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Aggressive Tax Planning – Challenge of the Digital Era

(Schemes, Problems Caused and Remedies)

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Preface

Coming from an emerging market economy state (Georgia), understanding Tax Law and its complexities has always been challenging for me. Georgia is currently developing tax system to attract investment and trade flow. Comprehending tax avoidance is thus relevant in order to form full perspective. As Georgia is not a member of the European Union, my interest is wider and global systems are just as relevant for my research as regional. In this thesis I try to determine the tax avoidance scheme and explore legal or political means of addressing it.

I would like to thank Cécile Brokelind for her guidance and input in the research process as well as her supervision in my Tax Law courses in Lund University, which enhanced my interest in the field. I also would like to thank my professors and classmates from European and International Tax Law courses, since working with them gave me relevant background and comprehension to conduct this research.

This publication has been produced during my scholarship period at Lund University, thanks to a Swedish Institute scholarship.

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List of Abbreviations

AOE	Apple Operations Europe
AOI	Apple Operations International
ASI	Apple Sales International
BEPS	Base Erosion and Profit Shifting
CEO	Chief Executive Officer
CFC	Control Foreign Company
ECJ	European Court of Justice
EU	European Union
FSC	Foreign Sales Corporations
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IBFD	International Bureau of Fiscal Documentation
IP	Intellectual Property
IRS	Internal Revenue Service
MNE	Multi National Enterprise
OECD	Organization of Economic Co-operation and Development
PE	Permanent Establishment
R&D	Research and Development
SCM	Agreement on Subsidies and Countervailing Measures
SIAT	Société d'Investissement pours l'Agriculture Tropicale
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom of Great Britain and Northern Ireland
UN	United Nations
US/USA	United States of America
VAT	Value Added Tax
WTO	World Trade Organization

Introduction

i. Background

Aggressive Tax planning has recently become topical issue in the European and International Tax Agenda due to its influence on global issues. It is suggested that with tax planning techniques Multinational Enterprises try to avoid their tax obligations, which in the end affects the economies of certain countries damaging them in the long run. International tax law has been designed to avoid double taxation, with the purpose to ensure that income is taxed once and only once. Its purpose has never been to ensure double non taxation of the income, but anecdotal evidence demonstrates that in some instances recent national and international tax laws not only eliminate double taxation, but also enable taxpayers not to pay tax at all. International Society sees aggressive tax planning to be a serious problem. As stated in G20 Leaders' Declaration:

> "Cross-border tax evasion and avoidance undermine our public finances and our people's trust in the fairness of the tax system. Today, we endorsed plans to address these problems and committed to take steps to change our rules to tackle tax avoidance, harmful practices, and aggressive tax planning."[1]

Technological advancement and business globalization have changed the methods of making profit. Intellectual Property has become main source of income for many businesses. Information and Communication Technology development enables MNEs to sell their services and goods without having actual presence within the jurisdiction. Therefore today income is received from the good that is easier to transfer, making profit shifting substantially easier. Hence it is logical that laws designed several decades ago have become ineffective in the new era.

The lack of remedies in international tax law to combat aggressive tax planning emerged as main challenge in the field. Unfair tax competition practices, tax havens and difference in understanding of legal issues have enabled MNEs to territorially separate their value creation activities form their income receiving activities and shift their profit outside the high tax jurisdictions.

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[1] G20 Leaders' Declaration, Saint Petersburg Summit, 5-6 September 2013, para.6, available at https://www.oecd.org/g20/summits/saint-petersburg/Saint-Petersburg-Declaration.pdf (last visited 22.02.2017)

This thesis describes what stands behind tax planning and how it works, what kind of damages are affiliated with it. How it harms businesses, governments and the people. The Paper describes most effective tax avoidance structures used by US MNEs. It discusses methods they use and analyses national law provisions enabling it.

The thesis is oriented to demonstrate the problems caused by nonexistence of suitable legal tools to contradict creativity of MNEs in tax planning and offers the understanding, interpretation and use of the existing international laws to remedy them. The thesis will also offer what can be amended, i.e. what new rules should be created in the view of the author to contradict the problem.

ii. Research Questions

The main research question in this thesis is:

What are the problems caused by aggressive international tax planning and how to remedy them?

The analysis will be done based on tax planning structure described in chapter 2. The purpose of thesis is two demonstrate that lack of remedies in international tax law is effectively used in practice and show the possible solutions. Purpose of the author is not to cover all the possible tax planning schemes and to answer every possible problem that might exist in this field. Practical examples are used to demonstrate the problem and need of international and national measures to contradict it.

iii. Methodology and Delimitations

This thesis utilizing descriptive and analytical methods illustrates techniques of tax avoidance and how they are used in practice; it demonstrates that international tax law does not have enough remedies to counter tax avoidance by aggressive tax planning. In some sub-chapters case study method is also applied (particularly when describing “Double Irish Dutch Sandwich” and “I-tax” examples of tax planning) exploring reasons and solutions in analytical ways. Thesis discusses possible legal tools in international legal system to counter tax avoidance problem described in case studies. It further offers possible changes that can be made in national and international level to remedy the problem.

The analysis is limited to the taxpayer's actions which are considered legal, but still cause reduction of taxes due. For the purposes of this work Tax Avoidance and Tax Planning are terms used to describe legal action of taxpayer. Thesis does not discuss tax evasion, which involves reducing tax burden by implicitly breaking the law. Paper is oriented on the problems caused by nonexistence of necessary legal tools, not on problems of ineffective enforcement of the tax laws. Legal problems and possible solutions are described in relation to the case studies presented in chapter 2. Transfer pricing issues, problems and possible solutions related to modern transfer pricing rules are not discussed in the paper.

iv. Outline/structure

This Thesis comprises of five main chapters:

The first chapter describes the concept of tax planning, what the methods used to avoid taxes and negative effects caused by it are.

Second chapter describes two aggressive tax planning structures used by Google and Apple and national law provisions enabling them.

Third chapter describes how state aid rules can be used as possible remedy to eliminate harmful tax competition practices.

Fourth chapter reviews actions taken through international cooperation seeking possible measures to remedy aggressive tax planning practices.

Fifth chapter describes the power of transparency and its effect on tax planning practices used by MNEs.

1. Tax Planning – what and how

1.1. *Tax Planning – Legal, Yet Problematic*

Tax is a compulsory contribution paid to the governments in return of which taxpayer does not receive any specific benefit.[2] Paying taxes is a duty of every taxpayer which is not related to specific counter governmental obligations or benefits; setting obligation to pay taxes restricts the right to property recognized in every democratic system around the world. It is fundamental that restriction of human rights, including the right to property shall be prescribed by the law and be justified in the democratic society; therefore, governments do not enjoy absolute discretion in choosing subjects and objects of taxation. Principle of Legality together with the constitutional guarantees on protection of property right obliges the states to create legal system predefining duties of a taxpayer. Individuals are bound to pay taxes as defined by the law; nobody should be required to pay more taxes than prescribed by pre-existing law for a taxable transaction.

As was described above individuals are bound to pay only as many taxes as is required by the law, therefore tax authorities cannot use fairness or sufficiency as a criteria for evaluating Taxpayers' action, nor can they increase or decrease payable amount to reach the fair outcome. Their competence is limited to check the legality of taxpayer action and requiring taxpayers to pay as much tax as required by the law, even if the amount to be paid seems too low or too high compared to the income they have received. This view has been shared by the national courts of various countries,[3] for example in the case of *Gregory v. Helvering* the court stated: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes".[4] This statement demonstrates that paying taxes is a legal duty, prescribed by the law and it is not something required based on morality, fairness, etc. If the law is well balanced and neutral it results in nondiscriminatory and fair outcome when applying it, while loopholes might lead to discriminatory results. Therefore, the legislator is the one who can and should try to create the legal system in which

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[2] See Thuronyi, Victor. *Comparative Tax Law*, Kluwer Law International, 2003, p. 45-51.
[3] See Russo, Raffaele. *Fundamentals of International Tax Planning*. n.p.: Amsterdam: IBFD, 2007, p 51-54.
[4] Circuit Court of Appeals, Second Circuit, *Helvering v. Gregory*, 69 F.2d 809 C.A.2 1934; March 19, 1934.

legal duty to pay taxes ensures neutrality of taxation and thus imposes fair burden on taxpayers.

In order to ensure full and compressive analysis, difference between tax avoidance, tax evasion and tax planning should be demonstrated. Although the result of all these three is similar - reducing taxes paid to the state, they widely differ from each other in terms of legal classification. The most widely adopted definition of tax evasion is: “The taxpayer avoids the payment of tax without avoiding the tax liability, so that he escapes the payment of tax that is unquestionably due according to the law of the taxing jurisdiction and even breaks the letter of the law”.[5] Therefore the term tax evasion usually refers to reduction of taxes through unlawful means. The terms tax avoidance and tax planning are often used interchangeably,[6] sometimes tax planning is used to describe the "acceptable tax avoidance"[7]. Tax avoidance and tax planning refer to taxpayer’s actions which are compatible to the law, but still result in reduction of taxes sometimes to the level not intended by lawmakers. As it will be demonstrated below, this could include abuse of law by conducting artificial transactions or simply creating legal structures distributing profit among different jurisdictions, sometimes it even creates stateless income and causes substantial reduction of tax paid to government.

Usually national legislation contains legal remedies (including criminal punishment) against violating tax laws, therefore effective inspection of taxpayers actions by tax authorities can recover taxes decreased as a result of tax evasion. Fighting against tax evasion usually does not require legislative action in terms of changing the law, for instance. Fighting against tax avoidance is more difficult compared to tax evasion. It is harder to combat reduction of taxes as a result of lawful actions of taxpayer. In such cases law does not contain remedies which can be used against reduction of taxes and thus tax authorities’ capabilities are limited. Legislative changes usually require wider consensus and longer time compared to tax inspection.

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[5] Russo, Raffaele. *Fundamentals of International Tax Planning*. n.p.: Amsterdam: IBFD, 2007, p 50.

[6] There is no universally accepted definition of the term “tax avoidance”, In different legal systems it might be used to describe illegal action of taxpayer. Some scholars might argue that there is the difference in these terms. For the purpose of this paper, the terms tax avoidance and tax planning will be used as to describe same kind of taxpayer action.

[7] Russo, Raffaele. *Fundamentals of International Tax Planning*. n.p.: Amsterdam: IBFD, 2007, p 49.

Existence of legal loopholes enabling tax avoidance has become one of the main problems in national and international taxation. Different methods are used for tax avoidance which becomes more and more "creative"; MNEs are coming up with new ways to make their tax bill as small as possible. Actions of taxpayers are more flexible compared to counter measures employed by lawmakers on international or national level. Development of technology and globalization of business makes old taxation laws less effective. This paper will demonstrate how tax law loopholes exploited by MNEs hinder neutrality of taxation. The paper will also will also try to offer possible solutions for the issue.

1.2. *Harm to States, Businesses and People*

As already mentioned taxes are the contribution towards the State constituting main income of the state budget. It is the main source of financing state expenses, by which government fulfills its functions, including creating public goods, financing public services, providing healthcare and other social benefits, etc.

Some countries have so called "big government", for example for the year of 2012 Sweden taxed 42.3% of its GDP,[8] other governments might be "smaller" - for instance in the same year US taxed 24.4% of its GDP, [9] Mexico taxed 19.6%,[10] etc. The fact that tax burden is different in different countries demonstrates that there is no consensus whether high taxation is better or not. There are arguments on both sides – with high taxation state gets more money from its residents, has ability to provide better services, including better welfare benefits. Lower taxes might not allow states to afford high social security and other costs; however low taxation enables private sector to develop better. One might also argue that private individuals can manage their money more effectively than the state, thus taxes should be as low as possible.

