LLM Programme International and European Legal Studies

International and European Tax Law

6. Tackling tax avoidance

Andreas Tsourouflis

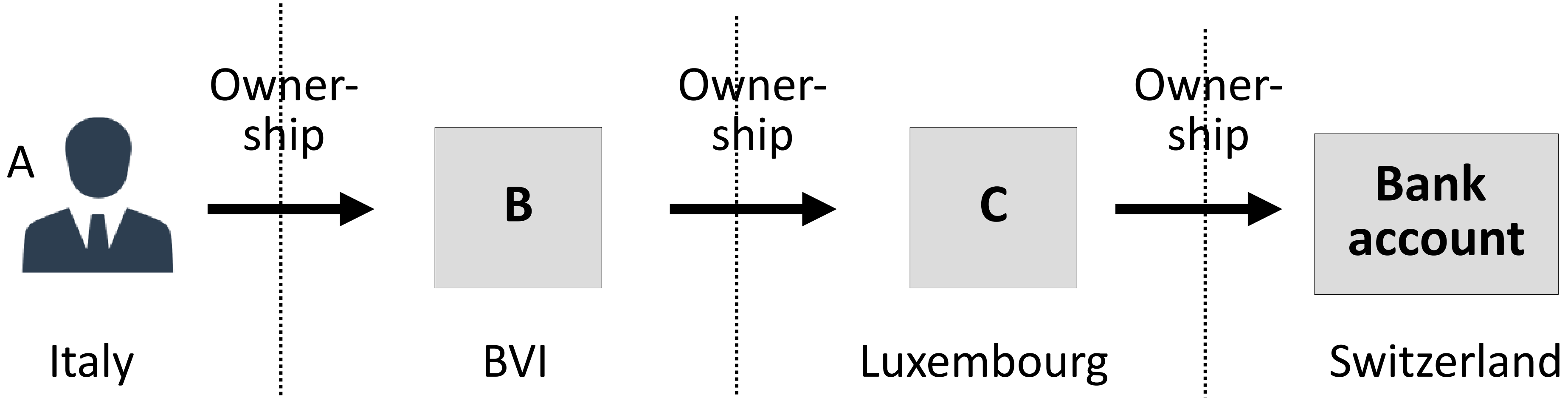
14 November 2024

Tackling tax avoidance

Case study

"A", an Italian tax resident, holds a bank account in Swiss, where he deposited significant amounts of money in previous years. In 2023, "A" transferred the entire sum from his account to another Swiss account held by "C", a Luxembourg foundation. "C" has been established by "B", a company incorporated in British Virgin Islands, which is wholly owned by "A". During 2024, no amount was paid out from the Swiss bank account to "C". Neither "B" nor "C" distributed any profits.

"A" requests your professional advice as to whether there is any tax liability in Italy



Tackling tax avoidance

Concept

- Tax avoidance: policy measures
  - Political actions
    - Political pressure
    - OECD initiatives
  - Legal measures
    - Controlled Foreign Company (CFC) rules
    - GAAR (General Anti-Abuse Rule)
    - Limitation of benefits
    - Interest limitation
    - Exit taxation
    - Special disincentives
    - Transfer pricing

Tackling tax avoidance

BEPS

- Base Erosion and Profit Shifting (BEPS)
  - tax planning strategies that exploit gaps and mismatches in tax rules to make profits “disappear” for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.
  - Strategies employed by MNEs
  - Those strategies constitute tax avoidance

Tackling tax avoidance

BEPS

- Base Erosion
  - Tax base of a country: the profits that a country is permitted to tax
  - Erosion: Reduction of the amount of profits which a country can tax
  - Examples
    - A company moves its residence to a different country
    - A company transfers its intellectual property to another country where royalties are taxed at a low rate (e.g. Luxembourg, the Netherlands, UK etc.)
- Profit shifting
  - Attributing tax profits to lower tax jurisdictions
  - Example: A group company takes a loan from an affiliate company located in a low tax jurisdiction

Tackling tax avoidance

BEPS

- OECD BEPS Action Plan
  - In 2012, the G20 group of finance ministers and central bank governors requested that the OECD produce a report and an action plan to combat BEPS.
  - In response, OECD published the 2013 BEPS Report
  - OECD initiated an Action Plan consisting of 15 actions

