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# The Compatibility of the OECD Modified Nexus Approach with EU Fundamental Freedoms and the Case Law on Abuse

**by**

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## Summary

Since its adoption in 2015, the OECD Modified Nexus Approach as found in BEPS Action 5 is the preferred method for implementing an IP regime. By linking IP-related expenditures with tax benefits, the approach redefined substance with the aim to prevent tax base erosion which could occur in lenient IP regimes. EU Member States have been altering their regimes to comply with the approach.

This essay investigates whether the implementation of the MNA in Member States, which are bound by EU law, carries any incompatibility in the realm of EU fundamental freedoms. Furthermore, the MNA is also benchmarked against the EU law on abuse, after it was arguably altered after the *Danish cases* of 2019. From a fundamental freedoms perspective, the treatment of outsourcing and acquisition costs under the MNA could conflict with the freedom of establishment and freedom to provide services. Furthermore, the obligation to combat tax abuse under the *Danish* cases could mean grandfathering under the MNA is substantially limited.

## List of Abbreviations

| | |
|---|---|
| BEPS | Base Erosion and Profit Shifting |
| EU | European Union |
| ECJ | European Court of Justice |
| IRD | Interest and Royalty Directive |
| IP | Intellectual Property |
| MNA | Modified Nexus Approach |
| OECD | Organization for Economic Cooperation and Development |
| PSD | Parent-Subsidiary Directive |
| R&D | Research & Development |
| TFEU | Treaty on the Functioning of the European Union |

# 1. Introduction

## 1.1 Background

International efforts are being undertaken to combat tax avoidance and evasion. The Organization for Economic Co-operation and Development has been a driver of such efforts with its Base Erosion and Profit Shifting project. The project culminated in the creation of 15 Action Points which function as guidelines to address various issues in international taxation.

Research and development regimes may aim to incentivize economic activity that has positive spill over effects in society, but also function as prime avenue for tax manipulation of the intellectual property (IP) created therefrom. By having a state provide tax benefits without requiring the appropriate level of activity within its regime, a harmful tax practice could exist. BEPS Action 5 developed the modified nexus approach (MNA) to apply tax benefits only to "qualifying" income within a territory, which was the answer to addressing aggressive tax planning within IP regimes. Action 5 therefore, relates to the refinement of requirements for such preferential regimes.

## 1.2 Aim

The aim of this research is to understand the legal compatibility of the OECD-developed Modified Nexus Approach with EU fundamental freedoms and the EU case law on abuse.

Over the past years, EU Member States have been modifying their IP regimes to incorporate the MNA. Yet, Member States must keep in mind that their implemented measures must be compliant with EU law. While the MNA is a noble goal, it may have issues of compatibility with EU fundamental freedoms as the OECD MNA was not drafted for all the intricacies of EU legislation. Additionally, the MNA aims to address tax base erosion, but the EU has case law on the similar concept of tax abuse and economic substance which arguably changed after the *Danish Beneficial Ownership* judgments of 2019. The MNA will also be looked at based on the *Danish* cases findings to determine any conflicts with EU case law pertaining to abuse and substance. Even though the OECD started with addressing tax base erosion through IP regimes, the result is that its practical implementation touches upon more complex elements of EU law.

Essentially, the question being addressed is "*Does the OECD MNA comply with EU fundamental freedoms and the case law on abuse?*"

## 1.3 Method and material

To answer the research question, a legal-dogmatic method will be used to address positive law as it currently stands.[1] The BEPS Action 5 proposal which outlines the MNA and its characteristics will be contrasted with EU primary, secondary and case law of the Court of

[1] Sjoerd Douma, *Legal Research in International and EU Tax Law*, (Kluwer, 2014), 18.

Justice to determine the interactions between the proposal and the available EU law at hand. Academic sources such as books, articles, journals, and other commentary can provide valuable insight into understanding the proposal from the perspective of EU law.

### 1.4 Delimitation

The research focuses more on the MNA in the realm of fundamental freedoms and substance. R&D incentives and patent boxes also have extensive relationship with the concept of State aid in the EU, but that will not be covered as that analysis aims to identify whether a State has provided prohibited assistance to specific undertakings within the EU market using more economic criteria.

It is likewise not the purpose of this thesis to delve into the details of patent box regimes at a national level, as the goal is rather to provide insight from the perspective of EU law. The effectiveness of patent box regimes themselves will not be discussed, but it is noteworthy to mention that their status is controversial based on their effectiveness. This is because literature suggests that such regimes do not always fulfil their stated goal of providing social benefits, but rather may be a suitable avenue for tax planning.[2]

Furthermore, findings in this investigation may already be addressed or be of limited applicability based on other BEPS Action Points or particularities of implemented national legislation.

### 1.5 Outline

Part I aims to discuss R&D and tax planning, outlining the benefits of such tax incentives to spur innovation, but which can and have been misused by corporations to minimize their tax liability.

Part II discusses the features of the OECD MNA as it was proposed in the BEPS Report, proceeded by a discussion of the elements which may conflict with EU fundamental freedoms. EU case law is used to highlight discrepancies and limitations of the MNA, outlining the potential difficulties that may be faced when trying to introduce the MNA into jurisdictions bound by EU law.