The consensus is lacking even regarding the necessity of having corporate income tax - some might argue that taxing income on shareholding level is more effective and can better solve the state problems. There are also some arguments supporting elimination of corporate income tax and using turnover taxes, such as VAT for example. However, it is clear that if states decide to have corporate income tax,

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[8] See *Revenue Statistics Tax to GDP Ratio Changes between 2007 and Provisional 2013 Data,* OECD, available at: http://www.oecd.org/ctp/tax-policy/revenue-statistics-ratio-change-latest-years.htm (last visited 29.04.2015).
[9] *ibid*.
[10] *Ibid*.

all taxpayers should bear fair burden and taxation should be neutral. Hence the goal is to achieve neutral treatment towards taxpayers, not necessarily collection of high revenue from corporate taxation.

US MNEs such as Google, Apple, Facebook, etc. manage to keep their effective corporate income tax rate around 2% for the income received from sales outside the US.[11] This tax rate is much lower than statutory rate any EU member state imposes on corporate income; even Ireland has 12.5% statutory income tax rate on trade income, which is one of the lowest in European Union.[12] According to the OECD the fact that current tax laws enable MNEs to greatly minimize their tax burden, has led to the situation in which citizens become more sensitive toward tax fairness issues.[13] Tax avoidance not only undermines fairness in tax system, but can cause some economic problems. Every state has a plan of how much money is needed for financing the public expenses. The fact that one taxpayer avoids taxes can cause either the decrease of entire tax revenue, or the increase of general taxation by the Government to pop up the revenue from taxing other taxpayers more heavily. If one taxpayer avoids taxes either others should pay instead of him/her, or the government will have to stop paying for some services, for example financing tuition for students. "When tax rules permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted, other taxpayers in that jurisdiction bear a greater share of the burden."[14]

According to the OECD *Action Plan on Base Erosion and Profit Shifting* tax avoidance harms business as well, it creates bad reputation and distorts the competition. MNEs may face significant reputational risk if their effective tax rate is viewed by general public as being too low.[15] At the same time, different businesses may assess such risk differently, and failing to take advantage of legal opportunities to reduce an enterprise's tax burden can put it at a competitive disadvantage.[16] Similarly, corporations that operate only in domestic markets, including family-owned businesses or new innovative companies, have difficulty

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[11] See de Graaf, Arnaud, de Haan, Paul & de Wilde, Maarten. *Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS*, INTERTAX, Volume 42, Issue 5, 2014 Kluwer Law International BV, The Netherlands, p.312.
[12] See http://www.revenue.ie/en/tax/ct/basis-charge.html (last visited 29.04.2015).
[13] OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013, chapter 1, page 8, available at: http://www.oecd.org/ctp/BEPSActionPlan.pdf, (last visited 03.05.2015).
[14] *ibid*.
[15] See Barford, Vanessa & Holt, Gerry. *Google, Amazon, Starbucks: The rise of 'tax shaming'*, BBC News Magazine, May 21, 2013, available at: http://www.bbc.com/news/magazine-20560359 (last visited 22.02.2017)
[16] *supra note 13*.

competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax.[17] Therefore tax avoidance harms not only the governments and the people but also businesses. It destroys integrity and public trust in tax system. As it was mentioned in the OECD report *International Tax Avoidance and Evasion:* "Tax avoidance [...] is of concern to governments because such practices are contrary to fiscal equity, have serious budgetary effects and distort international competition and capital flows."[18]

Tax avoidance is recognized to be a serious problem by the G20 as well, as it was mentioned in the G20 communiqué: "Ensuring that all taxpayers pay their fair share of taxes is a high priority in the context of fiscal sustainability, promoting growth, and the needs of developing countries to build capacity for financing development. Tax avoidance, harmful practices and aggressive tax planning have to be tackled".[19] It is clear from the mentioned that OECD and G20 aim to promote neutral taxation based on which every taxpayer bears the fair burden. The main problem is reaching the consensus on what measures should be implemented in order to fulfill this goal. The difference in tax systems and approaches of different governments toward taxation makes it challenging to achieve a possible common outcome on several issues. Furthermore some countries even benefit from tax planning systems used by MNEs which will be discussed below.

1.3. *Tax planning schemes*

The amount of income tax due is generally calculated based on two variables - tax base and tax rate.[20] Since the tax rate is usually fixed number defined by the law, tax planning strategies usually involve reduction of taxable base, which is usually conducted by base erosion and/or profit shifting. To say in simple manner, MNEs try to decrease taxable base of their group by either shifting their income making activities in low tax jurisdiction or creating deductible payment to foreign entities.

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[17] *supra note 13*.
[18] Russo, Raffaele. *Fundamentals of International Tax Planning*. n.p.: Amsterdam: IBFD, 2007, p 52, quoting OECD report *International Tax Avoidance and Evasion,* para. 10.
[19] Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors Moscow, July 20, 2013, para. 18, available at: http://www.g20.utoronto.ca/2013/2013-0720-finance.html (last visited 29.04.2015).
[20] See de Graaf Arnaud, de Haan, Paul & de Wilde, Maarten. *Fundamental Change in Countries' Corporate Tax*
Framework Needed to Properly Address BEPS, INTERTAX, Volume 42, Issue 5, 2014 Kluwer Law International BV, The Netherlands, p.306.

Development of technology and globalization of business gives an opportunity to MNEs to choose the places from where they manage their foreign activities, without changing main course of business.[21] Therefore it creates opportunity to choose low tax jurisdiction as a place of receiving income. Different methods are used to shift the profit in low tax jurisdiction, for example allocation of economic right on intangibles in low tax jurisdiction gives substantial tax cut to MNEs oriented on producing technology. Allocation of the mentioned economic right is conducted by either carrying out substantial part of R&D in low tax jurisdiction,[22] or using cost sharing agreements or other means assigning substantial part of intellectual property rights to the subsidiaries established in tax havens.[23] In terms of management and use of IP it does not make difference for MNEs whether they will own intangibles directly or through subsidiary in low tax jurisdiction.

MNEs which provide services through internet (such as Facebook, Google, Amazon, etc.) generate their income from internet sales and therefore it is hard to track specific geographic location where the income is received.[24] Therefore internet service companies can use low tax jurisdiction for establishing business and receiving income there. MNEs try to avoid establishing permanent establishment in high tax jurisdiction and supply goods and services by the company established in lower tax country. Same tendencies are described in OECD transfer pricing guidelines. Specifically, according to the article 9.2:

> "Since the mid-90's, business restructurings have often involved the centralisation of intangible assets and of risks with the profit potential attached to them. They have typically consisted of: Conversion of full-fledged distributors into limited-risk distributors or commissionaires for a foreign associated enterprise that may operate as a principal, Conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a foreign associated enterprise that may operate as a principal, Intangible, Internet services Moving manufacturing Transfers of intangible property rights to a central entity (e.g. a so-called "IP company") within the group".[25]

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[21] *supra note 20.* pages 310-311.
[22] *supra note 20.* page 310.
[23] For example US MNEs use cost sharing agreements to transfer economic right on its intangibles to Irish subsidiaries, see bellow chapter 2.1 and 2.2.
[24] See de Graaf Arnaud, de Haan, Paul & de Wilde, Maarten. *Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS,* INTERTAX, Volume 42, Issue 5, 2014 Kluwer Law International BV, The Netherlands, p.310.
[25] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publishing, Paris 2010, para. 9.2.

As an alternative to profit shifting MNEs use base erosion strategies to minimize tax burden. MNEs try to lower taxable base on high tax jurisdiction by creating deductible payments to related enterprises.[26] The deductible payments are very often related to assigning intangibles in the low tax jurisdiction, subsidiaries pay royalties for using IP right to the parent company resident in tax heaven. Such royalty becomes deductible payment for subsidiary registered in high tax jurisdiction but is not taxed as an income (or taxed with very low rate) at the hand of parent companies.[27]

Thin capitalization by taking excessive loan from related company and creating deductible interest payment is base erosion practice frequently used in international tax planning.[28] The structure is simple, a company from low tax jurisdiction grants loan to affiliated company in high tax jurisdiction (loan usually is not needed) and receives interest payments which is deductible payment for borrower, and not taxable income (or taxed with very low rate) in the country of lender.

Using Hybrid arrangements is one of the most effective ways to avoid taxes. Hybrid instruments include entities of transaction which are treated differently in different countries.[29] Using hybrid instrument MNEs can choose preferential tax treatment in different countries and receive tax benefit created by different system in a way never intended by lawmakers. Hybrid entities might include dual resident or nonresident entities which are either considered as resident in several countries and therefore can claim deduction on same payment in several states[30] or entities which are not resident anywhere therefore their income becomes stateless income.[31] Hybrid transactions are treated differently for the purpose of tax laws in the countries involved, for example as a debt in one country and as

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[26] See de Graaf Arnaud, de Haan, Paul & de Wilde, Maarten. *Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS,* INTERTAX, Volume 42, Issue 5, 2014 Kluwer Law International BV, The Netherlands, p.310

[27] For example see "Double Irish Dutch Sandwich" structure described below (Chapter 2.1). royalties are paid from Irish subsidiary (resident in Ireland) to another Irish subsidiary (resident in Bermuda) through Dutch subsidiary.

[28] See for example: Eduardo Traversa, *Interest Deductibility and the BEPS Action Plan: nihil novi sub sole?* British tax law Review, 2013.

[29] OECD, *Combating BEPS and Making Sure We Have Fair Tax Systems: An OECD/G20 Venture*, 29.09.2014, available at http://oecdinsights.org/2014/09/29/combating-beps-and-making-sure-we-have-fair-tax-systems-an-oecdg20-venture/ (last visited: 08.05.2015).

[30] See OECD, *Hybrid Mismatch Arrangements: Policy and Compliance Issues*, para. 10-11, available at: http://www.oecd.org/tax/exchange-of-tax-information/HYBRIDS_ENG_Final_October2012.pdf, (last visited 08.05.2015)

[31] See chapter 2.1 and chapter 2.2 below.

equity for another;[32] or transfer of ownership in one country and collateralized loan in another.[33] Such transactions might create deductible payment in one country and not taxable income in another; therefore it might be part of deduction/no inclusion schemes.[34] By hybrid arrangements MNEs might take advantage of difference in tax systems of different countries and reach double non taxation of the income which was never intended by lawmakers. The practical aspects, negative effects of such activities and possible solutions will be discussed below.

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[32] See OECD, H*ybrid Mismatch Arrangements: Policy and Compliance Issues*, 2012, para. 10, available at: http://www.oecd.org/tax/exchange-of-tax-information/HYBRIDS_ENG_Final_October2012.pdf, (last visited 08.05.2015)
[33] *ibid*.
[34] *ibid*, para. 11.

2. Tax planning in action - Practical examples

2.1. *Double Irish Dutch Sandwich*

The tax planning strategies used by Google are a good example to demonstrate that theoretical issues described above are successfully used in practice. The strategy is also very interesting from analytical stand point; it includes using hybrid entities for creating stateless income, assigning intangibles to low/no tax Jurisdiction, shifting royalties to tax haven and so on.

In 2003 Google Inc. entered in cost sharing agreement with its wholly owned Irish subsidiary Google Ireland Holdings. Based on the agreement Google Ireland holding acquired an economic right on the intangibles of Google Inc. for Europe, the Middle East, and Africa.[35] Google Ireland holding made a "buy-in" payment for the intangibles that already existed for the time and agreed to pay part of the cost of future R&D of Google Inc. Costs borne by Google Ireland holding were proportional to the territory where it acquired economic right to use intangibles compared to the entire world market of Google Inc.[36] With this action Google assigned substantial part of its intangibles to the Irish holding, therefore shifted substantial part of its future profit from the US, which has one of the highest statutory corporate income tax rate.[37] Google Ireland Holdings had five employees at the time,[38] which made it less likely that Google Inc. was receiving new substantial R&D potential from Irish holding. It can be reasonably assumed that tax planning was main purpose of establishing Irish subsidiary and entering in cost sharing agreement with it.

