so, what proportion of the total value creation of digital companies is made up of users and data? The users and the data they provide in the source state are not considered under current tax rules.

Second, the question arises as to whether a further tax link or digital tax needs to be created for the digital economy in the source state. Under the current tax rules, a company in the sales market can be taxed in another country if there is a genuine link to that country, for example, due to a separate company or a permanent establishment. However, the founding of a permanent establishment requires a physical presence. In other words, a permanent establishment requires a fixed place of business or local employees. In the digital economy, on the other hand, a physical presence is no longer required to do business in another country. Under the traditional tax rules, a fixed place of business or local employees gives rise to a tax liability. The only exception to this is tax on consumption, in particular value added tax, and there are different rules in that respect.

Third, there is the question of appropriate and “fair” taxation of the digital economy and the distribution of the tax base in the state of residence of the company and in the source state of the users.

The issues that are related to the taxation of the digital economy represent a major challenge for all of the parties involved - the individual states, the tax administrations, and the companies.

It is clear that dealing with these problems requires a global, internationally coordinated solution in order to avoid distortions of competition. In 1998, the OECD created certain guidelines regarding the taxation of E-commerce in the Ottawa Taxation Framework Conditions. The intention was to use this as a base in future initiatives in the tax field.

These guidelines can be summarized according to five main headings. (1) Neutrality - taxation should be equally designed for both conventional and electronic forms of commerce and for domestic and foreign companies. (2) Efficiency - compliance costs for companies and administrative costs for tax authorities should be minimized as far as possible. (3) Certainty and simplicity - tax provisions should be as clear and simple to understand as possible, so that companies can anticipate the tax consequences in advance of a transaction. (4) Effectiveness and fairness - taxation should provide the right burden at the right time and the potential for tax evasion and tax avoidance should be minimized. (5) Flexibility - tax systems should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

Both the OECD, the EU and individual countries have subsequently addressed the issue of taxation in the digital economy, with the aim of developing new tax policies. The OECD developed various points of action to combat tax avoidance and artificial profit shifting within the framework of the base erosion and profit shifting project.

Action Item 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) has already expanded certain aspects of the concept of permanent establishment in order to take into account developments in the digital economy, among other things. This is in addition to Action Item 1.

The OECD Model Convention and the Commentary on it were adapted in 2017. According to this amendment, certain facilities (warehouses, distribution centers, purchasing offices, or facilities for the procurement of information) are no longer automatically classified as permanent establishments, unless the activity associated with them is actually an auxiliary or preparatory activity. For example, a distribution center of an online retailer in the respective country can secure a permanent establishment.

Action Item 1 of the BEPS project, which explicitly addresses the tax challenges of the digital economy, discusses various concepts in the field of direct taxation. First, the introduction of a “digital place of business” (digital presence and digital nexus) is discussed. Second, withholding tax on certain digital transactions was introduced. Third, was the introduction of an equalization levy on certain digital services.

The OECD decided to pursue the issue of taxation of the digital economy and published an interim report in March 2018. Since positions differed widely between countries, this interim report did not contain any concrete, let alone substantial, proposals. However, the OECD wanted to further investigate two key aspects of international tax law. First was the question of the nexus. Under what circumstances does a company in a certain country becomes liable for income tax or direct taxes in a broader sense. Second was the question of profit allocation and how the company's profit is allocated between countries for tax purposes. The OECD then planned to publish further results in 2019 and to present mutually agreed solutions in 2020, both of which were carried out according to schedule.

As early as March 2018, the EU Commission went one step further compared to the OECD and published concrete proposals for taxing the digital economy. With these proposals, the EU Commission wanted to avoid different and unilateral measures by the EU Member States. The EU Commission is of the opinion that under the current tax rules, value creation in the digital economy (e.g., the value added by the data provided by users) is not duly considered and that there is an unjustified discrepancy between the place of value creation and the place of taxation of profits.