Tackling tax avoidance

BEPS

- OECD BEPS Action Plan
  - Action 1: Tax challenges arising from digitalisation
  - Action 2: Neutralising the effects of hybrid mismatch arrangements
  - Action 3: Controlled Foreign Company
  - Action 4: Limitation on Interest Deductions
  - Action 5: Harmful tax practices
  - Action 6: Prevention of tax treaty abuse
  - Action 7: Permanent establishment status

Tackling tax avoidance

BEPS

- OECD BEPS Action Plan
  - Action 8: Assure that transfer pricing outcomes are in line with value creation: intangibles

    Action 9: Assure that transfer pricing outcomes are in line with value creation: risks and capital

    Action 10: Assure that transfer pricing outcomes are in line with value creation: other high risk transfactions
  - Action 11: BEPS data analysis
  - Action 12: Mandatory Disclosure Rules
  - Action 13: Country-by-Country Reporting
  - Action 14: Mutual Agreement Procedure
  - Action 15: Multilateral Instrument

Tackling tax avoidance

BEPS

- OECD BEPS Action Plan
  - Outcome in 2014: A report was drafted for each action
    - Analysing OECD conclusions
    - Recommending specific solutions
  - Implementation
    - Unilaterally by each country (under OECD supervision)
    - Bilaterally by amending tax treaties
    - Multilaterally by an international convention

Tackling tax avoidance

MLI

- Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
  - Known as Multilateral Instrument (MLI)
  - Aim: to ensure quick and uniform implementation of BEPS measures
- Public International Law Convention
  - Signed in Paris on 7.6.2017
  - Effective as of 1.7.2018
  - 67 states joined at the beginning, now 104 (as of October 29th, 2024)

Tackling tax avoidance

MLI

- Mechanism
  - The MLI introduces the measures resulting from BEPS Actions 2, 6, 7 and 14 into the tax treaties of the signing states
    - Action 2: Neutralising the effects of hybrid mismatch arrangements
    - Action 6: Prevention of tax treaty abuse
    - Action 7: Permanent establishment status
    - Action 14: Mutual Agreement Procedure
  - Each state chooses which tax treaties it wishes to have amended.
  - Once a tax treaty is declared by both contracting states, it is automatically amended
  - Whenever the OECD Model Treaty is changed, all countries automatically update their treaties with each other.

Tackling tax avoidance

ATAD

- Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (Anti-Tax Avoidance Directive, ATAD)
- It aims for a coordinated implementation of BEPS measures in EU Member States, in order to
  - prevent fragmentation of the market
  - strengthen the average level of protection against aggressive tax planning in the internal market
- Scope of application: legal persons, legal entities

Tackling tax avoidance

ATAD

- ATAD lays down the minimum standard for 5 measures
  - Interest limitation
  - Exit taxation
  - General anti-abuse rule (GAAR)
  - Controlled Foreign Companies (CFC) rules
  - Hybrid mismatches
- Hybrid mismatch arrangements (HMA) are arrangements which exploit differences in the tax treatment of instruments, entities or transfers on cross-border trade and investment and often lead to "double non-taxation"

Tackling tax avoidance

ATAD II

- Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries
- Extension of application scope to relations with third countries
- Elaborating rules for hybrid mismatches

Tackling tax avoidance

ATAD III

- Proposal for a Council Directive to be adopted in 2025
- Intended to address the abusive use of so-called shell companies
- Shell companies: legal entities with no - or only minimal - substance and economic activity
- Business substance: a combination of many elements which include human and material resources
- CJEU highlighted the factors which should be considered to analyze the actual economic substance of a company (Danish Cases)
    - e.g. management of a company, balance sheet, structure of its costs, the expenditure incurred, employees, premises, equipment.
- Criteria laid down by the proposal
    - Passive income: more than 65%
    - Cross-border activities: more than 55%
    - Outsourced management and administration