For the US tax purposes Company is resident in the country of incorporation,[39] while for Irish law purposes, company is resident of the country where its central place of management is located.[40] Because of this "consistency" between The US and Irish Law Google Irish subsidiary converted into a hybrid entity. It was incorporated in Ireland but its central place of management was in Bermuda. Therefore for US law purposes it was considered as Irish resident, and for Irish

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[35] Kleinbard, Edward D. *Stateless Income*, Florida Tax Review, 2011, p.707.
[36] *ibid*, p.708
[37] The United State federal corporate income tax rate is 35%, which is one of the highest in the world, see OECD data available at: http://stats.oecd.org//Index.aspx?QueryId=58204 (last visited 30.04.2015)
[38] Kelsall, Angus. *Dublin Go Bragh*, Google Blog (Oct. 6, 2004), http://googleblog.blogspot.se/2004/10/dublin-go-bragh.html (last visited 03.04.2015)
[39] Kleinbard, Edward D. *Stateless Income*, Florida Tax Review, 2011, p.709.
[40] See: http://www.revenue.ie/en/tax/ct/basis-charge.html (last visited 29.04.2015).

law purposes it was considered as resident of Bermuda. Hence Google Ireland holding was not considered as a resident in either country.

Google Ireland holding company licenses its intangibles to Dutch subsidiary ("Google BV"), which licenses the technology to second Irish company Google Ireland Limited.[41] Google Ireland Ltd. is incorporated in Ireland and has place of central management there, therefore is considered as Irish resident. Google Ireland Limited is company with substantial amount of employees (2000 employees in 2011)[42] and is the company which manages Google's intangibles in EU, Africa and Central Asia. Google Ireland Limited licenses technology and collects revenues from it. The company is fully taxable in Ireland, but makes substantial deduction in the form of licensing fee payment to Google Dutch subsidiary. Which by itself pays licensing fee to Google Ireland Holding, which is Bermuda's company, for the purposes of Ireland, and Irish company, for US tax law purposes. Therefore passive foreign income received by Google Ireland Holding is taxed neither in Ireland nor in the US; While Bermuda has no corporate income tax at all.[43]

This structure results in the fact that substantial part of Google's non-US income from intangibles becomes stateless income and is not taxed by corporate tax anywhere. The structure ensures on the one hand that royalty payment from most of the EU countries are paid to Google Ireland Limited, which is an undertaking established and fully taxable in EU member states, therefore EU law ensures that other EU countries can neither deny deduction for these payments[44] nor tax them at the source.[45] On the other hand, existence of Dutch subsidiary ensures that payment received by Google Ireland Holding will not be subject to Ireland withholding tax, since royalties paid by Irish company to Bermuda Company is subject to withholding tax not applicable to royalties paid to Dutch company.[46]

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[41] Kleinbard, Edward D. *Stateless Income,* Florida Tax Review, 2011, p.709.
[42] *ibid*. p.710.
[43] *ibid*. p.713
[44] According to the ECJ case law state cannot treat payments to company established in other EU state differently from payments to its own corporation (see for example: ECJ Case C-231/05 OY AA, Case C-200/98 X AB and Y AB). Therefore the state can either make royalties non deductible payment for everyone (which is unreal) or allow deduction for payment to Irish company as well. ECJ has developed Abuse of Right doctrine applicable to artificial transaction, in such cases state is in some situation allowed to deny deduction to payment made for foreign companies, but in this case royalty payment is not artificial transaction. Abuse of law principle in EU law will be further discussed below.
[45] In certain cases state can tax payment to foreign corporation at the source, but not in the cases when expense is directly linked to the income received by resident (see ECJ Case C-345/04 *Centro Equestre*).
[46] Kleinbard, Edward D. *Stateless Income,* Florida Tax Review, 2011, p.712

Netherlands does not have withholding tax on such royalties.[47] The structure used by Google is called *Double Irish Dutch Sandwich*, since two Irish subsidiaries are used and one Dutch subsidiary is inserted between them.

2.2. *I-tax*[48]

Apple used simpler structure compared to the *Double Irish Dutch Sandwich***.** It has some similarity, including using hybrid Irish subsidiary, but does not involve "Dutch Sandwich".

In 1980 Apple established three Irish subsidiaries: Apple Operations International (AOI), Apple Sales International (ASI) and Apple Operations Europe (AOE).[49] All of these companies were incorporated under Irish law and had central place of management in the US. As it was described above such entities do not have tax residency in either US or Ireland.

Apple has divided its worldwide sales into two parts. Sales in Americas are conducted by Apple Inc., company incorporated in the Unites States. Sales in other part of the world (Europe, Middle East, Asia, Africa, India and Pacific) are coordinated by the Irish subsidiary of Apple - ASI.[50] Apple also assigned Economic rights (everywhere besides Americas) on its intangibles to ASI. ASI has entered in cost sharing agreements with Apple Inc., based on this agreement ASI holds economic rights on IP on the product sold in Europe, Middle East, Asia, Africa, India and Pacific, while Apple Inc. holds economic intellectual

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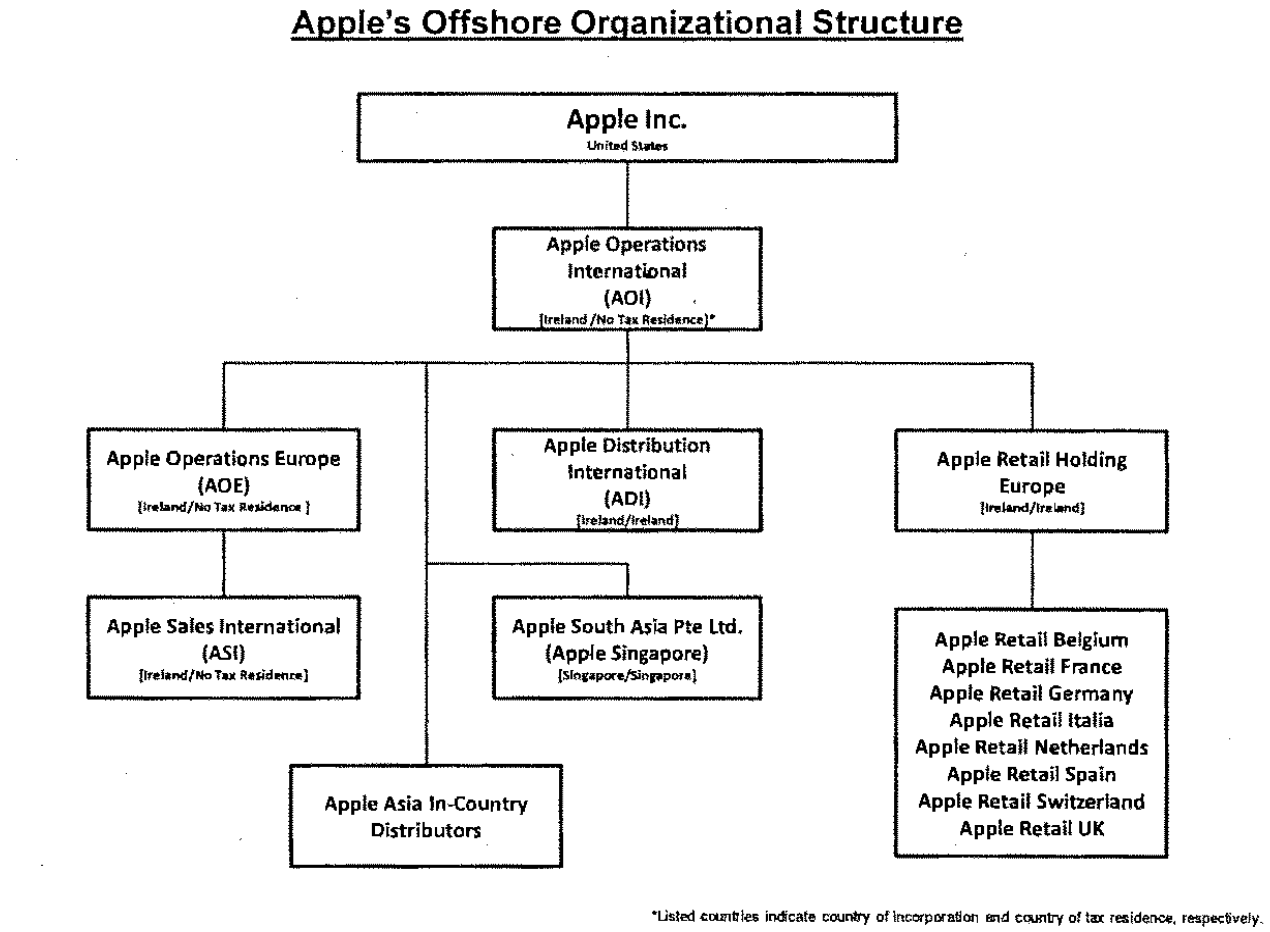
[47] *supra* note 46.

[48] I-tax stands for tax planning strategy used by Apple, term is taken from Antony Ting's article *iTax - Apple's International Tax Structure and the Double Non-Taxation Issue*, British Tax Review 2014 No.1, March 19, 2014.

[49] Memorandum from Senator Carl Levin (subcommittee Chairman), Senator John McCain (Ranking Minority Member) to Members of the permanent subcommittee on investigations, *US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.)*, available at: http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2 (last visited 11.05.2015), page 17, included in *Report on Hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).* Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, United States Senate One Hundred Thirteenth Congress First Session (hereinafter Hearing Report). May 21, 2013, page 168, available at: http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[50] *ibid*, memorandum page 19, report 170.

property right on the product sold in Americas.[51] ASI pays cost of R&D proportional to the sales.[52]



At the time of the Apple hearing before US senate subcommittee (May 21, 2013) apples corporate structure looked like this[53]:

AOI and ASI are central in Apple's tax planning structure. AOI is a holding company; it receives dividends from its subsidiaries established in different countries. Dividends are not taxable either in Ireland or in US.[54] This structure is not as aggressive as Double Irish Dutch Sandwich since dividend does not run through Dutch subsidiary to avoid source taxation of dividends. Therefore some

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[51] *supra* note 49, memorandum page 19, report 170.
[52] *ibid*.
[53] Structure is prepared by Permanent subcommittee of investigation based on the material provided by the Apple.
supra note 49. memorandum page 20, report page 171.
[54] *supra note 49*, memorandum page 22-23, report page 173-174.

dividends can be taxed at source, for example dividends paid by ADI (Irish company to US Company) might be subject to Irish withholding tax. As it was mentioned in the hearing besides using perfect fit of Irish tax residency definition, in 80s Apple also has entered in the agreement with Irish Government about its future taxation.[55]

ASI is the company responsible for sales of Apple products around the world (except Americas). Apple products are generally produced by Chinese manufacturers. ISA and Apple Inc. separately enter into the agreement with manufacturer, product produced based on the contract between ASI and the manufacturer is owned and sold by ASI. Apple's Irish subsidiary has commission agreement with national distributors; therefore from Apple's product sales national distributor receives only commission (around 5%) as an income.[56] This is income received in the country of sales and therefore is taxed there, but biggest part of income from sales is the income of Apple's Irish subsidiaries therefore it is not taxed anywhere.

2.3. *Factors enabling tax planning by the US MNEs*

Several factors encourage US multinationals to come up with comprehensive tax planning strategy, which allows them to reach very low corporate tax rate for non US income. Perfect interaction between the Irish and the US tax law definitions of corporate residency is not the only reason why income received according to the structure described above is not taxed anywhere.