Under the title of “Fair Taxation of the Digital Economy,” the EU Commission made two legislative proposals for Council Directives. The first proposal was intended as a long-term measure and aimed at introducing a digital permanent establishment. This is called a significant digital presence. The second proposal was intended to be a transitional solution from the outset and provided for the introduction of a digital tax on income from certain digital services. Both proposals have not been agreed upon yet.

This embraces the BEPS rules, Action Item 1 from 2015, which unfortunately did not come up with a recommendation or a concrete result. It expresses the hope that a broad-based, preferably concerted action by the OECD Member States would find greater international acceptance, even among non-OECD Members. In time, the OECD, in cooperation with the Inclusive Framework on BEPS, published the “Work Program for the Development of a Concerted Solution to the Challenges of Managing Digitization of the Economy,” in the form of a working paper on 31 May 2019. The working paper is based on the assumption that an agreement could be reached among the OECD Member States by the end of 2020. Once again, the OECD was putting itself and the Member States under enormous time pressure, which is objectively considered to be artificial. The “official justification” for this is the “threats” of individual states to unilaterally stick with national measures in the event of a failed international consensus-building process.

### Self-Check Questions

1. Please complete the following sentence.

Dealing with taxation problems of the digital economy requires a global, internationally coordinated solution in order to avoid distortions of competition.

1. The OECD Model Convention and the Commentary were changed with respect to permanent establishments in the year…
* 2014
* *2017*
* 2020
* 2022

## 5.5 OECD BEPS Project Implementation

The issue is so complex that it goes without saying, any solution that is agreed upon internationally is going to have incalculable consequences for individual taxpayers and states from a macroeconomic point of view. Furthermore, it is a fact that a uniform, international solution is better than a multitude of individual measures in different countries, even if it must be conceded that the diversity of tax systems already affects taxpayers today. But it is also a fact that an international unification of the European countries “against the United States” makes no sense. The OECD has already warned of a “tax war” which would probably lead to a trade war with the U.S. within a short time. This is of course not in anyone’s best interest. Having said this, the U.S. stepped back from the discussion table for a while in mid-July 2020.

The above-mentioned OECD work program outlines various measures that are methodically based on two different approaches, called “Pillars.” These Pillars have different objectives. With regard to companies that maintain or offer digital business models, the basic concept for the distribution of global taxation rights which has been widely accepted internationally will be reconsidered and replaced by innovative taxation concepts. Looking beyond companies in the digital economy, the previous measures of the BEPS project will be encircled by a world-wide minimum taxation. The work program is explained in more detail below, not least because it will be a key element in shaping the new world tax system.

Although Pillar 1 of the work program is headed by the taxation of the digital economy, its content differs from Action Item 1 of the BEPS project to the extent that it does not go into the underlying causes of profit relocation in detail. Three new types of taxation concepts for digital enterprises are presented for discussion, namely the user participation concept, the marketing intangible concept, and the concept of a significant economic presence. These three concepts are then described and examined in greater detail by highlighting three different aspects. The first aspect is the type of profit-sharing method to be applied. The second aspect is the new starting points for the taxation of digital services and third, the accompanying measures that will be prescribed.

The first aspect - the user participation concept - is based on a proposal from Great Britain. It is based on the idea that the user participates in the creation and increase in value of the company whose services he or she uses against payment. In concrete terms, this means that every user resident in a country who enters a keyword in the Google search engine improves the precision of the algorithm behind Google by implementing a search query and consequently increases the company value of Google.

Highly digitalized companies thus create a “user base” distributed over many states world-wide, through which data and content are generated and taxation in these states is justified. However, the value added associated with this cannot be taxed according to the previous taxation concepts because of a low physical presence in the jurisdictions concerned. To solve this problem, there is a proposal for a modified profit distribution analysis to be used to determine the part of the profits generated by a user activity. This part of the profits should then be distributed to the countries in which the users are resident on the basis of an agreed allocation metric (e.g., sales or turnover).