Part III looks at the recent *Danish cases* which played a substantial role in elaborating on the concept of abuse and substance at an EU level, and considers its effects on the implementation of the MNA. Because the MNA introduces its own definition of substance, incompatibilities may arise where it differs from the EU definition of substance.

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[2] Åsa Hansson, Cécile Brokelind, "Tax Incentives, Tax Expenditures Theories in R&D: The Case of Sweden" (2014) 6 World Tax J. 2, 196.

# 2. R&D and Tax Planning

## 2.1 Introduction to R&D and Tax Competition

Modern society has been substantially affected by the emergence of new technological developments. Innovations across all industries have transformed many aspects of contemporary life, both from a personal and commercial perspective. Inevitably, technological development is an indicator of progress capable of fundamentally overhauling society.

In a primarily market-oriented world, business is driven by competition. An economic actor is incentivized to develop a new or improved product or service which can provide value to consumers. In turn, the economic actor is rewarded with generally increased profits as compared to one that is not innovative. Innovation is therefore key in any given market as it brings with it profit for the creator, which ideally transfers over to the state as taxable revenue.

Like businesses, countries also compete against one another. Countries have justifiable reasons to attract businesses and knowledgeable workers, as such an aim allows the creation of more jobs within a society and overall increase welfare.[3] While a country may be interested in the effects of innovation within its territory, it may be equally motivated by tax revenue which functions as the main method of increasing its budget.

States logically aim to attract businesses to their country through many different incentives, including corporate tax rates. A lower tax rate may attract investment as it will reduce the tax burden on a company's income as compared to a higher-tax jurisdiction, raising post-tax returns.[4] A country which offers a low tax rate, along with other factors, may be a strong motivating factor to establish or relocate a business there. That is not to say there are no negative effects of reducing tax rates. One negative aspect of this international tax competition is a potential "race to the bottom" where countries cut tax rates in a tit-for-tat process, which may be counterproductive as it can perversely result in a detrimental effect on their overall revenue.[5]

## 2.2 Benefits of R&D

One tool available for these countries in this battle for tax competition are research and development (R&D) tax incentives, which have been popping up over the past years. R&D is aimed at promoting research within a certain territory. The European Union aimed to make it a competitive economy, by creating a milestone that Member States should increase spending

[3] Åsa Hansson, 'Chapter 3: Free factor mobility and fiscal competition. Can the national welfare state survive in a "United Europe?' (2007), 8.
[4] Jason Brown, "Patent Box Taxation, A Comparison of Four Recent European Patent Box Tax Regimes and an Analytical Consideration of If and How the United States Should Implement Its Own Patent Box" (2012) 46 Int. 3, 932.
[5] ibid.

on R&D to 3% of their GDP by 2020.[6] Over the past years, 11 Member states of the EU have been adopting IP box regimes to attract capital.

Intangibles (such as patents) have become a new method of attracting capital, but they do have certain shortcomings from a tax perspective. For one, they are highly mobile meaning that they can be transferred to low-tax jurisdictions. Secondly, they are difficult to value, as the creator of the intangible has leeway in determining the appropriate price for their exploitation or sale.[7] Therefore, they can concentrate in jurisdictions which treat them favorably through the provision of lower tax rates.[8] As R&D incentives can result in the creation of IP intangibles, a preferential regime must aim to not make its incentives too lenient, as that could classify it as a tax haven, resulting in political backlash or countermeasures. Similarly, providing too few incentives would make it uncompetitive and business would take their capital elsewhere. Ideally, a suitable balance is achieved.

R&D may have the beneficial effect of creating positive externalities, reaching beyond the sector of the R&D undertaker.[9] In public finance, externalities are ‘spillover’ effects on society stemming from the consumption or creation of a good. A positive externality is one where society attains a greater benefit than the private producer of the research or good. A private company may enjoy additional profits stemming from a novel development, but society gains the knowledge which can be utilized in other fields. The positive externality stems from the knowledge being more accessible for society.[10]

However, a company may not necessarily always produce the socially optimum amount of innovation in a market. Because knowledge developed by firms is not always fully protected by IP rights, firms produce less of such knowledge.[11] Markets therefore may choose to underinvest into R&D as they do not consider all positive externalities it causes, and other market failures can lead to a reduced social optimum amount of investment in R&D.[12] A government may therefore intervene and decide to help incentivize such development.

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[6] Aleksandra Bal, Rene Offermanns, ‘European Union- R&D Tax Incentives in Europe’ (2012) 52 European Taxation 4, p 168.

[7] Wolfgang Schön, ‘Transfer Pricing Issues of BEPS in the Light of EU Law’ (2015) BTR 1.

[8] ibid

[9] Åsa Hansson, Cécile Brokelind, ‘Tax Incentives, Tax Expenditures Theories in R&D: The Case of Sweden’ (2014) 6 World Tax J. 2, 175.

[10] ibid.

[11] Phedon Nicolaides, ‘Economics of Subsidies for R&D, The Intrinsic Difficulty of Determining Optimum Subsidies and Implications for Reform of EU State Aid Rules on R&D’ (2013) BEER n 26, 9.