The US does not have worldwide taxation on every foreign income of MNEs, but it does not have exemption system either. The US uses system of deferral, which means that income is taxed once it repatriated in the US as a dividend or other payment to parent company; tax paid in foreign country is credited in the US.[57]

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[55] Testimony of Peter Oppenheimer, Senior Vice President and Chief Financial Officer, Apple Inc, US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.). Report of apple hearing before US senate subcommittee, report page 42, available at: http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[56] Testimony of J. Richard Harvey, Professor, Villanova University School of Law, Villanova, Pennsylvania; US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.). Report of Apple hearing before US senate subcommittee, report page 29, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[57] Memorandum from Senator Carl Levin (subcommittee Chairman), Senator John McCain (Ranking Minority Member) to Members of the permanent subcommittee on investigations, *US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the*

Additionally subpart F of the US tax code includes anti-deferral rules, with the purpose to fight against the desire of the US based MNEs to create offshore subsidiary for the sole purpose to receive dividend from CFCs there instead of the US. Under subpart F passive income paid from one CFC to another is immediately taxable,[58] therefore as a general rule dividends received by AOI is taxable in the US. In 1997 the US Treasury adopted check-the-box regulation. Based on this regulation US multinational can choose tax treatment towards its lower tire subsidiaries; they can elect these subsidiaries to be considered as corporation, partnership, sole proprietorship, branch or disregarded entity.[59] Therefore in case of Apple by simply "checking the box" Apple can choose all its subsidiaries, except AOI to be disregarded for the US tax purposes. Therefore all the subsidiaries will be treated as a single entity and dividends received by AOI will be treated as a sales income (active income). Hence provision of subpart F about taxation of dividends will not be applicable. Furthermore in 2006 congress enacted the law which exempts from taxation certain dividends, interests, rent and royalties received by foreign subsidiary from another subsidiary.[60] This law is known as CFC "look through rule", it was enacted as a temporary measure, but its force was extended several times.[61] CFCs "look-through" rule creates extra remedy for MNEs not to pay taxes on dividends received by foreign subsidiaries.

Furthermore, US tax laws include other exemptions from subpart F taxation. For example dividends, royalties and interest paid from one CFC to another are not taxed if the CFCs are organized and operating in the same country. This rule is usually called as "same country exemption".[62]

Therefore in theory the US has tax system which taxes some of the income received by Irish subsidiaries, but in practice by using the "Check-the-box" and CFC "look through rules" US MNEs can make the US system of deferral work almost as an exemption system.[63] They are able and have come up with a tax structure ensuring them not to pay any tax in the US on foreign income. At the same time Irish definition of resident entity perfectly fits the US definition of

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U.S. Tax Code - Part 2 (Apple Inc.), 12.05.2013, part II.A, page 7. Included in the report of apple hearing before US senate subcommittee, report page 158, available at: http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015)

[58] *ibid*. memorandum page 13, *hearing report* page:164.

[59] *ibid*.

[60] *ibid*. memorandum page 14, *hearing report.* page165.

[61] *ibid*. memorandum page 14-15, *hearing report,* page165-166.

[62] *ibid*. memorandum page 15, *hearing report,* page:166.

[63] Difference is that Income is taxable when it is repatriated in US as a dividend from Irish subsidiaries. As long as MNEs keep income at Irish subsidiary it is not taxed.

residency, allowing US MNEs to create hybrid entities and avoid big part of taxation in the source states as well.

2.4. *Whose problem is it - whose tax US MNEs Avoid?*

The US senate subcommittee hearing has demonstrated that the US Multinationals use Irish subsidiaries to perform operations outside the United States.[64] For example in the case of Apple, sales in entire Americas are conducted by Apple Inc. (company incorporated in the US). Technically Apple could have been more aggressive in tax planning. For example at least it could run sales outside US entirely through offshore company; but Apple chooses not to. As Apple CEO has pointed out it his sworn testimony before the US senate subcommittee hearing:

> "Apple has real operations in real places with Apple employees selling real products to real customers. We pay all the taxes we owe, every single dollar. We not only comply with the laws, but we comply with the spirit of the laws. We do not depend on tax gimmicks. We do not move intellectual property offshore and use it to sell our products back to the United States to avoid taxes. We do not stash money on some Caribbean Island. We do not move our money from our foreign subsidiaries to fund our U.S. business in order to skirt the repatriation tax."[65]

Apple has allocated 102 billion untaxed cash in Irish subsidiary[66], but this is income received from sales outside Americas; repatriation of this income is subject to the US corporate income tax.

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[64] See US senate subcommittee rearing reports on: *Offshore Profit Shifting and the U.S. Tax Code - Part 1 (Microsoft & Hewlett-Packard),* available at: http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code (last visited 09.04.2015) and *Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.)* available at: *http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code -part-2* (last visited 09.04.2015).

[65] Testimony of Timothy D. Cook, Chief Executive Officer, Apple Inc., US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).
Report of apple hearing before US senate subcommittee, report page 43, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[66] Opening Statement of Senator McCain**,** US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).

As it was pointed out by Peter Oppenheimer, Senior Vice President and Chief Financial Officer of Apple Inc., the fact that Apple's Irish subsidiaries are not tax residents in Ireland does not reduce Apple's US tax.[67] The statement should be agreed upon, in case of amending Irish laws and taxing Apple in Ireland does not increase Apple's US tax bill. "Apple could certainly choose to manage foreign after-tax profits in numerous foreign subsidiaries without moving the cash to AOI or ASI, but that would have absolutely no effect on the taxes we pay in the United States."[68] As it was maintained by Apple team on the hearing, "Apple's Irish Structure" does not result in avoidance of US tax.

Furthermore it was clearly stated by J. Richard Harvey, tax law Professor, invited on the hearing that they don't think introducing worldwide taxation in the US tax code will be a positive change unless US lowers its corporate tax rate.[69] US has one of the highest statutory corporate tax rate in the world (35%), if US MNEs' worldwide income was taxed with 35% rate this would create substantial competitive disadvantage for US MNEs, and might even drive them out of the country. One might say US benefits from tax avoidance structure used by MNEs; it ensures that US MNEs are still competitive internationally while paying high corporate income tax for US profit.

As it was pointed out by Peter Oppenheimer Apple was not always a successful company. It has had its downfalls; in 1997, Apple was on the break of bankruptcy and about out of cash.[70] In just 2 years, it had lost $2 billion.[71] Today Apple is one of the biggest tax contributors to the US government; it has paid around 6 billion as corporate tax to the US treasury,[72] which is six billions more than what

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Report of apple hearing before US senate subcommittee, report page 10, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[67] Testimony of Peter Oppenheimer, Senior Vice President and Chief Financial Officer, Apple Inc, US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).

Report of apple hearing before US senate subcommittee, report page 39, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[68] *ibid*, Report page 39.

[69] Testimony of J. Richard Harvey, Professor, Villanova University School of Law, Villanova, Pennsylvania; ., US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).

Report of apple hearing before US senate subcommittee, report page16, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[70] See Testimony Of Peter Oppenheimer, Senior Vice President And Chief Financial Officer, Apple Inc. *Report* page 39.

[71] *ibid.* Page 39.

[72] Testimony of Timothy D. Cook, Chief Executive Officer, Apple Inc, Report, p. 39.

it has paid in 1997.[73] So US MNEs are not invincible either, therefore giving them competitive disadvantage with high taxation might create extra cash in the US Treasury in short term, but at some point corporate tax might also become zero, as it was in 1997. Having $102 billion cash offshore could also be some kind of guarantee for Apple that 1997 will never happen again, if company losses are too high it can always repatriate Irish money as a dividend. Losses will be deducted from dividend income and cash received will still be untaxed.

It is the position of G20 that: "Profits should be taxed where functions driving the profits are performed and where value is created".[74] To say in simpler way it is principle of the International Tax Law that profit should be taxed where commercial activity is performed.[75] In case of Apple product is designed (Intangibles are created) in the US,[76] its product is manufactured in China and sold around the world by Irish subsidiaries. Apple's Irish subsidiaries pay cost of R&D based on cost sharing agreement. For example in the years of 2009-2013 they have paid $4.9 billion[77], this payment is regulated by US transfer pricing rules, cost sharing arraignments is considered to be based on Arm's length principle.[78] Therefore one can argue that for the functions driving the profits outside Americas Apple has paid US corporate tax. Payment made by the Irish subsidiary is the cost that otherwise would have been deductible by Apple Inc. Hence this payment is equivalent to the taxable income of Apple Inc. and Apple's tax avoidance is related to activities such as production and marketing, functions

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[73] A company does not pay any corporate tax when it has no profit.

[74] Communiqué, G20 Meeting of Finance Ministers and Central Bank Governors Moscow, July 20, 2013, para. 18, available at: http://www.g20.utoronto.ca/2013/2013-0720-finance.html (last visited 10.04.2015)

[75] EU commission press release, available at http://europa.eu/rapid/press-release_IP-15-4436_en.htm

[76] Timothy D. Cook,1 Chief Executive Officer, Apple Inc., Cupertino, California; Testimony Before Us Senate Subcommittee, "much of that innovation takes place in a single U.S. Zip code—95014. That is Cupertino, California", reports, p. 36.

[77] Memorandum from Senator Carl Levin (subcommittee Chairman), Senator John McCain (Ranking Minority Member) to Members of the permanent subcommittee on investigations, *US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).*
12.05.2013, part II.B, page 29. included in the report of apple hearing before US senate subcommittee, report page 180, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[78] Memorandum from Senator Carl Levin (subcommittee Chairman), Senator John McCain (Ranking Minority Member) to Members of the permanent subcommittee on investigations, *US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).*
12.05.2013, part II.B, page 8-9. included in the report of apple hearing before US senate subcommittee, report page 159-160, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015)

carried out outside the US. Thus it could be argued that US MNEs avoid taxes other than the American Corporate tax.

These arguments in addition to other factors are enough to believe, that among US lawmakers there has not been a consensus yet, and it is less likely to be in future, for closing the loopholes in the US tax code such as "check-the-box", "look through rules", "same country exemption" and others.

Ireland also benefits from its tax law. It is attractive for investors to open offices in Ireland, they pay very low tax rate (which does not necessarily mean that the amount paid is very low), but without such legal system Ireland would lose substantial tax revenue from US MNEs. Furthermore MNEs help job creation, for example for 2013 Apple had 4000 employees in Ireland[79]. "In 2011, a small number of sectors dominated by foreign-owned multinational enterprises (MNEs) accounted for one quarter of total economy wide gross value added (GVA)",[80] which is substantial for Irish Economy. If tax avoidance by MNEs is the problem, it is more the problem of source countries, rather than capital exporting states. Therefore it is less likely that it will be solved by entirely voluntary unilateral action from the US or Ireland.

2.5. *Is "Double Irish Dutch Sandwich" structure still functional?*

Several actions have been taken on international and regional level to eliminate stateless income creating machines enabled by the US and the Irish tax laws. There has been serious pressure on Ireland to change its tax residency laws. Fighting BEPS has been importance direction of G20 and OECD. Some scholars even considered Irish economy to be antisocial to the developing countries.[81] Ireland has expressed its desire to keep up with the international tendencies fighting tax avoidance and on October 14, 2014 the Irish Finance Minister released the document accompanying state budget of Ireland, "Competing in a

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[79] See Testimony of Peter Oppenheimer, Senior Vice President And Chief Financial Officer, Apple Inc.*Report* page 38.

[80] Department of Finance of Ireland, Economic Impact Of The Foreign-Owned Sector In Ireland, Part Of The Economic Impact Assessment Of Ireland's Corporation Tax Policy, October 2014, page 2, available at: http://www.budget.gov.ie/Budgets/2015/Documents/Economic%20Impact%20of%20the%20FDI%20sector.pdf (last visited 24.05.2015)

[81] See the commentary of the Special Rapporteur on Poverty of the UN, Philip Alston. 12 February, 2015. Available at: http://www.theguardian.com/world/2015/feb/12/irish-tax-policies-anti-social-developing-countries-un-expert (last visited 28.04.2015)

Changing World a Road Map for Ireland's Tax Competitiveness". [82] According to this proposal Ireland intends changing definition of tax residency. The proposal recognizes that Ireland's company tax residence rules have not kept pace with international tax developments. They therefore will be updated in Finance Bill 2014 to provide a default rule that all companies incorporated in Ireland are tax residents in Ireland.[83]

According to the proposal the amendment should have been enforced from January 1, 2015, but transitional period until year 2020 will be given to the companies which already operate in Ireland.[84] Changes will be effective for new companies from January 2015, but it will not affect companies already operating in Ireland before 2020, therefore we can assume that "Double Irish" system is still functional at least until 2020.