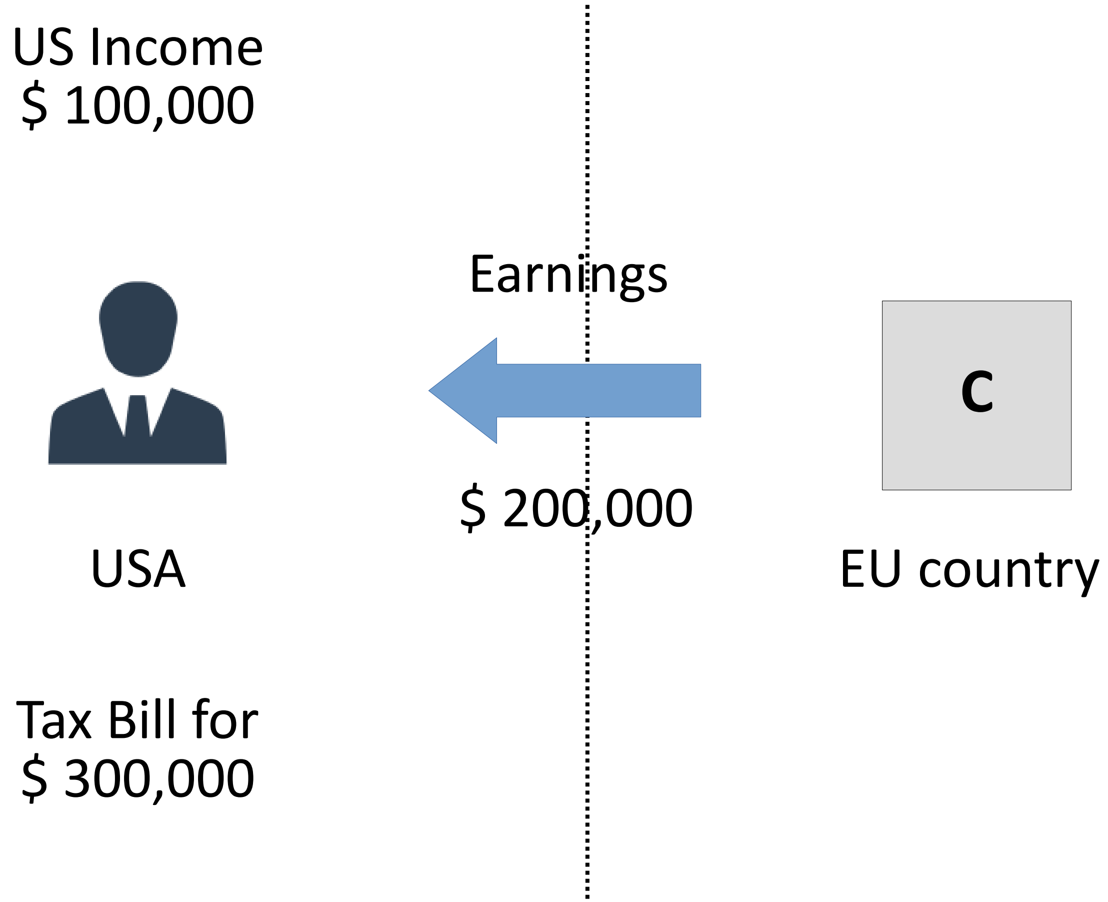
Tackling tax avoidance

CFC rules

- Terminology
  - Controlled Foreign Companies/Corporations (CFC)
- Problem
  - Resident taxpayers divert income to foreign companies they control
  - Such companies are typically resident in low or no-tax jurisdictions
- Tax implications
  - Tax deferral = tax avoidance
  - Non taxation = tax evasion