The second concept is known as the “marketing intangibles approach” and it is favored by the U.S. in particular. This concept outlines a situation in which a group of companies intervenes from a distance in the economy of a state through targeted sales activities and related measures, creating a user or customer base and other “marketing intangibles.” In other words, intangible assets are created as a result of a company's marketing expenditure without this added value becoming taxable. In this situation as well, the proposed approach is a modified profit distribution analysis in which mechanical approximations are used to determine the profit that can be allocated to the marketing of intangible assets. In a second step, this profit is distributed to the jurisdictions in which the marketing intangibles were generated using an agreed allocation metric.

In the third proposed concept, which is called the “significant economic presence approach,” an economic presence is taxed as soon as it can be proven that an intended and continuous interaction with a state exists. An example of this is through digital technologies. This would be the first time in the history of tax law that such an approach is adopted, and it goes beyond the current permanent establishment concept. For the determination of the profit to be taxed, it is proposed that the global profit margin of a group of companies be applied to the turnover within the respective jurisdiction and subsequently modified, taking into account certain factors such as turnover, economic goods, number of employees, or the size of the “user base.” For the appropriate allocation of the profit, a distributive allocation method is proposed, whereby the previously determined profit is distributed to the affected jurisdictions using weighted allocation keys.

The above-described nexus principle, already in force for decades, would have to be changed in order to give jurisdictions the right to tax the added value generated in their respective countries within the framework of the three concepts. Proposals in this respect include the modification or extension of the definition of a permanent establishment or the introduction of a new, stand-alone nexus for digital services, which would need to be defined in more detail according to the technology used.

Currently, within the framework of a unified approach, discussions are being held about the restriction of both the scope of the new regulations and the new nexus via turnover thresholds. In general, only groups of companies that operate a “consumer facing” in the broadest sense are to be covered. Everything that is suitable for use by a consumer should ultimately be covered. A limitation to purely digital companies is not intended. This recaps the BEPS Action Item 1. The digital economy today can no longer be separated from the rest of the economy.

In addition to the exceeding of the turnover threshold in the market state, other factors are to be added in order to arrive at a taxation right for the market state. Examples are click figures or certain value contributions from users, as yet undefined. If these prerequisites are fulfilled, a total profit of the company is to be determined on the basis of an accounting standard not yet defined, which differentiates between routine and non-routine profits at the first level. Moreover, a distribution key is then partly applied to all market states, which would ensure a uniform allocation of taxation rights.

If one reads the proposals for Pillar 1 impartially, two aspects stand out. The first aspect concerns the fact that “taxation according to value creation,” which was one of the central guidelines of the BEPS project, is not reflected in the justification for Pillar 1. The second aspect concerns the fact that the OECD claims that high-tax countries benefit from the previous proposals. This is *prima facie* astonishing, because ultimately the concept of Pillar 1 amounts to taxation of supply profits, which is a general problem for nations that export.

Pillar 2 of the work program is intended to ensure, also for the first time in the history of tax law, a global effective minimum taxation of company profits. By way of background, this idea is based on a Franco-German proposal. It is assumed that the special features of the digitalized economy allow profits to be shifted to low-tax countries and therefore justify limiting tax competition to a certain minimum level.

In this context, two interrelated measures are currently being discussed at the OECD level, namely an extension of the national rules on supplementary taxation and a limitation or prohibition of the deduction of business expenses if the effective minimum taxation level is not reached. The impact of these measures on the individual countries and the tax burden on companies depends significantly on the effective tax level prior to the introduction of the new rules. It also depends on the global target effective minimum taxation level that is being sought. At the same time, the full sovereignty of states to set tax rates should be preserved.

The first component, the extension of national rules on supplementary taxation, specifically provides for the addition of low-taxed profits of foreign subsidiaries of a company to the parent company's profit for the purpose of taxation. For this purpose, national supplementary taxation is to be extended along the lines of the U.S. Global Intangible Low-Taxed Income (GILTI). Whether the income to be added is taxed at the level of the parent company's state of residence or at a lower tax level remains open. The type of income should be irrelevant, as should the activity and substance of the foreign, low-taxed company. This is to be achieved by adapting the respective national tax laws, but also requires international harmonization. For example, within the European Union, this would be conceivable by means of an EU directive. In relation to third countries, this would be by means of a bilateral agreement within the framework of a double taxation agreement.