Based on the above mentioned arguments it is clear that "Double Irish Dutch Sandwich" structure of aggravate tax planning is still valid and current international tax law does not provide for the remedies to counteract against it. Changes in national tax laws of particular countries (for example in Ireland) will not be able to remedy aggravate tax planning. Even if Ireland eliminates any possibilities of tax planning in its national laws, as long as international tax laws give opportunities for tax avoidance there will always be "new Ireland", another country used for base erosion and profit shifting by MNEs. As it has been shown above, although effective tax rate is low for subsidiaries of MNEs, tax paid in cash is still relevant amount; furthermore, establishing subsidiaries by big companies give boost to state economies through job creation and other ways. Therefore, it is arguable, that countries willing to offer beneficial tax laws to promote MNEs establishing subsidiaries in their territories may still exist in the future. More comprehensive and effective international tools should be developed in order to fight tax avoidance.

Next part of the paper will be devoted to discuss possible solutions to the problems described above. I will try to discuss what existing international tax law remedies can be, or what remedies should be created in order to eliminate or at least lower the effect of aggravate tax planning. Taxation of MNEs is regulated by both resident state and source state taxation rules; therefore I will try to show possible remedies from both perspectives. From the perspective of resident state

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[82] Department of Finance of Ireland, *Competing In a Changing World a Road Map for Ireland's Tax Competitiveness*, October 2014, page 2-4, avalable at: http://budget.gov.ie/Budgets/2015/Documents/Competing_Changing_World_Tax_Road_Map_final.pdf (last visited 28.04.2015).
[83] *ibid*, page 8.
[84] *ibid*.

taxation I will try to demonstrate how far existing state aid rules can remedy the problem. As for the source state perspective, I will discuss possibilities to fight against hybrid entities and the role of permanent establishment (PE) taxation. The role of transparency and information sharing regarding the taxation issues and its influence on tax planning will be the final topic of the paper.

3. State aid rules - Possible remedies to counter state practices enabling tax planning

3.1. *EU State Aid*

3.1.1. Commission Decision SA.38373 of August 30, 2016

a) Background

On June 2014 European Commission initiated formal investigations to examine whether decisions by tax authorities in Ireland, with regard to the corporate income tax to be paid by Apple, was compatible with state aid rules enshrined in TFEU.[85] The Commission stated that it was going to investigate "the individual rulings issued by the Irish tax authorities on the calculation of the taxable profit allocated to the Irish branches of Apple Sales International and of Apple Operations Europe."[86] According to the press release, the Commission also investigates actions of the government of the Netherlands and Luxemburg with regards to corporate tax paid by Starbucks and Fiat. Initially investigation involved three countries, but in December 17, 2014 the European Commission issued new press release announcing that "the Commission extends information enquiry on tax rulings practice to all Member States."[87] According to the press release the Commission is going to ask EU states to provide information about tax ruling practices. These press releases show that the Commission intends to conduct comprehensive research about tax practices in different EU states and plans to use state aid rules for eliminating tax havens and unfair tax competition practices within the EU. It seems from press releases that the Commission is willing to perform comprehensive investigation all around the Europe and the result might change state tax practices greatly. So far only Commission decision on two tax rulings, made by Irish tax authorities, was delivered on August 30, 2016.

b) Finding of the Commission

Pursuant to the Decision SA.38373 Commission's investigation was limited only to the two tax rulings issued in 2001 and 2007 against Apple by Irish Tax

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[85] Commission press release, *State aid: Commission investigates transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg)*, Brussels, 11 June 2014, available at, http://europa.eu/rapid/press-release_IP-14-663_en.htm?locale=en (last visited 12.04.2014).
[86] *ibid*.
[87] European Commission, Press release, 17.12.2014, available at: http://europa.eu/rapid/press-release_IP-14-2742_en.htm (last visited 12.04.2014).

Authorities. The Commission found that between the ASI and its Irish branches income was not allocated based on arm's length principle.[88] As indicated above, based on the cost sharing agreement between the ISA and Apple Inc. economic rights (everywhere besides Americas) on Apple's IP was assigned to ASI and thus income received by ASI was considered to be stateless income and was taxed nowhere. However, the Commission indicated that the Irish branch of ASI and ASI itself are parts of the same legal person.[89] Therefore, property assigned to ISA is a property of its branch as well. Thus, since most of the economic activity was carried out by the Irish branches,[90] the income of ASI should be allocated to them based on the arm's length principle. Since according to the Irish tax regulation non-resident company (ASI in this case) is taxed for the income received by its Irish branches, not taxing ISA for the income, which based on the arm's length principle was considered to be income of the branch, was declared to be selective advantage incompatible to the article 107 of TFEU. The Commission's Decision is applicable only to the Apple situation and only due to the fact that ASI had established branches in Ireland instead of subsidiaries. Therefore, the ruling of the Commission's Decision is not capable to remedy more general schemes described above, involving hybrid, "stateless", companies. Even if Apple had conducted its Irish operations through the Irish subsidiary instead of the branches, the Commission most probably would not be able to find breach of state aid rules based on the same argumentation. The Commission indicated in its decision that "the Commission's investigation did not examine either the compatibility of Section 23A TCA 97 with the State aid rules, or ASI's and AOE's lack of tax residency resulting from an application of that provision under those rules. Nor did it examine whether the structure and set-up of the Apple group companies in Ireland complies with the State aid rules. Rather, as explained in Recital (39), its investigation was concerned with the contested tax rulings and whether the profit allocation methods endorsed by Irish Revenue in those rulings resulted in the grant of State aid."[91]

Therefore, the recent decision of the Commission does not involve verifying the compatibly of the tax avoidance schemes described in the previous chapter of this paper with state aid rules. Neither is there any other case law of the Commission and/or the ECJ assessing the mentioned tax schemes; hence, it is not possible to be certain whether the state aid rules can remedy tax planning mentioned above or not. However, based on the extensive case law of the Commission and the Court it

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[88] Commission Decision SA.38373. para. 305
[89] Commission Decision SA.38373. para. 271
[90] Commission Decision SA.38373. para. 307
[91] Commission Decision SA.38373. para. 277.

is possible to assess the described situation and provide the author's opinion on the mentioned issue.

3.1.2. Author's Assessment of the Compatibility of the Described Tax Schemes with EU State Aid Rules

Article 107.1 of TFEU creates general prohibition of state aid within the European Union; second paragraph of article 107 TFEU lists the aid which should be considered compatible with internal market and third paragraph lists aid which might be considered compatible for the internal market. If Government measure is cut under paragraph one of article 107 and not covered by second or third paragraphs, it is considered to be prohibited state aid, which is *per se* unlawful. There is no grounds to justify state aid besides paragraph 2 and paragraph 3 of article 107.

As article 107.1 of TFEU was interpreted by the European Commission and the ECJ, State measure should fulfill four criteria to be considered as state aid:

> "(i) the measure has to be granted out of State resources,
>
> (ii) it has to confer an economic advantage to undertakings,
>
> (iii) the advantage has to be selective and distort or threaten to distort competition, and
>
> (iv) the measure has to affect intra-EU trade".[92]

Guiding principle is that the measure should confer an advantage to undertaking to constitute a state aid.[93] State aid covers not only positive benefits, such as direct subsidies, "but also measures that mitigate the charges an undertaking would normally bear".[94] Tax exemption is thought to be financial advantage,[95] because it is cost otherwise borne by an undertaking. Taxes are considered to be state resource,[96] therefore tax exemption is the advantage provided by state

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[92] Decissions of European Commission SA.34466, para.19, SA.34576, para.16.

[93] Craig Paul, de Búrca Gráinne, *EU Law: Text, Cases, and Materials*, fifth edition, 18 Aug 2011, page 1088

[94] *ibid*, quoting ECJ Case C-237104 Enirisorse SpA v Sotacarbo SpA [2006] ECR I-2S 43, [42]; Case C-222104 Ministero dell'Economia e delle Finanze v Cassa di Risparmio di Firenze SpA [2006] ECR I-289, [r3l]; Case C- 393104 and 41105 Air Liquide SA v Protince de Litge [2006] ECR I-5293.

[95] *ibid*, quoting ECJ Case C-387192 Banco de Credito (n 85); Cases C-182 and 217103 Belgium and Forum i87 ASBL v Commission[2006] ECR r-s479.

[96] See ECJ case C-387/92 Banco Exterior de Espana.

resources; hence, it satisfies first two criteria derived from article 107.1 as interpreted by the Commission and the Court.

It should be stated that based on third criterion, general measures usually do not fall under the prohibition established by article 107 of the TFEU.[97] State measure should be selective to be considered contrary to the article 107 of TFEU. "Advantages resulting from a general measure applicable without distinction to all economic operators do not constitute State aid".[98] The measure is selective if "national measure is such as to favor 'certain undertakings or the production of certain goods' in comparison with others which, in the light of the objective pursued by that regime, are in a comparable factual and legal situation".[99] The measure can be materially and/or regionally selective, both is independently capable of breaching article 107.[100] Trade between the Member States is affected if the measure can potentially affect such trade, evidence that the measure actually affected trade or distorted competition is not necessary.[101]

Based on the abovementioned State is free to tax as much as it desires; corporate income tax can be very low, even zero, as long as taxation system is general and does not include selective measures creating tax advantages on certain undertakings or products. Also State Aid rules cannot entirely eliminate tax havens they can still serve as useable remedy against aggravate tax planning. One thing that would be cut under prohibition of article 107 TFEU is individual agreements between state governments and undertaking regarding tax treatment of those companies. Compared to more general schemes it is easier to assume that individual agreement lowering tax burden would fulfill "selectivity" criterion and therefore such agreements are more likely to be qualified as a measure constituting state aid. Thus, we can assume that the least the Commission investigation will do is to uncover such agreements and demand governments to withhold subsidy. Individual tax agreements should not be very uncommon for some of European countries, during the hearing before the US senate subcommittee Apple representative mentioned, that there is an agreement between Apple and Irish Government which ensures corporate tax rate below 2%.[102]

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[97] See ECJ case C-143/99 Adria-wien, para. 35,36
[98] See ECJ case, C-106/09 P and C-107/09 P, Gibraltar, para.73.
[99] See ECJ case C-143/99 Adria-wien, para. 41;
[100] See ECJ case, C-106/09 P and C-107/09 P, Gibraltar, para. 184-187
[101] Decision of the European Commission, SA.34466
[102] Testimony of Peter Oppenheimer, Senior Vice President and Chief Financial Officer, Apple Inc, US senate Permanent Subcommittee on Investigations, hearing on Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.).

Some authors have also claimed that individual agreements about income taxation are common practice in Netherlands as well.[103]

Main reason enabling "I-tax" and "Double Irish Dutch Sandwich" structure is the US and Irish tax law definition of residency and the Dutch law which does not have any withholding tax on Dividends paid to companies outside Netherlands. Unlike individual tax agreements these measures are more general in nature. So it is interesting what part of such measures could be caught under 107 of TFEU.

The very first Question is whether the system which determines residency of a company based on its management body location can be considered to be selective. Wording of the rule looks to be neutral towards any undertaking, mere criteria that undertaking is resident if it is managed in Ireland looks to be neutral. However, it is also clear that regulation benefits certain undertakings, namely MNEs, which do business internationally. MNEs can easily choose place of management for Irish subsidiaries, this option is not that easily available for the businesses operating locally in Ireland. Furthermore, this regulation is exceptionally beneficial for companies established under legal system using the place of incorporation as sole criteria for determining place of residence. Therefore if Irish system was more closely evaluated selectivity could be seen in the rules defining Irish residency.