[12] Paolo Arginelli, ‘Innovation through R&D Tax Incentives: Some Ideas for a fair and Transparent Tax Policy’ (2015) 7 World Tax J. 1, 1.

### 2.3 R&D incentives and IP boxes

It is of no surprise that states are interested in increasing the R&D within their territory. Tax incentives for R&D are precisely a method utilized by countries which aim at reducing the tax rates on IP developed during R&D, or on the R&D related costs.

R&D incentives can be tailored to target input or output activities. Input incentives can be exemplified through tax credits for related R&D expenses, which mainly focus on increasing innovation within the country implementing it.[13] This may occur in the form of allowing accelerated depreciations, allowances and tax credits linked to the R&D expenditure.[14] Output incentives target existing intangible assets, and therefore attract capital in the form of IP. Output-based incentives may focus on excluding or lowering income which relate to the exploitation of intangible assets such as intellectual property. This may include income such as the sale of the IP, or licensing fees.

R&D tax incentives rest on the assumption that they will in fact attract capital. IP box regimes, while attracting foreign investment and potentially increasing R&D on the territory, do not have clear effects on welfare.[15] Part of this can be attributed to poor targeting and measurement of their intended effects.[16]

One concrete example of an output-based incentive would be the "IP box". Over the past years, Member States of the EU have been adopting such regimes. However, they differ in their scope, structure, base tax rates and tax bases.[17] Such a difference inevitably may lead to discrepancies which are exploitable in tax planning. If Member States are to compete to attract capital, unless all the incentives across the states are identical, some regimes will inevitably prevail over others. Consequently, businesses will prefer certain jurisdictions for their R&D activity, and those with particularly attractive incentives effectively out the groundwork for use as a "tax haven", which has been the case over the past decades.

### 2.4 MNE's Decreasing Tax Liability through Tax Incentives

The problem of tax incentives is that they are open to abuse. If a business has the primary goal of making profit and providing for the highest possible return to its shareholders, an MNE can arrange its affairs to decrease its tax liability.

Tax planning by corporations have hit headlines.[18] The public has started to understand that companies engage in tax planning, allowing them to get away with paying substantially less tax than they are "supposed" to. A reason for this outrage lies in the sharpening of what

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[13] ibid 20.
[14] ibid 37.
[15] ibid 29.
[16] Antonio Vezzani, Salvador Barrios, Gaetan Nicodeme, 'Patent Boxes Design, Patents Location and Local R&D' (2015) JRC, para 4.
[17] ibid 29.
[18] Sathyvelu Kunashegearan, "How Uber, Google, Facebook and Other Tech Giants Avoid Paying Billions in Tax?" (*Medium,* 2017) <https://medium.com/betaschoolhq/how-uber-google-facebook-and-other-tech-giants-avoid-paying-billions-in-tax-365b7c8b7dbc> Accessed April 27th 2020.

constitutes "fair" tax behavior for corporations, particularly if viewed from the perspective of a taxpayer. [19] A taxpayer may utilize their income tax rate to as a reference point (i.e between 20%-50% in the EU), which makes the result more upsetting when companies pay single-digit fractions of that amount.[20]

Multinational Enterprises (MNE's) have the toolset available to limit their overall tax liability as compared to individual taxpayers. For one, most taxpayers' activity is not as complex as the one for an MNE, which is governed by financial products, tax incentives, and tax breaks of varying complexity. Secondly, taxpayers do not have the same international cross-border presence. In fact, one of the issues of international tax lies precisely in its outdated framework which cannot hold up due to the integration of economics and markets.[21]

### 2.5 International and EU efforts to Curb Tax Planning through R&D Incentives

As the opening line reads in the BEPS explanatory statement, "International tax issues have never been as high on the political agenda as they are today".[22] Coming in at a hefty \$100 to \$240 billion of lost revenue as a result of numerous international tax issues,[23] it follows that coordinated efforts are being undertaken to combat tax avoidance and abuse. The work of the OECD's Base Erosion and Profit Shifting (BEPS) project, backed by the G20, culminated in 15 Action Points that were proposed to combat base erosion. These findings come in the form of guidelines and recommendations to be implemented by countries, ranging from addressing the digital economy, to the adoption of a multilateral instrument in bilateral tax treaties. However, such efforts do not exist in a vacuum. The European Union is an evident ally of the project, operating under a similar anti-base erosion agenda.[24]

Action 5 is the primary action which relates to identifying and combatting harmful tax practices. Part of determining a harmful tax practice can be illustrated through a low/no tax rate, combined with either ring fencing, lack of transparency, or lack of exchange of information. Most IP regimes are integrated with domestic markets (so no ring-fencing) and the EU has multiple directives on exchange of information, so IP regimes are not harmful tax practices per-say according to the OECD.[25]