The second component provides for limiting the deduction of operating expenses for payments to low-taxed foreign countries. Following the model of the Base Erosion and Anti-Abuse Tax (BEAT) introduced as part of the U.S. tax reform, this measure is intended to cover profit-reducing payments to foreign, affiliated companies with the aim of reducing domestic tax liability. The aim is to tax the company's profit before deduction of the said harmful payment. However, this goes far beyond the nexus approach that has been used to date for licenses. Since it could be designed to be expenditure-oriented rather than profit-oriented, there are very significant negative effects.

The proposals outlined for Pillar 2 have four different features which are to be implemented in legal terms. (1) The “income-inclusion” rule allows a state to include certain foreign income in its tax base if this income is taxed abroad below a minimum rate. (2) The “under-taxed payment” rule is intended to allow a state to refuse a tax deduction for business expenses or, alternatively, to levy a withholding tax if these payments are not taxed or are taxed below a minimum rate in the recipient's state of residence. (3) The “switch-over” provision allows a state to amend tax advantages under a double tax agreement for such branches or establishments if their taxation abroad is below a minimum tax rate. (4) The “subject-to-tax” regulation covers those income components where the underlying payments are under-taxed in relation to the minimum rate.

Public hearings on the Pillars were held in Paris from 21-22 November 2019 and 9 December 2019 respectively. Following the evaluation of the public discussions and the written comments, the OECD prepared further comments in the course of 2020. These comments then resulted in concrete recommendations for action and implementation to the Member States in late 2021-early 2022. It is important to note that Pillars 1 and 2 only exist as a political “package.” Pillar 1 is essentially based on the demands of those source states which, according to the classical criteria for linking to Pillar 1, can claim almost no taxation rights for digital services or none at all. Pillar 2, on the other hand, is based on the demands of the classic residence states and serves as a kind of compensation for Pillar 1.

The OECD is reported to have intended to summarize the findings of the consultations in a guidance paper by the end of January 2020, in order to start further detailed work. The paper was drafted by the Inclusive Framework on BEPS and with the participation of many non-OECD countries and went online on 31 January 2020. In the paper, the Inclusive Framework explicitly acknowledges the preliminary work of the OECD. Legal certainty with the least possible complexity is pinpointed as the main challenge of the ongoing work. In addition, a large number of legal and political issues need to be resolved. For example, the delimitation and differentiation of digital services is difficult, the threat of double taxation must be prevented, and more thought must be given to binding dispute resolution mechanisms.

To continue work on Pillar 1, eleven working groups were set up and reports were submitted by the end of 2020. Of particular interest in this context is the announcement that Pillar 1 may possibly be implemented via a further multilateral tax treaty. For Pillar 2, the Paper of 31 January 2020 merely contained a progress report summarizing the current state of the debate on global minimum taxation. But here, too, the talks were progressing rapidly. In January 2021, public consultation meetings were held on the blueprints of Pillar 1 as well as Pillar 2. Both projects are still under discussion in 2022, although more progress was made with regard to Pillar 2. In March 2022, for instance, the OECD published an extensive Commentary with respect to the minimum taxation rules.

### Self-Check Questions

1. Please complete the following sentence.

Highly digitalized companies create a “user base” distributed over many states worldwide, through which data and content are generated and which therefore justifies taxation in these states.

1. Which is not a feature of the intended Pillar 2 solution?
* undertaxed payments rule
* *net income rule*
* income inclusion rule
* subject to tax rule

## 5.6 Tax Treaties and Dispute Resolution Mechanisms

It happens quite often in practice that taxpayers are in danger of ending up in a double taxation situation. This is mostly the case when the contracting states apply a tax treaty differently from their own tax perspective, or when they apply the treaty unanimously but assume different amounts of income for the same taxpayer.

Unfortunately, there is no “international tax court” that has jurisdiction over tax disputes between countries, so that it is far from clear whether a taxpayer can actually avoid or mitigate double taxation. There are, however, instruments in the law that help to avoid double taxation in principle. The three main instruments have a slightly different material scope and are explained below.