Tackling tax avoidance

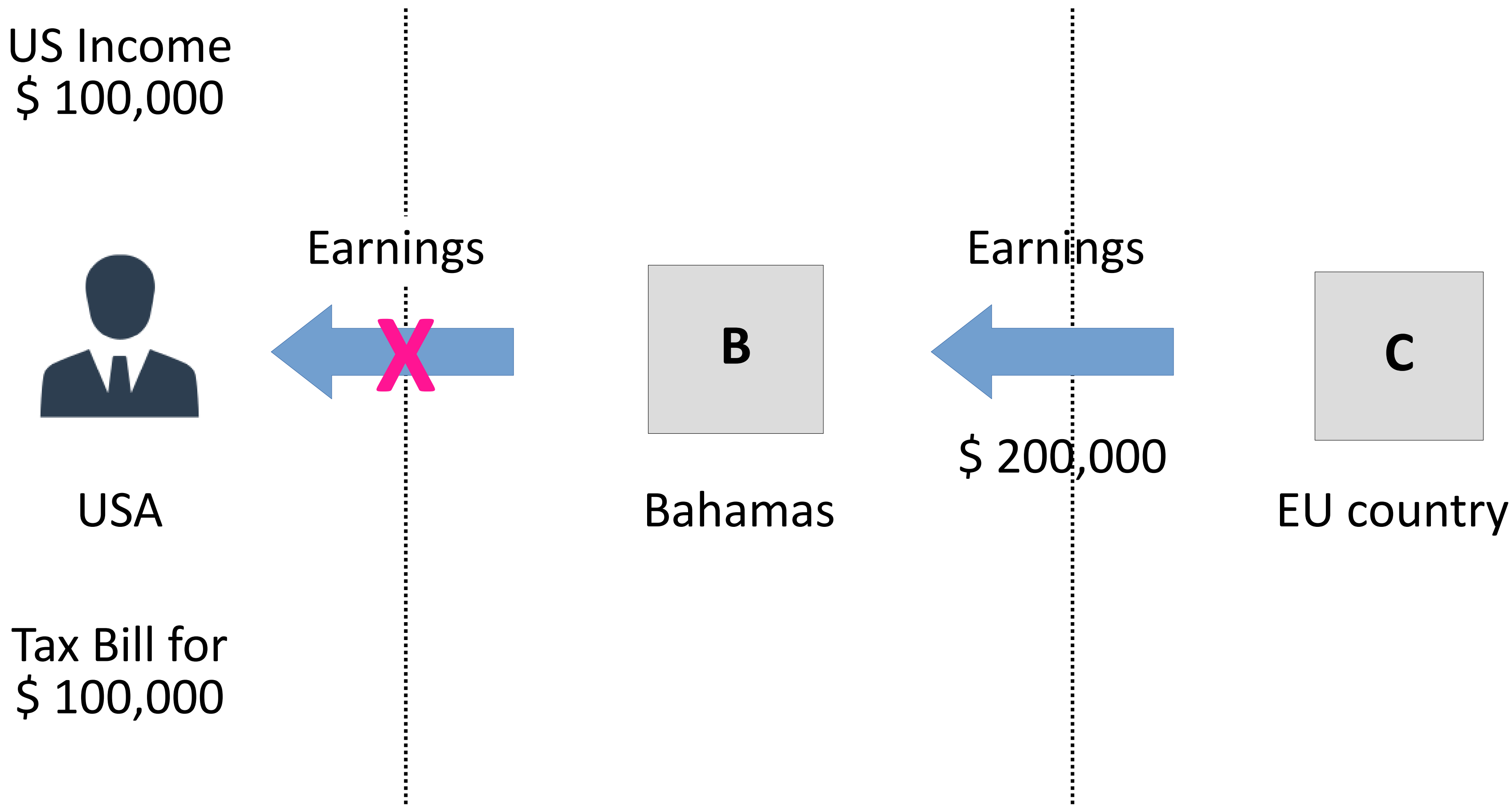
CFC rules



Tackling tax avoidance

CFC rules

<u>No CFC legislation</u>



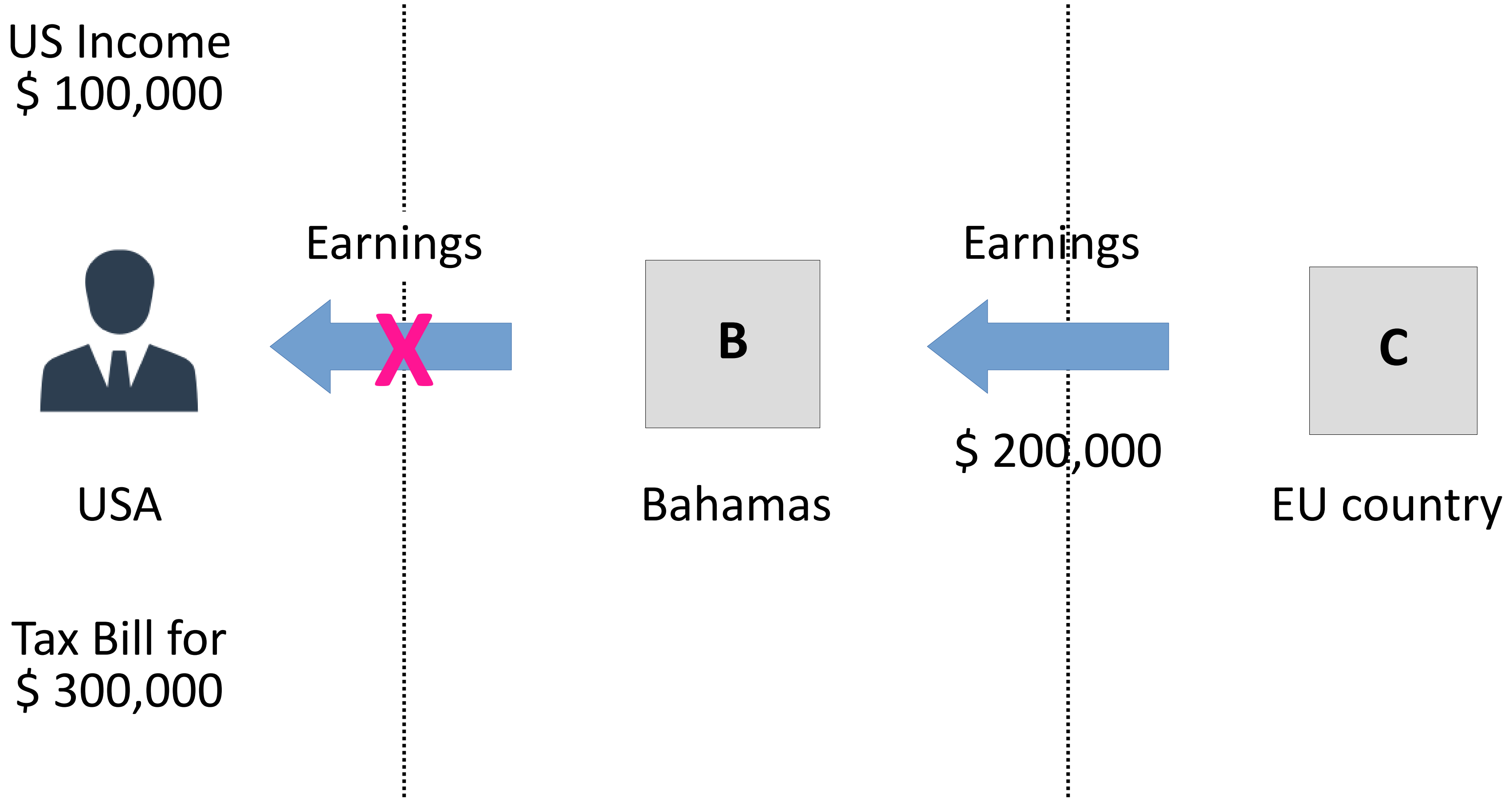
Tackling tax avoidance

CFC rules

- CFC legislation
  - Lifting the company veil
  - Residence state taxes the ultimate owners of the foreign company for income accruing in the company
- CFC regimes
  - Rules vary across countries
  - Most countries apply some form of CFC legislation
- OECD initiative
  - It urges countries
    - to adopt CFC rules, if they do not currently have
    - to strengthen CFC rules, if they already have
  - BEPS Action 3 (Final Report)
    - It does not prescribe a particular system of CFC legislation
    - It suggests various options

Tackling tax avoidance

CFC rules



Tackling tax avoidance

CFC rules

- CFC considerations
  - Location of the foreign subsidiary or other entity
  - Extent of control
  - Controlling persons
    - Companies and/or individuals
    - Ultimate beneficiary
    - Minority shareholders acting in concert
  - Nature of the transactions carried out by the foreign entity
    - Source of income approach
    - Substance approach

Tackling tax avoidance

CFC rules

- Source of income approach
  - Passive income
    - Income from a passive activity, i.e. an activity in which the recipient does not materially participate.
    - Similar terms: investment income, portfolio income, income from capital
    - Examples: rental income, interest, royalties, dividends
  - Active income
    - Income from an activity requiring a material participation by the recipient.