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[19] Robert Dover, 'Fixing Financial Plumbing: Tax Leaks and Base Erosion and Profit Shifting in Europe' (2016) 51 The International Spectator 4, 48.
[20] See, for example Michael Selby-Green "Starbucks' EU unit paid just 2.8% in UK tax last year", (Business Insider, 2018) <https://www.businessinsider.com/the-european-division-of-starbucks-paid-28-uk-tax-last-year-2018-9> Accessed April 27th 2020, or Kristin Meyers, "Amazon paid a 1.2% tax rate on \$13,285,000,000 in profit for 2019", (Yahoo! Finance, 2020) <https://finance.yahoo.com/news/amazon-paid-a-12-tax-rate-on-13285000000-in-profit-for-2019-210847927.html?guccounter=1>, Accessed April 27th 2020.
[21] OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, para 1.
[22] ibid para 1.
[23] ibid para 2.
[24] This can be evidenced, for example, through the adoption of the ATAD, as an implementation of BEPS findings into EU law.
[25] Fabian Mang, '(In) Compatibility of IP Box Regimes with EU Law, the Code of Conduct and the BEPS Initiatives' (2015) 55 Eur. Taxn. 2/3, 83.

Substance become a relevant focus point of the OECD under Action 5. National law should require substantial activity from an entity seeking to benefit from a IP box regime. It was no longer acceptable to grant preferential tax treatment to IP which has no connection with the country, as that would not be aligned with the aim of the Action. The European Code of Conduct for Business Taxation was also involved in the creation of the February 2015 consensus pertaining to substance, culminating in the "Modified Nexus Approach". The effect is that patent boxes must be adopted to the MNA by June 2021.[26] The European Commission echoed the consensus[27], illustrating the EU's support behind the approach.

Essentially, the OECD attempted to apply the same principles of input incentives to output incentives. Input incentives provide benefits to related R&D expenditures, as that is the basis for the tax benefit.[28] Under the nexus approach, income received from exploiting IP therefore also qualifies for a tax benefit assuming sufficient link between the activity and the income.[29] With the majority of OECD countries being in Europe, widespread adoption of this approach would occur within the EU. Even though the OECD recommendations are soft law with no binding legal obligation, the development of the MNA does impose a sense of sociological validity backed by threat of international sanction in case of non-compliance.[30]

# 3 R&D and Fundamental Freedoms

## 3.1 EU Fundamental Freedoms

Before discussing the MNA in more detail, it is relevant to outline the relevant features of EU fundamental freedoms. The TFEU is the source of fundamental freedoms, which were developed to uphold unimpeded access to the EU internal market. The four freedoms are the free movement of capital goods, persons, and the freedom to provide services.[31] More relevant for this essay is the freedom of establishment which aims to prevent restrictions on establishment in territories of other EU Member States,[32] and the similar prohibition on the freedom to provide services in other EU Member States.[33] Companies and firms are also able to rely on such freedoms.[34]

Both direct and indirect discrimination is prohibited under the TFEU. Direct discrimination is based on nationality,[35] whereas indirect discrimination may exist based on other differentiating

[26] Robert J. Danon, 'Will nexus-based patent boxes be internationally safe?' (2015-2016) 84, 1-2, 174.
[27] ibid.
[28] OECD, 'Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report' (BEPS Action 5 Report), (OECD Publishing 2015), para 28.
[29] ibid.
[30] See Pedro Guilherme Lindenberg Schoueri, 'The OECD's Approach to IP-Boxes as a Norm: Hard, Soft or Half-Baked?' (2017) British Tax Review, Issue 4, outlining the sociological validity of the MNA and the sense of binding obligation it carries.
[31] Marjaana Helminen, 'Non-Discrimination and Basic Freedoms' in Marjanaa Helminen's *EU Tax Law – Direct Taxation – 2018* (IBFD 2018), 6 .
[32] Consolidated Version of the Treaty on the Functioning of the European Union (2012) OJ C326, art 49.
[33] ibid art 56.
[34] ibid art 54.
[35] Consolidated Version of the Treaty on the Functioning of the European Union (2012) OJ C326, art 18.

criteria, which leads to the same result as discrimination based on nationality.[36] Implementing directly or indirectly discriminatory measures that limit entities from using their freedoms is therefore incompatible with EU law.

The MNA itself has discriminatory characteristics based on its treatment of outsourcing expenses which relate to the freedom of establishment and freedom to provide services, as will be discussed in the next sections.

### 3.2 The Modified Nexus Approach

BEPS Action 5 Report of 2015 is the source of the MNA, being created with the aim to define substantial activity, acting in tandem with Pillar 2 of the project to align taxation with substance in order to prevent artificial profit-shifting from countries where value is created. [37] Originally dubbed the "nexus approach", the approach applied the IP regime to a taxpayer to the extent the taxpayer incurred qualifying R&D expenditures giving rise to IP income.[38] The MNA aims to address tax base erosion which occurs when companies seek to exploit a preferential IP regime by having R&D activities done in one country, but incorporate and fulfil the minimum legal requirements purely to move the developed IP rights and exploit it in another. Such R&D incentives themselves are not analyzed by the OECD, but it does recognize the contribution towards growth and employment that IP industries have.[39]

The MNA provides benefits towards eligible IP income which can be calculated according to the 'nexus formula' below:

$$\textit{Eligible income} = \textit{Overall IP income} * \frac{\textit{Qualifying expenditures incurred to develop IP(+ uplift)}}{\textit{Overall expenditures incurred to develop IP}}$$

Overall expenditures include all the expenditures that would count as qualifying expenditures if undertaken by the taxpayer itself. It includes the same qualifying expenditures, but incorporates related-party outsourcing and acquisition costs.[40] As a result, outsourcing to related parties increases the overall expenditure which decreases the amount of income subject to a preferential regime. Overall income would mean income derived from an IP asset.