### Mutual Agreement Procedures

Double taxation treaties normally allow the authorities concerned to hold direct discussions with each other in order to avoid a situation in which the assessment of a tax case contradicts or conflicts with the aim of a tax treaty. The purpose of the discussions is to find a uniform view of the events or to reconcile different views in such a way that the treatment of the individual case ultimately corresponds to the objectives and aims of the treaty and above all to eliminate double taxation. This is called a mutual agreement procedure and is laid down in Article 25 of the OECD Model Convention. In practice, it can easily last two-three years or even longer, depending on the countries involved.

Taxpayers who believe that a tax treaty has not been applied correctly in a specific individual case can request a mutual agreement procedure, but do not have an unconditional right to have such a procedure carried out. In practice, the mutual agreement procedure is one which the tax authorities can use in order to assist a taxpayer, but the authorities are under no obligation to do so. The authorities tend to make use of this arrangement if they are convinced that the taxpayer has proceeded in good faith, fulfilled the tax obligations in both countries to the best of his or her knowledge, and is at risk of being at a disadvantage due to the lack of agreement between the two countries through no fault of his or her own.

The shortcoming of the mutual agreement procedure is that an agreement is not enforceable. This problem has recently been mitigated in some double taxation treaties by the addition of a few clauses that allow recourse to an arbitrator when the tax authorities do not agree on a concerted treatment. However, such clauses are rare and as yet do not belong to the standard regulations proposed by the OECD for a double taxation treaty in its Model Convention.

### EU Arbitration Convention

The EU Arbitration Convention is an international treaty between all EU Member States which addresses a specific problem – the need to eliminate double taxation resulting from different views on the appropriate level of intra-company/group transfer pricing.

The double taxation treaties provide that each state may only tax those parts of the income of a company or group that are generated in permanent establishments within its territory. This is the permanent establishment principle. However, if several permanent establishments or subsidiaries are jointly involved in the production of a service, the question of how much profit is generated in each case by the individual permanent establishment or subsidiaries depends crucially on how the internal company services are offset. These are the transfer prices.

Although the arm's length principle legally requires that transfer prices must correspond to the prices that market participants in arm's length transactions would have chosen, it is by no means possible to clearly determine how high the price would have been under these conditions in most cases. It is therefore not only conceivable, but even probable, that the authorities of different countries will arrive at different conclusions in their assessments. Consequently, parts of the group's profit could be claimed by different countries at the same time, and therefore taxed twice.

This problem can only be solved if a body is created which is given the authority to make a binding decision for all countries concerned in an individual case. However, the Arbitration Convention avoids the establishment of a permanent court for such matters. Instead, the Arbitration Convention provides for the formation of an arbitration commission in each individual case and the commission’s decision is ultimately binding on all the authorities concerned.

The arbitration proceedings will only start if an affected taxpayer requests arbitration from one of the authorities. A request can be made if the dispute concerns transfer pricing. Other cases in which the rules of a tax treaty are applied inconsistently in two states in an individual case cannot be resolved by these means. The tax authorities are initially given up to two years following a request to find a resolution to the problem and come to an amicable agreement. Alternatively, a course of action to avoid double taxation can be developed. If the parties fail in their efforts to reach an agreement, the Arbitration Commission convenes and draws up a proposal within six months. After submission of a proposal, the authorities have a further six months to agree, at which time the proposal of the Arbitration Commission comes into force. The arbitration process can therefore take up to three years until legal clarity is achieved.

The authorities may refuse to conduct the arbitration proceedings if the taxpayer has committed a tax offense in connection with the transfer prices in question or has behaved improperly in another, more closely regulated manner. This is to prevent taxpayers from initiating arbitration proceedings in the hope of benefiting from the Arbitration Commission's decision. The costs of the proceedings are borne by the tax administration.

### EU Arbitration Directive

Another available instrument is the EU Arbitration Directive. Dispute settlement proceedings under the EU Arbitration Directive may be brought by persons affected by a dispute concerning the interpretation and application of a tax treaty between Member States of the EU. According to the Directive, the person concerned must be a resident of one of the two states. If a partnership or co-entrepreneurship is involved, eligibility for this procedure is closely examined. If the partnership is not considered to be eligible for the agreement, the partners must each pursue the EU dispute resolution procedure on their own.