    - Similar terms: business income
    - Examples: income from sales or services, employment income

Tackling tax avoidance

CFC rules

- Substance approach
  - Substantial contribution analysis: Where was value created?
  - Viable independent entity analysis: Is it likely that the CFC would be owning the assets it owns and bearing the level of risk it bears if it was an independent entity?
  - Employees and establishment analysis: Are the CFC's core functions performed by its own employees at its own premises?

Tackling tax avoidance

Interest limitation

- MNEs may reduce their global tax liability through excessive interest payments.
- The interest limitation rule discourages such practices by limiting the deductibility of taxpayers' exceeding borrowing costs.
- Formerly known as thin capitalisation: A company is said to be “thinly capitalised” when it has a high proportion of debt capital in relation to its equity capital.
- The interst limitation rule fixes a ratio for deductibility which refers to a taxpayer's EBITDA (earnings before interest, tax, depreciation and amortisation)
- Borrowing costs are deductible only up to a certain percent of the taxpayer’s EBITDA

Tackling tax avoidance

GAAR

- General Anti-Avoidance Rule (GAAR)
  - Opposite:
    - Specific Anti-Avoidance Rule (SAAR)
    - Targeted Anti-Avoidance Rule (TAAR)
  - Definition: An anti-avoidance measure, generally statute based, providing criteria of general application to combat situations of perceived tax avoidance.
  - The GAAR gives the tax authority discretion to cancel tax benefits where transactions are entered into purely for tax purposes.