Qualifying expenditures are IP-related costs which can be partially decided by the state itself, that may include R&D related costs such as "salary and wages, direct costs, overhead costs directly associated with R&D facilities, and cost of supplies". It also includes outsourcing or acquisition costs to unrelated parties. The underlying rationale for the criteria is to provide a preferential rate to R&D activity undertaken by the taxpayer themselves, therefore preventing capital contributions or expenditures by other parties to qualify the income.[41] Qualifying

[36] *Helminen* (n 31) 2.
[37] BEPS Action 5 Report, para 24.
[38] ibid p 9.
[39] ibid para 26.
[40] ibid, para 43.
[41] ibid, para 29.

expenditures may not include “interest payments, building costs, acquisition costs, or any costs that could not be directly linked to a specific IP asset”.[42]

Costs based on outsourced R&D activity to related parties or relating to existing acquired IP do not generally gain access to the IP regime.[43] The exception is that qualifying expenditures can be increased by the 30% uplift, created to not excessively penalize those who engage in outsourcing.[44] This treatment of expenses is where friction with EU law begins.

### 3.3 Two Versions of the MNA

The MNA exists in two forms, with the differing approaches resulting due to EU law. One is the EU-compliant “entity” version, and the other is the “territorial” version. The territorial version can be seen in the footnotes of the BEPS Final Action 5 report.[45] It is therefore the case that EU countries would have to operate with the “main” version while the “territorial” footnote version applies to non-EU countries.[46] It seems the OECD developed it as it was aware of the conflict between the territorial approach entailed and ECJ case law.[47] Justification for differing approaches is that in order to comply with EU fundamental freedoms and the principle of non-discrimination, R&D could not be restricted to costs within a territory as that territorializes the tax benefit.

Under the so-called entity approach, EU Member States classify expenditures based on what entity undertook them.[48] Essentially, qualifying expenditures under the entity approach does not include income derived from outsourcing to any related parties. The logic for this denial is because the R&D is not performed by the taxpayer itself.[49] Due to the approach’s treatment of each entity within an MNE as separate, it does not matter where the entities are located, so outsourcing is consistently disallowed (subject to the 30% uplift mentioned earlier).

Under the territorial approach, where the focus is on R&D expenses tied to a jurisdiction, outsourcing constitutes qualifying expenditure irrespective of who does the R&D as long as it is within the jurisdiction.[50] On the other hand, outsourcing expenditure to an entity in another jurisdiction no longer constitutes qualifying income and ceases to subject the respective income to a preferential IP regime.[51] Overall expenditures are also included, consisting of both domestic and international expenditures.[52] The territorial approach therefore allows

[42] ibid, para 39.
[43] Lisa K. Evers, ‘Intellectual Property (IP) Box Regimes’ (2014), 196.
[44] BEPS Action 5 (n 25) para 41.
[45] ibid, footnotes 16 and 19, 42.
[46] Daniele Fabris, ‘To Open The Box Or To Close The Box? “Patent Box” Regimes in the EU Between R&D Incentives and Harmful Tax Practices’ Amsterdam Law Forum, Vol: 11:1, 57.
[47] Rene Matteoti, Philipp Roth, ‘The OECD's Modified Nexus Approach for Patent Boxes - Is BEPS leading towards coherence or distortion in taxing income from intellectual property?’ (2015) ASA, IFA, 770.
[48] Lilian Faulhaber, ‘The Luxembourg Effect: Patent Boxes and the limits of International Cooperation’ (2016), Georgetown University Law Center, 19. See also Robert Danon*,* ‘General Report’ (2015) IFA labelling it as “ personal nexus”, 49.
[49] See *Danon*, ibid.
[50] *Faulhaber* (n 48) 22.
[51] ibid.
[52] ibid p 20.

outsourcing within the jurisdiction to occur. Again, this option is only available for non-EU Member States as it would otherwise clash with fundamental freedoms.

In any case, further mentions of the MNA will be focused on the "main" approach which is the that would be implemented by Member States.

### 3.4 The Entity Approach to Outsourcing and Acquisitions considering EU Fundamental Freedoms

The entity version does not differentiate between domestic and foreign IP outsourcing or acquisition of IP, which disincentivizes all forms of acquisition.[53] This entity approach would function under EU law, assuming it does not discriminate between resident and non-resident related parties.[54] However, the issue is that the treatment of outsourcing and acquisition expenditures may conflict with fundamental freedoms.

Usually, comparability should first be established between taxpayers. If there is comparability, then there may be prohibited discrimination as it results in different treatment of entities in the same circumstances.