An arbitration proceeding is a bilateral procedure. Proceedings are conducted not only vis-à-vis the German tax authority, under the responsibility of the Federal Central Tax Office, but also versus the tax authorities of the other EU Member State affected by the dispute in question. Therefore, procedures are carried out simultaneously and in the same manner in all of the states concerned.

The procedure is simplified for small or medium-sized enterprises. For example, when a small or medium-size enterprise initiates the proceedings, the dispute resolution complaint is only filed in the state of residence. However, procedural implementation in all of the states concerned must always be taken into account.

There are also exceptions to the rule. For instance, proceedings in Germany are only allowed to be conducted in German, leading to multi-lingual proceedings. Other countries, such as Austria, allow English in the course of the proceedings in addition to the national language.

The EU dispute resolution procedure is intended to lead to a binding settlement of a dispute between states. The taxpayer is not a party to the dispute, but only an interested party. The taxpayer’s rights in the proceedings are correspondingly less pronounced than in national law appeal proceedings, in which his or her own legal position can actively be presented. The taxpayer can initiate or terminate the proceedings, and initiate or advance individual procedural steps by filing motions. However, there is no right for the taxpayer to actively participate in the negotiations and be involved in finding a solution. The taxpayer’s role remains passive, as seen with the previous mutual agreement procedure.

After the dispute resolution complaint is filed, negotiations are held between the authorities involved to try and resolve the dispute. This is the mutual agreement procedure. The deadline for these negotiations is two years (extendable by a further year). If the authorities involved reach an amicable result, this is communicated to the party concerned. If the taxpayer accepts the result, he or she waives the right of legal remedies against the implementing tax assessments. The result of the mutual agreement is then binding and the relevant tax office issues corresponding, legally enforceable notices.

If no agreement is reached within the deadline, this is communicated to the party concerned, including a statement of reasons. As a major innovation, at this point the procedure enters a dispute resolution stage. Within 50 days, the affected person has the opportunity to request the establishment of an Advisory Committee in each participating state with the aim of reaching a binding arbitration decision. There is no need for procedural facilitations for small and medium-sized enterprises. The Advisory Committee is composed of a chairperson, one representative from each of the participating states, and one independent representative from each participating state.

There is a list from which the participating states can choose persons who act as independent representatives and/or chairpersons. Within six months (this can be extended by a further three-month period), the Advisory Committee submits its arbitration decision to the participating states. There is then another six months in which to accept the mediation ruling, or find another solution by mutual agreement. If the authorities are still unable to reach agreement, the decision of the Advisory Committee is considered binding on the states involved. The taxpayer, in turn, decides whether to accept the result and waive further legal remedies. At that point, the states involved are obliged to implement the result of the conciliation, or another mutually agreed solution, in tax assessments.

### Self-Check Questions

1. Please complete the following sentence.

The cost for proceedings under the EU Arbitration Convention are borne by the tax authorities.

1. Which is not a widely recognized instrument for the settlement of tax disputes?
* Mutual Agreement procedures
* EU Arbitration Convention
* Mutual Arbitration Treaty
* EU Arbitration Directive

Summary

The international tax system, as it has been known for roughly 100 years, is undergoing dramatic change. In 2022, about 140 countries of the Inclusive Framework on BEPS decided on the future of international tax law. The main focus is fundamental work on the taxation of the digital economy and global minimum taxation. The results of these two projects will have repercussions on the national tax landscape of countries as far as direct taxes are concerned as well.

These developments are accompanied by increased cooperation between countries and tax administrations. The attempt at joint audits is only the beginning. Transparency, coordination, and harmonization are high on the agenda. As with tax havens, such goals close loopholes for taxpayers.

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# Appendix 2 – List of Tables and Figures

**Structure I**

Source: Florian Haase (2022).

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**Structure II**

Source: Florian Haase (2022).

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