Furthermore as it was described above Ireland is planning to change definition of tax residency and to include companies incorporated in Ireland. However according to the proposal there will be transitional period for undertaking already operating in Ireland and they will still be nonresident until 2020.[104] So Ireland is planning to create special treatment for certain undertakings, including US MNEs already operating in Ireland. It is easier to assume that such system will give tax benefit only to the selective list of undertaking, selectivity looks clearer here.

As it was demonstrated above, EU state aid provisions have potential to be used as substantial remedies against aggressive tax planning. It could eliminate individual tax arrangements and provide tax system which will be more general and will not have preferential tax regime for certain type of undertakings or certain kinds of products. EU state aid provision cannot force countries to have

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Report of apple hearing before US senate subcommittee, report page 42, available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf (last visited 11.05.2015).

[103] See for example: Kleinbard, Edward D., *Stateless Income*, Florida Tax Review, 2011, p.712.

[104] See: Department of Finance of Ireland, *Competing In A Changing World A Road Map for Ireland's Tax Competitiveness*, October 2014, page 8, avalable at: http://budget.gov.ie/Budgets/2015/Documents/Competing_Changing_World_Tax_Road_Map_final.pdf (last visited 28.04.2015).

corporate income tax on certain level, or create anti-avoidance rules within the general taxation system. In addition, EU state aid rules are only binding on EU member states; therefore, it cannot eliminate tax subsidies in countries outside the Union. So it is clear that EU state aid rules cannot fully eliminate tax avoidance, but they could substantially limit aggravate tax planning within the European Union.

3.2. *WTO State Aid*

State aid provisions are also part of the international conventions adopted under the framework of the World Trade Organization. Provisions prohibiting state subsidies were part of The General Agreement on Tariffs and Trade (GATT 1947).[105] In 1994 in the framework of WTO "Agreement on Subsidies and Countervailing Measures" (SCM Agreement) was adopted. State aid rules enshrined in the agreement might not be as demanding as article 107 TFEU, but SCM Agreement has special importance, it is binding on every WTO member state,[106] which includes almost entire world, counting the Unites States of America. Therefore, the WTO state aid rules might be a remedy against tax planning caused by non-taxation of several incomes under the US law.

Unlike article 107 TFEU SCM Agreement does not make general prohibition on state aid. According to the article 3 of the agreement two types of subsidies are prohibited:

> "(a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance" and
>
> "(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods".[107]

Therefore, the mere existence of a subsidy is not breaching SCM agreement; evidence that the subsidy is related to export or promotion of use of domestic goods is also required.

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[105] See article XVI of *The General Agreement on Tariffs And Trade*, 1947. Available at: https://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf (last visited 24.05.2015).
[106] See article Article XIV of the *Marrakesh Agreement Establishing the World Trade Organization*, 14 April 1994. available at: *https://www.wto.org/ENGLISH/res_e/booksp_e/analytic_index_e/wto_agree_04_e.htm* (last visited 24.05.2015)
[107] *Agreement on Subsidies and Countervailing Measures*, 1994, article 3, available at: https://www.wto.org/english/docs_e/legal_e/24-scm.pdf (last visited 01.05.2015).

Definition of subsidy itself is enshrined in Article 1 of SCM Agreement. Several governmental actions can be considered as subsidy, including direct transfer of funds (e.g. grants, loans and equity infusion),[108] or a government providing goods or services other than general infrastructure.[109] The most relevant for taxation is article 1.1(a)(1)(b), according to which "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)" is considered as subsidy.[110] Therefore in some circumstances tax incentive can be prohibited under WTO law. Taxation of foreign income by the US tax laws was under the scrutiny in the dispute before WTO Dispute Settlement Panel in the case of *"United States — Tax Treatment for "Foreign Sales Corporations,"*[111] the case is relevant for our discussion, the Panel defined the situation when non taxation of certain foreign income could be considered export subsidy.

In the dispute European Communities (applicant) claimed that the US tax treatment towards Foreign Sales Corporations (FSC) constituted export subsidy prohibited under article 3.1 of the SCM Agreement. According to the US law valid at the time of the dispute a FSC was defined as corporation created, organized, and maintained in the foreign country.[112] FSC was entitled to tax exemption on its incomes from foreign trade, namely the Income generated by transaction generally involving sale or lease of "export property."[113]

According to the US tax laws income received by the foreign corporation (corporation incorporated outside US) within the US territory was taxable according to US tax law. Generally income received by foreign corporation was not taxed, unless it was "effectively connected with the conduct of a trade or

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[108] *supra* note 107, article 1.1(a)(1)(i).
[109] *ibid*, article 1.1(a)(1)(c).
[110] *ibid*, article 1.1(a)(1)(b).
[111] Available at: https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds108_e.htm#top (last visited 01.05.2015).
[112] World Trade Organization, Report of the Panel, *United States – Tax Treatment for "Foreign Sales Corporations"*, WT/DS108/R, 8 October 1999, para.2.1, available at: https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S006.aspx?Query=(@Symbol=%20wt/ds108/r*%20not%20rw*)&Language=ENGLISH&Context=FomerScriptedSearch&languageUIChanged=true# (last visitied 23.04.2015)
[113] *ibid*., para 2.2. export property was defined as:
• property held for sale or lease;
• manufactured, produced, grown, or extracted in the United States;
• by a person other than a FSC;
• sold, leased, or rented for use, consumption, or disposition outside the United States; and
• with no more than 50 per cent of its fair market value attributable to imports.

business within the United States".[114] FSC regime ensured that Foreign trade income was deemed as income not "effectively connected with the conduct of a trade or business within the United States" therefore was not taxable.[115] Thus FSC regulation exempted from taxation the income which was generally taxable.

It this case panel ruled that FSC measure enshrined in US law was breaching article 3.1 of the SCM Agreement, because it constituted an export subsidy. As was defined by the Panel (the Appellate Body agreed with the Panel) two elements must be present in order the subsidy to exist for the purposes of article 1 of the Agreement: there must be financial contribution from the government; and the benefit must thereby be conferred.[116]

According to the article 1.1. (a)(2) "Government revenue that is otherwise due is foregone or not collected" (e.g. fiscal incentives such as tax credits) is considered to be contribution by the government. It was underlined by both the Panel and the Appellate Body that the SCM Agreement does not create obligation on any government to tax or not tax any transaction.[117] Governments are free to decide what is generally taxable and what is not. The Panel and the Appellate Body indicated that criteria to evaluate what should be considered as "government revenue that is otherwise due" is national legal system of the state. "[G]overnment revenue …otherwise "owing or payable" must, absent a clear indication to the contrary in the SCM Agreement, be determined by reference to that government's own tax regime."[118] The Panel applied "but for" test to determine whether a subsidy exists. According to the Panel's definition subsidy exists if tax measure exempts certain transaction from taxation, which would be taxable without existence of the measure. The term "*otherwise* due" refers to the situations that would prevail but for the measures in question.[119]

Since FSC measure exempted from taxation certain income that would otherwise be taxable according to the general rules, panel declared that it constituted financial contribution within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement,[120] furthermore panel indicated that because of the FSC measure

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[114] World Trade Organization, Report of the Appellate Body, *United States – Tax Treatment for "Foreign Sales Corporations*", WT/DS108/AB/R**,** 24 February 2000, para.7.
[115] *United States – Tax Treatment for "Foreign Sales Corporations"*, WT/DS108/R, quoted supra 107. para.2.3.
[116] *ibid*, para 7.40.
[117] Appellate body Report, quoted *supra* 109, para. 98.
[118] Panel Report, quoted *supra* 107, para 7.42.
[119] *ibid*, para. 7.45-7.48.
[120] *ibid*, para 7.98-7.102.

Parent companies save taxes, therefore it clearly confers benefit.[121] Based on these two reasons FSC measure was classified to be subsidy within the meaning of Article 1.1 of the SCM Agreement.

Moreover the Panel concluded that subsidy was "contingent upon export performance" within the meaning of Article 3.1(a) of the SCM Agreement. The Panel reached this conclusion based on several conditions related to the measure:

“The subsidy is only available with respect to "foreign trading income"; foreign trading income arises from the sale or lease of "export property" or the provision of services relating to the sale or lease of export property; and export property is limited in effect to goods manufactured, produced, grown or extracted in the United States which are held for direct use, consumption or disposition outside the United States. Thus, the existence and amount of the subsidy depends upon the existence of income arising from the exportation of US goods or the provision of services relating to the exportation of such goods. The existence of such income, in turn, depends upon the exportation of US goods or, at a minimum, in the case of income from services related to the exportation.”[122]

It is obvious that there are some similarities between FSC measure and all the exemptions (“Check-the-box”, “look through rule”, “same country exemption”[123]) of foreign income taxation used by US MNEs. Above mentioned rules exempt income from taxation which would be otherwise taxable based on anti-deferral regulation included in subpart F of the US Tax Code. It is also clear that based on these rules US MNEs save a lot of taxes otherwise payable based on subpart F. Based on “but for” test described above, measures creating financial contributions confer benefit on enterprises, therefore they constitute subsidy within the meaning of Article 1.1 of the SCM Agreement.

More comprehensive analyses need to be done to decide whether the subsidy is "contingent upon export performance". In *“United States — Tax Treatment for “Foreign Sales Corporations”* case the Panel mentioned several reasons to explain why FSC measure was "contingent upon export performance". It could be arguable whether the same condition exists in the current US regulation. First of all it should be mentioned that as the FSC measure, current regulations are also only effective for exempting foreign trading income. FSC measure and current exemption both cover income received from the foreign sales. The main notable difference is that the FSC measure specifically mentioned that exemption was

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[121] Panel decision, para. 7.103.
[122] Panel decision, para. 7.108.
[123] See chapter 2.3

only available for the sale of exported products and services related to it. Wording of current exemptions does not limit tax benefit solely to the exported product, but one might argue that in fact it has the same result. As it was mentioned according to the article 3.1 of the SCM agreement "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I" Is prohibited. Thus evaluation of Tax measure should be made based on its effect of export performance, not merely based on wording. Therefore the fact that wording of the US regulation is not mentioning exported product does not *per se* prove that it is not export subsidy. Furthermore according to the Annex 1 subparagraph "e" of the SCM Agreement "The full or partial exemption, remission or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.[124]" Hence for the correct analysis it should be evaluated whether the US measures are in fact benefitting export performance of US MNEs.

First of all it should be mentioned that current exemptions create tax benefit on income received by CFCs also from exported product. In fact it is common practice for US MNEs to move its manufacturing in low cost jurisdiction, for example Apple product which is sold in Europe is "designed in California, manufactured in China"; therefore technically one might argue that, for example, tax subsidy received by Apple on the income from IPhone sales is not related to the product exported from the US. But it is questionable, whether the fact that US MNEs shifted manufacturing in low cost jurisdiction changes the nature of the US tax laws, exempting foreign income from taxation. Notwithstanding where actual product is manufactured the fact remains the same - above mentioned tax exemptions give the tax benefit to the US MNEs on the income received from foreign sales of product.

Secondly it should be mentioned that most income received by CFCs of US MNEs are income from the exploitation of Intangibles. As it was already described above,[125] almost 100% of intangibles are usually produced in the US and are sold/assigned to CFCs based on arm-length transaction.[126] Therefore income received as royalties and even a part of the income received from selling tangible product is the income from the sale of intangibles produced/created in the US.[127] The SCM Agreement does not give definition of export performance;

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[124] See SCM Agreement, Annex 1, subparagraph "e".
[125] See above chapter 2.2 (I-tax).
[126] The fact that IP is acquired based on the cost sharing agreements does not change nature of transaction, it is still considered as IP acquired based on arm-length price from parent company.
[127] For example in the case of apple Irish subsidiary does not produce anything, entire income they receive is from exploitation of intangibles. Profit is made by solely contracting to manufacturer in

therefore it is hard to be sure whether selling intangibles should be considered as export performance. But for the taxation purposes any income is income and there is no real difference whether undertaking will receive tax benefit for selling tangible or intangible product. The SCM Agreement is designed to ensure that there will be no unfairness in trade by distorting competition through subsidizing certain undertaking. For this purposes subsidy for exporting tangible and intangible product has the same effect and therefore it is logical to be equally prohibited by the SCM Agreement.