From the perspective of an R&D entity wishing to outsource, one contention is that the comparability does not lie between non-resident and resident entities, but rather between affiliated and non-affiliated entities. An entity in a given jurisdiction is equally limited in outsourcing to both a domestic and foreign subsidiary. [55] That would indicate that resident and non-resident entities are treated equally, and no direct discrimination may result. Instead, non-affiliated and affiliated entities are treated differently, evidenced when outsourcing to non-affiliated entities as such costs constitute qualifying expenditure in the MNA regime, whereas such expenditure is significantly restricted (based on 30% uplift) if outsourcing to a related entity. But, because affiliated and non-affiliated entities may not be in comparable circumstances, there may be no restriction of fundamental freedoms.[56]

On the other hand, even with such incomparable treatment, such a limitation on outsourcing options can constitute a restriction on the freedom of establishment, as it may discourage setting up a related R&D entity in another jurisdiction by limiting the usefulness of outsourcing costs to such an entity in a given preferential regime.[57] Instead of outsourcing under the MNA, the incentive for a company shifts to restructuring in order to have one entity engaging in both R&D *and* earning the income to qualify for the benefit. [58]

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[53] ibid 26.
[54] *Danon* (n 48) 49.
[55] Daniele Fabris, 'To Open The Box Or To Close The Box? "Patent Box" Regimes in the EU Between R&D Incentives and Harmful Tax Practices' Amsterdam Law Forum, Vol: 11:1, 58.
[56] ibid.
[57] ibid.
[58] *Danon* (n 48) 42.

Comparability however may exist between domestic and foreign R&D service providers, as they perform the same function of providing R&D services. From the perspective of a R&D service provider, incompatibility with EU law similarly arises with the exclusion of acquisition costs, infringing their freedom to provide services. [59]

As they are comparable, the question is whether discrimination exists which can limit the freedom to provide services. One perspective is that based on the criteria of market access and market equality, no discrimination exists. [60] Service providers are able to access the market in an unrestricted fashion and are not discriminated in treatment based on their nationality. Again, the nexus approach does not treat foreign and domestic service providers differently. [61]

However, that argument may imply discrimination exists only based nationality (or residence). The counterpoint is that instead of direct discrimination, indirect discrimination may exist not only based on nationality, but on criteria which leads to the same result which runs counter to EU law.[62] Such application of differentiating criteria was reiterated towards companies as found in *Biehl*.[63]

The differing criteria for the purpose of indirect discrimination would be whether the service provider is a related entity or not. One consequence is that a domestic enterprise would be less likely to acquire IP from a related foreign service provider if such acquisitions would not be (fully) subject to a preferential regime in the domestic state.[64] An unrelated foreign service provider is therefore put at an advantage as compared to a related foreign service provider. It is also true that a domestic unrelated party is put at an advantage over a domestic related party, but that does not contain the cross-border element necessary to be governed by EU law. Accordingly, related R&D service providers may be indirectly discriminated against which hinders their provision of services based on the application of the MNA, as acquiring their services does not constitute fully qualifying income.

To summarize, the freedom to provide services and freedom of establishment may be restricted based on the differing treatment of outsourcing/acquisition expenditures between related and unrelated parties if an MNA-compliant regime is implemented.

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[59] ibid.
[60] Chu Shi, 'IP Boxes in Light of the BEPS Project and EU Law – Part II' (2016) 56 Eur. Taxn. 9, 377.
[61] ibid.
[62] Maria Cruz Barreiro Carril, 'Chapter 26 – Difficult relationship between fundamental Freedoms and Nexus approach' in Cid et al. *Combatting Tax Avoidance in the EU* (Kluwer 2018), 787.
[63] Niels Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, (IBFD, 2012), 529.
[64] *Fabris*, (n 46) 58.

## 3.5 Qualifying Taxpayers under the MNA

Under the MNA, qualifying taxpayers are broadly defined to include resident companies, domestic permanent establishments of foreign companies and foreign PE's of resident companies. [65]

It is also stated that "expenditures incurred by a PE cannot qualify income earned by the head office as qualifying income if the PE is not operating at the time that income is earned. ".[66] That would indicate that generally, expenditures can qualify the income of the head office if the PE is operating. Schoueri discusses the issue of qualifying expenditures relation to exempt and non-exempt foreign PE's. When a foreign PE is exempt from being a qualifying taxpayer under the MNA, it does not have the qualifying income which the head office can use for its nexus ratio (driving it down and reducing amount of qualifying income), as compared to the non-exempt PE which can qualify the head office's income and increase the amount of income falling under the IP regime.[67] The issue is that a head office with an exempt foreign PE therefore enjoys less overall qualifying income under the MNA, as compared to a head office with a non-exempt foreign PE. In turn, this may limit the freedom of establishment based on the treatment between domestic (and non-exempt foreign PEs) and exempt foreign PEs.[68]

Excluding non-residents from the MNA also carries some incompatibility. Certain cross-border royalty payments are tax free according to IRD, but payments falling outside the scope (such as to non-associated entities) of the IRD may be subject to a withholding tax. Schoueri qualifies the problem in domestic payments outside the scope of the IRD, as they could still be assessed according to the preferential IP regime.[69] The issue results in differential treatment between domestic and outbound royalty payments.[70] Cross-border transactions to non-associated companies may be subject to a withholding tax, resulting in a higher tax burden as compared to the same inbound distributions (where an IP regime applies). [71] This is operating on the assumption that residents and non-residents are in comparable situations, which may be the case if seen from the perspective of the tax base as found in *Denkavit* (assuming that case logic applies to royalties).[72]