Tackling tax avoidance

GAAR

- Art. 6 ATAD 1

  "1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

  2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

  3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law."

Tackling tax avoidance

GAAR

- Example 1
  - Individual “A” fabricates product C
  - A establishes a company "B" to sell product C.
  - The company B pays 25% tax, but, if “A” himself sold the products, he would pay 40% tax.
  - “A” has formed the company only to save 15% tax.
  - Tax authorities may disregard company "B" and tax income at the hands of "A"

Tackling tax avoidance

GAAR

- Example 2
  - “A” sells his car to his son "B" by means of a sale and purchase agreement.
  - "B" is a student, therefore he does not earn sufficient income to purchase the car
  - In fact, "A" donated his car to "B" but they chose to characterise their transaction as a sale in order to avoid donation tax
  - Tax authorities may disregard the contract title given by the parties and impose donation tax

Tackling tax avoidance

Limitation of benefits

- Definition: Provision in a tax treaty to prevent treaty shopping by limiting or prohibiting the application of the treaty to certain persons.
- Art. 29 (9) OECD Model – Entitlement to benefits

  "9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the **principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

Tackling tax avoidance

Limitation of benefits

- Principal Purpose Test (PPT): a motive test
  - PPT is defined in the negative sense.
  - A purpose will not be a principal purpose where it is reasonable to conclude that obtaining the treaty benefit:
    - was not a principal consideration; and
    - would not have justified entering into any arrangement or transaction that has resulted in, or contributed towards, the benefi
  - Opposite: Business Purpose

Tackling tax avoidance

OECD Global Tax Deal

- Agreement reached by OECD and 136 in Paris in October 2021
- Basics
  - Global Minimum Tax of 15%
  - Appicable to profits of multinational firms with EUR 750 million ($992 million) in sales globally
  - Source states can set whatever local corporate tax rate they want,
  - If companies pay lower rates in a particular country, their residence states may "top up" their taxes to the 15% minimum,
- Objective: Elimination of the advantage of shifting profits

Tackling tax avoidance

OECD Global Tax Deal

- Mechanism
  - Pillar 1 (Source States)
    - National taxing power expands to include a share of profits from companies that make sales in the country regardless of a company's physical location ("significant economic footprint").
    - For companies with global revenues of more than €20 billion and profitability above 10%, 25% of profits above 10% would be taxed according to a new formula based on where a company's customers are located.

Tackling tax avoidance

OECD Global Tax Deal

- Mechanism
  - Pillar 2 (Residence States)
    - **Income inclusion rule**: determines when a company's foreign income should be included in the parent (main) company's taxable income.
    - **Under-taxed payments rule**: allows a country to reject a deduction on cross-border payments to the parent company.
    - **Subject to tax rule**: makes it possible for countries to tax inter-company payments that would be under-taxed.

Tackling tax avoidance

OECD Global Tax Deal

- Politics
  - USA
    - Most Tech Giants are US-based
    - Opposition in the US Congress from Republicans
    - Biden administration was in favor but did not implement the agreement
  - EU
    - EU wishes to bring the minimum tax reform into EU law, but this requires unanimous approval of member states
    - Brussels is facing opposition from Poland and Hungary.
  - If there is no agreement, countries will impose taxes unilaterally

Tackling tax avoidance

OECD Global Tax Deal

- Implementation timetable
  - The agreement was intended initially to be implemented in 2022 so that it can take effect by 2023
  - Delayed until 2024
  - The 27 EU member states are in the process of implementing the Pillar 2 rules in line with Directive 2022/2523/EU.
  - As of 7 June 2024, 45 countries have either introduced draft legislation or adopted final legislation transposing Pillar Two's model rules into their national laws.
  - US support remains uncertain, especially after Trump's election

Case study

"A", an Italian tax resident, holds a bank account in Swiss, where he deposited significant amounts of money in previous years. In 2023, "A" transferred the entire sum from his account to another Swiss account held by "C", a Luxembourg foundation. "C" has been established by "B", a company incorporated in British Virgin Islands, which is wholly owned by "A". During 2024, no amount was paid out from the Swiss bank account to "C". Neither "B" nor "C" distributed any profits.

"A" requests your professional advice as to whether there is any tax liability in Italy