Since current exemptions established by the US tax law is not identical to the FSC measures reviewed in *United States — Tax Treatment for "Foreign Sales Corporations"* case, it cannot be said for sure that they constitute export subsidy for the purposes of the SCM Agreement. But it could be argued, that the current exemption in fact and in law has almost identical effect as the FSC measures. In the case of US MNEs current exemptions ensure that same income would be exempted from taxation,[128] therefore, it could be argued that "check-the-box", "look through rules" and others constitute export subsidy prohibited under the SCM Agreement. Thus, WTO law, specifically SCM Agreement, can be envisaged as a possible remedy against the tax law loopholes described in this paper.

China and delivering the product to distributor. It could be argued that all this income is basically income received from the use of Intangibles.

[128] The sole difference is that once income received abroad is repatriated in the US, it is taxable under current regulation. The CFC measure exempted foreign income from repatriation tax as well. But this was not decisive condition *"United States — Tax Treatment for "Foreign Sales Corporations"* based on line of reasoning used by the Panel and the Appelate Body it could be said that the FSC measure would be considered as export subsidy without existence of repatriation tax exemption.

4. Actions Taken Against Tax Avoidance through International Cooperation

Problem caused by tax planning is recognized by the OECD as well. In 2013 OECD designed Action Plan on Base Erosion and Profit Shifting[129] which includes comprehensive measures that need to be taken to eliminate BEPS. The BEPS action plan is fully supported by G20, as stated in Istanbul communiqué:

"We reiterate our full support to the G20/OECD Base Erosion and Profit Shifting (BEPS) Project, showing our resolve to tackle cross-border tax avoidance by modernizing international tax rules. We will finalize the deliverables under the BEPS Action Plan by year end. We endorse the mandate to develop a multilateral instrument to streamline the 4 implementation of the tax treaty-related BEPS measures. We also reaffirm our commitment to strengthen tax transparency to prevent cross-border evasion"[130]

BEPs action plan covers several measures, discussing all of them together would be nearly impossible. I will limit the discussion to the issues, which are highly relevant for the case described above (chapter 2.1 and 2.2), therefore my arguments will be oriented on hybrid entities (action 2) and artificial avoidance of PE status (action 6). Having Irish hybrid subsidiary and using commissionaire agreements to avoid permanent establishment status are the main factors enabling Irish holding companies to minimize tax bill. Hence, I consider these two elements to be the most interesting for the discussion.

4.1. *Potential Anti-Avoidance Measures*

4.1.1. Neutralizing Effects of Hybrid Instruments

As it was already elaborated above hybrid instruments are entities or transactions which have different legal classification in laws of different counties. For example as demonstrated above Irish subsidiary is a resident of the Country where its central management is located (US, Bermuda or others) for Irish law purposes and country of incorporation (Ireland) for US tax law purposes. As a result Irish subsidiaries are not taxed as resident anywhere. As it was already shown hybrid instruments are one of the most effective mechanisms used for tax avoidance,

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[129] See http://www.oecd.org/ctp/BEPSActionPlan.pdf (last visitied 23.04.2015).
[130] Communiqué, G20 Finance Ministers and Central Bank Governors Meeting, 9-10 February 2015, Istanbul, para 11 available at: https://g20.org/wp-content/uploads/2015/02/Communique-G20-Finance-Ministers-and-Central-Bank-Governors-Istanbul.pdf (last visitied 23.04.2015).

therefore elimination of hybrids is one of the main priorities of OECD BEPS action plan. "Neutralise the effects of hybrid mismatch arrangements" is the action two of OECD BEPS action plan.[131] The solutions proposed by OECD involve reevaluation of both international tax law rules and national provisions. The OECD intends to develop model treaty provision and design recommendations for national law amendments. To be more specific the measures may include:

> "(i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure."[132]

The OECD underlines the importance of interaction between possible changes in model tax convention and national measures. Work on hybrids will be coordinated with the "work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping."[133] Harmonization of national rules is one way to eliminate hybrid arraignments, but this option is utopian and unreachable,[134] every country has their tax sovereignty and long standing practice of how they approach these issues. Legal systems and legal classification of different transactions are diverse around the world, and it is less likely that the world will ever reach the consensus on how to harmonize national laws of different counties. Since it is not likely to harmonize the laws and elimination of hybrids is not possible, it is more practical to spend efforts to "neutralise the effects of hybrid mismatch arrangements", rather than fight against existence of hybrids. Therefore, the creation of anti-avoidance rules can be the single realistic solution for tax planning problems created by hybrids.

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[131] See, OECD, *Action Plan on Base Erosion and Profit Shifting*, action 2, available at: http://www.oecd.org/ctp/BEPSActionPlan.pdf (last visited 03.05.2015).
[132] *ibid.*
[133] *ibid.*
[134] See OECD, *Hybrid Mismatch Arrangements: Policy and Compliance Issues*, para. 30, available at: http://www.oecd.org/tax/exchange-of-tax-information/HYBRIDS_ENG_Final_October2012.pdf, (last visited 03.05.2015).

General and specific anti-avoidance rules (including judicial doctrines such as "abuse of law", "economic substance", "fiscal nullity", "business purpose" or "step transactions") can be useful tools to neutralize effects of certain hybrid arrangements.[135] But usually application of these rules includes evaluation of every single transaction and proof that it is artificial or does not correspond to the economic reality for other reasons. Direct link between transactions and avoidance needs to be demonstrated, which makes application of these rules difficult.[136] Several counties have introduced specific anti-avoidance rules impacting hybrid arrangements. For example rules denying deduction of payment where income received from this payment is not subjected to taxation in the country of recipient,[137] or rules denying deduction for a finance expense when main purpose of expense is to avoid advantage.[138]

As it was demonstrated, the main tool to neutralize effect of hybrids is to re-evaluate artificial transactions, or transactions, main purpose of which is tax avoidance and tax individuals based on real economic activity. It will usually include denial of deduction of the payment which as a general rule is otherwise deductible. In order the tax authorities to perform such evaluation presence of taxpayer within the jurisdiction is necessary (there should be someone to evaluate). As it was described above, it is the trend that the MNEs do not usually establish themselves in a certain country and they perform sales there based on commissionaire agreements. Doing business in a country without having permanent establishment there becomes more and more popular; therefore, in order anti-avoidance rules to be effective rules governing prevention from artificial avoidance of PE status has particular importance.

4.1.2. Preventing Artificial Avoidance of PE Status

Action 7 of OECD BEPS Action Plan is oriented on changing International and national law rules related to permanent establishment. OECD intends to established rules necessary to prevent artificial avoidance of PE status by MNEs.

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[135] *supra* note 134. para. 31.
[136] *ibid*.
[137] *ibid*. para 33, quoting Article 10a of the Netherlands Corporate Income Tax Act and Chapter 24 Sections 10 a – 10 e §§ of the Swedish Income Tax Law. Similar rules are contained in Article 11(1)(4) of the Austrian Corporate Income Tax Act.
[138] *ibid*. para 33, quoting Section 441 of the UK Corporation Tax Act 2009.

Definition of Permanent Establishment and conditions for acquiring such status is presented in article 5 of OECD model tax Convention.[139] According to the article 5 paragraph 1 "the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on."[140] Furthermore paragraph 5 of the article 5 establishes "dependant agent" test for PE. Person other than agent on independent status "acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise."[141]

Based on the above mentioned, under modern international tax laws one of two conditions should be fulfilled for the MNEs to be considered having PE in the country. Either it proves the existence of fixed place of business or dependant agent is required. If enterprise caries out business in the country through a broker, general commission agent or any other agent of an independent status it is not deemed that the PE is established.[142]

PE rules enshrined in model tax convention enable MNEs to carry out sales in the country without establishing PE there. Using commissionaire agreements enables the structure in which very small amount of income out of sales is books in the country where sales are conducted (cost of commission, around 5% of sales), big part is profit is shifted to hybrid entities established in other countries and becomes stateless income. The problem with current definition of PE is recognized by OECD as well, since developing "changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions"[143] is the main purpose of action 7 of BEPS action plan.

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[139] OECD *Model Convention With Respect to Taxes on Income and on Capital* is not binding by itself, but is it recommended document and is considered to be codified result of best practices. A lot of bilateral Double Taxation Treaties are based on OECD model convention; therefore the convention has special importance and its provision is very often binding on the states because in is included in bilateral DTTs.

[140] OECD *Model Convention With Respect to Taxes on Income and on Capital*, article 5, paragraph 1, available at: *http://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf* (last visited: 04.05.2015).

[141] *ibid* para. 5.

[142] *ibid*, para. 6.

[143] OECD, *Action Plan on Base Erosion and Profit Shifting*, action 7, available at: http://www.oecd.org/ctp/BEPSActionPlan.pdf, (last visited 03.05.2015).

4.2. *Anti-Avoidance Measures and EU Law*

As it was described above anti-avoidance rules involve denying right on deduction or other tax benefits generally available for a taxpayers. Fighting against international tax planning involves different treatment towards payments made to foreign entities compared to payment made within the same country. EU treaties establish the legal system with the main purpose to ensure equal treatment between nationals of member states. Fundamental Freedoms of EU law, Freedom of Establishment and Free Movement of Capital, prohibits different treatment toward national and foreign individuals,[144] or any other treatment which makes exercising EU freedom less attractive. As a general rule, EU freedoms prohibit treatment such as denying deduction on the payment made to the individual established in different member state, while the same payment is deductible if it is made within the same country. It is considered that such treatment makes doing business in other EU state less attractive. There is a chance that some of the rules offered by the OECD for prevention of tax avoidance might be considered as discriminatory and illegal under EU law by the ECJ. Therefore, the analysis of the ECJ approach towards any avoidance rules is interesting for the discussion. The main purpose of this section will be describing cases when the ECJ allows denying the EU right to an individual for the purpose of preventing tax avoidance.

The principle of prohibition of abuse of the law is used by the ECJ as well and considered to be general principle of the EU law. Under the principle some provisions of EU Law might become unenforceable in certain situation. "Member State is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law".[145] Based on this principle member state can deny benefits of the EU law provisions, if enforcement of the benefit is against the objectives of the provisions individual tries to rely on.[146] For example, in *Centros* case establishing company in the UK and setting up a branch in Denmark (solely for the purpose to avoid payment related to establishment of a company in Denmark) was not considered to be abuse of freedom of establishment. According to the ECJ the right to establish a company in one member state and set up branches in another is inherent for the

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[144] National of the other EU member states.
[145] "Centros Ltd v. Erhvervs-og Selskabsstyrelsen", ECJ Judgment, case C-212/97, 9. 3. 1999, para. 24.
[146] *ibid*, para. 25.

freedom of establishment guaranteed by the treaty;[147] therefore, it could not be in conflict with its objectives.

For taxation purposes doctrine can make EU right unenforceable, when taxpayer claim is related to wholly artificial arrangement, which does not reflect economic reality.[148] For example state could deny deduction created by international transaction if transaction is wholly artificial. This is the case when transactions are conducted solely for the purpose of avoiding taxation on profit made in national territory and transaction is not part of genuine economic activity conducted by taxpayer.