Similarly, Shi echoes the possibility of a breach of fundamental freedoms when a foreign royalty recipient and resident company are found to be in comparable situations if a withholding tax is levied on outbound royalties.[73] If a state chooses to exercise its taxing power over outbound dividend distributions, that creates the need to eliminate double taxation and hence non-resident companies and resident companies are put in comparable situations. [74] If

[65] BEPS Action 5 Report, para 33.
[66] ibid.
[67] Pedro Guilhermo Lindenberg Schoueri, *Conflicts of International Legal Frameworks in the Area of Harmful Tax Competition* (IBFD 2019), 112.
[68] ibid 113-114.
[69] ibid 105.
[70] ibid.
[71] ibid 109.
[72] ibid 108.
[73] Chu Shi (n 60), p 377.
[74] ibid 376 - 377.

there is indeed comparability between residents and non-residents in such circumstances, the result is a limitation to the freedom of establishment for non-associated companies.

### 3.6 Territoriality of Tax Incentives

As outsourcing is disincentivized under the MNA (subject only to a 30% uplift) an entity may be required to have a greater degree of connection with the country in which it seeks the preferential IP regime. Under EU law, this may constitute territorialization of the tax benefit.

*Baxter* was a case dealing with entities established in France and exploiting proprietary medical products. French legislation allowed deduction of technical and scientific research expenditure, but only where that research was carried out in France.[75] The problem was that businesses primarily established in other Member States where they have developed their research, but operating in France through a PE, were disadvantaged.[76] As this was a limitation on the freedom of establishment,[77] France tried to justify the measure based on the need for fiscal supervision.[78] While this may be justified, the legislation at hand prevented the taxpayer from providing evidence of expenditure in another Member State *a-priori*.[79] In any case, the French legislation was deemed incompatible with EU law. The similarity of the MNA is that as with *Baxter*, the full preferential treatment of expenses applies to R&D expenditure incurred within the domestic jurisdiction. Companies established in one Member State but operating through a PE in another Member State are likewise disadvantaged as the PE will not be able to use the company's R&D to qualify income.

*Laboratoires Fournier SA* had a similar situation, where a tax credit was available only relating to research that was done in France.[80] Companies were therefore disincentivized from providing R&D services in other countries due to the lack of deductibility of the credit. Justifications by France of promoting R&D expenditure were rejected by the ECJ as the non-deductibility ran counter to the Community aim of increasing cooperation and consequently preventing obstacles to R&D in the EU internal market.[81] The freedom to provide services was infringed based on the indirect restriction of cross-border activities caused by the tax credits.[82] Likewise with the MNA, not allowing outsourced expenditure to be included by its acquirers, unless purchasing from an unrelated party, unjustifiably limits the freedom to provide services for foreign R&D service providers.

*Commission v Spain* found similar incompatibilities of R&D incentives and limitation of fundamental freedoms.[83] Spain granted R&D expense-related tax credits, under the condition the R&D had to be carried within its territory. Consequently, entities were less likely to set up R&D PE's in other Member States, and other entities were disincentivized from setting up PE's

[75] Judgment of 8 July 1999, *Baxter*, C-254/97, EU:C:1999:368, para 3.
[76] ibid para 13.
[77] ibid para 15.
[78] ibid para 17.
[79] ibid para 20.
[80] Judgment of 10 March 2005, *Laboratoires Fournier*, C-39/04, EU:C:2005:161, para 13.
[81] ibid para 23.
[82] ibid para *18*.
[83] Judgment of 13 March 2008, *Commission v Spain*, Case C-248/06, EU:C:2008:161.

in Spain. Foreign companies were unlikely to benefit from the Spanish tax incentives as their R&D expenses would have been incurred in their respective country, where the main establishment is located. The freedom to provide services was also limited, as even though R&D centers were not required to be domiciled in Spain, the activities had to be carried out in Spain to qualify for the benefit. That limited the freedom to provide services because R&D costs incurred abroad were not deductible in Spain.[84] The MNA duplicates these effects as mentioned in the previous cases, where the freedom of establishment is affected when entities are less likely to set up subsidiaries in other States as the R&D costs such subsidiaries incur face less preferential treatment as compared to R&D performed locally. Resident subsidiaries are disincentivized from setting up subsidiaries in other Member States.