The state action denying benefits based on abuse of law doctrine shall be specifically intended for fighting against artificial arrangements. Restrictive national rules applicable "to every situation" "for whatever reason" without taking into account specific circumstances and subjective intention that indicate abuse are too general means of combating abuse.[149] ECJ also gives special attention to the principle of legal certainty. National measure should be specific to be used as anti-abuse measure. Effect of national measure national rules must be clear, precise and predictable, especially when they have unfavourable consequences for individuals and undertakings. Otherwise it is considered that such measure does not fulfil proportionality test and therefore is not allowed.[150] In *SIAT* judgment ECJ did not allow national rule denying deduction of payment made to companies established under "tax regime which is appreciably more advantageous than the applicable regime in the former Member State". According to ECJ "rule framed in such terms does not make it possible, at the outset, to determine its scope with sufficient precision and its applicability remains a matter of uncertainty".[151] In *Cadbury Schweppes* case the ECJ stated that national measure creating extra tax charge for CFC can be allowed only if it is designed to be applicable just on wholly artificial arrangements intended to escape the national tax normally payable. "Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is actually established in the host Member State and carries on genuine economic activities there."[152]

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[147] *ibid*, para 27, 29.
[148] ECJ Judgment Case C-196/04, Cadbury Schweppes, 12 September 2006, para 51, 55.
[149] Weber. Dennis, *Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ –Part 2*, European Taxation, July 2013, IBFD, page 313.
[150] ECJ Case C-318/10, SIAT, 5 July 2012, para 51.
[151] *ibid*, para 27, 52.
[152] ECJ Case C-196/04, Cadbury Schweppes, 12 September 2006, para. 75.

The fact that ECJ applies the abuse of the law doctrine only on artificial transaction might be in conflict with approach of the OECD. As it was described above, the OECD considered general avoidance rules less effective and hard to enforce due to the fact that it involves need of proof of artificiality of the transaction and direct link to avoidance.[153] The OECD recommends enacting provisions that are more restrictive towards taxpayer and easier to enforce.[154] As it is clear from the ECJ case law, OECD's work has been well respected by the ECJ in the past. In some cases the ECJ even cites OECD model convention as recommendatory source of best practices and uses it to justify restriction of the EU right.[155] Furthermore, as it was clearly stated by the ECJ, the purpose of the Abuse of Law doctrine is to ensure that the EU right will not be used in a way which is against the purpose of existence of the right. It is highly disputable that the purpose of the EU law is protecting tax avoidance structures such as "Double Irish Dutch Sandwich". The practice of US MNEs shows that tax avoidance structure could be very effective without using artificial transactions as well. As it was described above for example transactions that Apple Irish subsidiaries perform are not artificial, licensing IP, contracting manufacturer in china and having distribution and commissionaire agreement all are real transactions. Therefore, Anti-avoidance rules suggested by the OECD might be in conflict with the EU law freedoms as interpreted by the ECJ.

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[153] See above Chapter 4.1.1 (Neutralizing Effects of Hybrid Instruments).
[154] *ibid*.
[155] See for example ECJ Case C-336/96, Gilly, para. 24, 31, 32,41.

5. Role of Transparency and its Power in Elimination and Aversion of Tax Avoidance Practices

Tax secrecy laws and lack of transparency makes international tax planning easier. As it was demonstrated above, anti-abusive regulation suggested by the OECD usually involves evaluation of the transaction nature and denying deduction or any other taxpayer right for international transaction, due to possibility that it involves tax avoidance. In order to evaluate the nature of international transaction tax authorities need more information than it is available within the state. Cooperation between tax authorities of different states and information sharing is crucial. "Abusive tax practices and harmful tax regimes breed in the shadows; transparency and co-operation are their natural foes. It is time for a new era of openness between tax administrations, a new age of solidarity between governments to ensure fair taxation for all. The Commission is fully committed to securing the highest level of tax transparency in Europe."[156] The need of more transparency and cooperation between tax authorities is recognized by the OECD, European commission and others.

On February 18, 2015 European Commission issued press release recognizing the need of more transparency and cooperation in tax matter.[157] In its press release the Commission has announced Tax Transparency Package, which was launched on March 18, 2015,[158] including proposal of directive about "mandatory automatic exchange of information in the field of taxation".[159] As it was clarified by the commission in its proposal, while granting tax ruling for cross-border structures, member states depend on each other to get complete picture, therefore member states working together are in a better position, compared to member states working individually. Harmonized EU approach would more effectively ensure tax transparency and cooperation between tax administrations in fighting tax

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[156] Moscovici, Pierre, Commissioner for Economic and Financial Affairs, Taxation and Customs, see European Commission - Press release, *European Commission lays the foundation for a fairer and more transparent approach to taxation in EU*, 18.02.2015, available at: http://europa.eu/rapid/press-release_IP-15-4436_en.htm (last visited: 10.05.2015).

[157] *ibid.*

[158] see *Communication From The Commission To The European Parliament And The Council* , Brussels, 18.03.2015, available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transparency/com_2015_136_en.pdf (last visited 25.05.2015).

[159] see European Commission, explanatory memorandum of Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transparency/com_2015_135_en.pdf (last visited 25.05.2015).

avoidance[160] Legislative proposal intends to amend Directive 2011/16/EU, and introduces requirement on a member state to automatically exchange information on their tax rulings. In every three months member states will be required to report to the Commission and other member states information on cross-border rulings they issued.[161] Information will be sent via secured electronic system and will include predefined standard set of information.[162] Member state can request more detailed information about the tax rulings.[163] Proposal includes retroactive application of new rule to the rulings issued ten years before the date on which the amendments in the Directive will enter into force.[164] Legislative proposal also includes several new measures such as creation of secured central directory by the Commission where information regarding the tax rulings, issued before adopting new proposal, will be recorded to ensure automatic exchange.[165] Based on the proposal the Commission tries to ensure that member states will have all necessary information from other member states before issuing tax rulings. Main news is that if proposal is adopted, information will be automatically exchanged, not upon the request of tax authorities of the member states.

Tax transparency has been long advocated by the OECD as well. It has established OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, which has made substantial work by studying problems related to tax transparency and suggested several recommendations in amending national laws, even drafted Model Bilateral Tax Information Exchange Agreement.[166] OECD has earlier developed *Convention on Mutual Administrative Assistance in Tax Matters* amended version of this convention becomes open for signatures in 2011[167] and as of today it is signed by more than 60 countries and has been

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[160] *supra* note 159. part 2.3., page 4.
[161] See article 1.(1) of the legislative proposal amending article 3 point 9 of Directive 2011/16/EU; Also see EY, Global Tax Alert News, *European Commission presents a package of tax transparency measures, 19 March,2015; available at:http://www.ey.com/Publication/vwLUAssets/European_Commission_presents_a_package_of_tax_transparency_measures/$FILE/2015G_CM5302_European%20Commission%20presents%20package%20of%20tax%20transparency%20measures.pdf (last visited 24.05.205)*
[162] *ibid*
[163] *ibid*
[164] See article 1.(3) of the legislative proposal inserting article 8a of Directive 2011/16/EU
[165] See article 1.(6) of the legislative proposal inserting para. 5 of article 21 of Directive 2011/16/EU
[166] See Van Weeghel, Stef and Emmerink Frank, *Global Developments and Trends in International Anti-Avoidance*, included in Bulletin for International Taxation, August 2013, IBFD, page 430.
[167] See, http://www.oecd.org/g20/topics/taxation/conventiononmutualadministrativeassistanceintaxmatters.htm (last visited 03.05.2015).

extended to over 10 jurisdictions.[168] The Convention relates to different forms of administrative assistance in tax matters, including information exchange. Furthermore article 6 of the convention states:

> "With respect to categories of cases and in accordance with procedures which they shall determine by mutual agreement, two or more Parties shall automatically exchange the information referred to in Article 4".[169]

Based on this agreement states are bound to automatically exchange information and procedures which should be determined by bilateral treaty. 54 jurisdictions have already signed bilateral agreements based on article 6 of the convention.[170]

Besides having binding tax law convention OECD also tries to increase tax transparency with the soft law instruments. Action 12 of the OECD Action Plan on Base Erosion and Profit Shifting is devoted to encourage tax transparency. According to Action 12 OECD is planning to develop recommendations regarding mandatory disclosure rules for aggressive and abusive transaction, arrangements and structures.[171]

Tax transparency and information exchange between tax authorities of different countries has crucial importance on correct evaluation of taxable transactions. Besides that, it also might have deterring effect on taxpayers, namely when transparency is provided the states are aware of tax practices and can ensure that their laws do not create situations which enable the existence of practices used by the MNEs elaborated in this paper.

Additionally, as the European Commission stated: "since the contested tax rulings were never notified to the Commission by Ireland, nor otherwise publicly available, the Commission could only have learnt of the existence of those rulings when their existence was publicly disclosed, which happened for the first time during hearings of the US Senate."[172] Even the European Commission was unaware of the schemes used by the MNEs, before the open hearing was held in

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[168] *supra note 167*.
[169] *Convention on Mutual Administrative Assistance in Tax Matters*, June 1 2011. article 6, available at: http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf (last visited 25.05.2015)
[170] See, http://www.oecd.org/g20/topics/taxation/conventiononmutualadministrativeassistanceintaxmatters.htm (last visited 03.05.2015).
[171] OECD, *Action Plan on Base Erosion and Profit Shifting*, action 12, available at: http://www.oecd.org/ctp/BEPSActionPlan.pdf, (last visited 03.05.2015).
[172] See Commission Decision. Para 440.

the US Senate, demonstrating the vitality of transparency and information exchange.

6. Conclusion

Aggressive tax planning and its practical application demonstrates that it is a relevant and problematic issue and needs to be addressed by international society. Enterprises have developed several tax avoidance schemes that cannot be effectively combated within current framework of national, regional and international legal systems. Therefore these systems require amending.

By using tools such as hybrid instruments, commissionaire agreement instead of independent distributors, assigning intangibles to subsidiaries established in tax havens and so on, US MNEs pay almost no tax for the profit received outside the US (see chapter 2). Non-payment of fair share of taxes by some taxpayers harms business, government and people. It diminishes ability of governments to provide public goods and services and creates externality on market economy damaging competition among businesses. The world already witnesses adverse impacts of tax planning, particularly with regards to competitive environment which is influenced by the "super effective" cost-savings MNEs have managed through tax avoidance. It seems that international enterprises compete not only on merits, such as production quality or marketing, but also by the ability of taking advantage of tax law loopholes.

General anti avoidance measures have been part of national or European law for decades. It is accepted that the law should not be abused; rights should not be used in a contradictory way to the purpose of the law establishing it. As it was demonstrated above some aggravate tax planning structures survive general anti avoidance measures and more specific approach needs to be taken. It is also evident that several states try to compete by offering tax haven treatment to investments creating unfair competition between businesses, damaging market economy and so on.

It is also apparent that the problem cannot be solved by a single state or by changing the law of few national systems. More comprehensive approach and cooperation between different countries and international organizations is required. OECD work in this direction has special importance, because it is an organization with strong political support able to lead to the consensus in many directions. Its BEPS Action Plan incorporates several steps, which can make tax system more fair and acceptable for all.

As described in the paper, the European Commission is planning to take important steps towards fighting tax avoidance. If the Commission is successful in its State Aid investigation and transparency package initiative, it will on the one hand ensure elimination of individual tax arrangements between state and

taxpayers; national tax systems will be oriented on general measures; taxation will be more predictable and fair; on the other hand states will be able to receive necessary information to make tax rulings and tax authorities will be able to identify tax avoidance schemes and make suitable actions.

Tax transparency is widely advocated issue, including in the OECD. It not only facilitates better assessment of taxable transaction but also has massive relevance for policy making. States, regional and international organizations need to be able to identify the problem to determine solutions. Anecdotal evidence indicates that tax planning strategies such as “I-Tax” or “Double Irish Dutch Sandwich” have been active for decades (see chapter 2), but have not become topical until recently. There is no open data to assess efficiency of tax planning even for as long as ten years ago, since such information did not become available at a time. Tax transparency can have extreme importance to fight tax avoidance and to make the system fairer. Hence the work of the EC and the OECD in this direction has special value.

It is also evident that technological development and economic globalization has modified profit making. At the time of drafting the current international laws it was implausible that MNEs could be managed from one location, could create value in another and make sales in third. Since profit-shifting is a creation of technology era, legal regulations should catch-up as well. It is also true that further development and innovation is likely to create new ways of profit making that cannot be foreseen, thus legal system needs to be able to follow up either by the tools of interpretation or where necessary by amending the existing regulations.

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