The underlying findings of the above cases are that treating R&D expenses differently, depending on where they were incurred, is incompatible with EU fundamental freedoms of establishment and the freedom to provide services. Furthermore, they cannot be adequately justified by grounds of promoting R&D, as exemplified in *Laboratoires Fournier*. The issue circles back to the treatment of expenses under the MNA, whose *modus operandi* constitutes partially territorializing the tax benefit. If a company outsources to a foreign related party, only 30% of those costs will qualify under the preferential regime. Foreign related R&D service providers are then seen as less attractive based on their provision of services. Per the MNA, an entity is instead incentivized to engage in R&D within the country rather than outsourcing it. If the entity is coming from a pre-MNA regime (and potentially with no substance link), after the MNA is implemented it would have to restructure its activity to the jurisdiction where it wishes to qualify for the regime. The result, as has been previously mentioned in literature, is that it creates similar effects to a territorial restriction.[85]

### 3.7 The 30% Uplift Under the MNA

As mentioned previously, most of the substantial activity is required to be undertaken by the qualifying taxpayer.[86] The uplift allows to increase the value of qualifying expenditures by 30%, subject to the requirement it is not greater than the overall expenditures incurred.[87]

One perspective is that it does not categorically address issue the underlying issue of discrimination. Aside from the 30% uplift, most R&D costs done in other states would not benefit from a domestic preferential IP regime.[88] On the other hand, entities outsourcing to unrelated parties have full access to a preferential regime.[89] Consequently, the conflicting issue

[84] Christof Ernst, *Evaluation of Tax Incentives for Research and Development in Germany* (Steuer, Wirtschaft und Recht, 2012), 28.
[85] Danon (n 48) 27.
[86] BEPS Action 5 Report, para 50.
[87] BEPS Action 5 Report, para 40.
[88] Christiana HJI Panayi, *Advanced Issues in International and European Tax Law* (Hart Publishing, ebook, 2015), c 6.5.
[89] Chu Shi, (n 60), 373.

that most foreign R&D expenditures cannot be considered in a given preferential regime remains unresolved, and so incompatibilities with EU law persist.[90]

The 30% also inherently opposes the logic of the MNA. If the goal is to align substantial activity with a tax benefit, the 30% uplift for the activities precisely being sought to not be included (i.e outsourcing) acts as a built-in exception. However, the reason for this uplift is more based on political bargaining.[91] If the promotion of R&D activities and spill-over effects is the goal, it is unlikely that would be achieved by qualifying such outsourcing and acquisition costs.[92]

It is plausible that such an uplift may be considered a proportionate measure which may improve its compliance with EU law.[93] A 30% uplift is better than the alternative, which is a full prohibition on outsourcing and acquisition costs as that would heavily discriminate against certain business (such as smaller businesses relying on outsourcing). As suggested by Danon, a potential solution is to exclude R&D outsourcing costs to both residents and non-residents but subjecting both to the 30% uplift.[94] This would even the treatment between the two.

### 3.8 Potential Justifications for Limiting Fundamental Freedoms

Restrictions to fundamental freedoms found in the previous sections may be allowed, assuming there is acceptable justification. The more acceptable justifications relate to the underlying concept of tax symmetry, which include coherence of the tax system and balanced allocation of taxing powers. Combatting abuse can also be a solid justification but will be further discussed in the next section. Furthermore, promoting R&D is not a justification for restrictive measures as mentioned in 3.6, so will not be discussed again.

Coherence of the tax system as a justification requires a direct link between the advantage, and the offsetting of that advantage.[95] This was found to be an acceptable justification in *Bachmann*, dealing with a cross-border pension contribution and a corresponding deduction in Belgium. A tangible example as found in *Bachmann* is that allowing life insurance deductions would have been allowed, as that loss for the state would be offset if an insurers payment is taxed.[96] If the state cannot tax distributions by the insurer, a person seeking a deduction creates an asymmetry if it is allowed, meaning an insurer's payment "contains" the usable deduction for a taxpayer if it is taxed, so to speak. The question is if this applies to MNA regimes.

In the context of cohesion, one perspective is that preferential regimes function by solely providing a reduced tax rate, so there is no offsetting of that advantage.[97] However, other literature suggests preferential R&D regimes in fact do have a corresponding tax offset. With

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[90] Christiana HJI Panayi, *Advanced Issues in International and European Tax Law* (Hart Publishing, 2015), c 6.5.
[91] *Rene Matteoti, Philip Roth* (n 41) 768.
[92] *Arginelli* (n 9) 62-64.
[93] Fabris, (n 46) 59.
[94] *Danon (*n 48) 49.
[95] Helminen, (n 28), 52-53.
[96] Judgment of 28 January 1992, *Bachmann,* Case C-204/90*,* EU:C:1992:35, para 22.
[97] *Mang* (n 25) 3.1.

respect to IP regimes, countries consider foreign R&D expenses if they can tax its derived income.[98] Indeed, this is reflected in the definition of qualifying taxpayer in the BEPS Action 5 Report.

Yet, qualifying foreign PE's to an R&D incentive only if they are subject to tax in the state with the tax incentive may conflict with EU law.[99] Danon mentions the potential issue of this approach, considering *Argenta.* A case dealing with balanced allocation of taxing rights, Belgium did not incorporate a foreign PE's income when calculating the resident company's notional interest deduction, as the PE was exempt in Belgium. Such treatment was held to deter a Belgian company from business activity through a PE in another MS which affected the freedom of establishment.[100] In cross border situations, the Court therefore did not allow the link between a subject-to-tax clause and a tax advantage.[101]

Discrimination created unilaterally by a resident state therefore cannot be justified on grounds of balanced allocation of taxing rights.[102] Similar to *Argenta,* the MNA's approach of exempting foreign PE's from the concept of qualifying taxpayers means a reduction in the amount of IP income subject to the preferential regime per the nexus ratio. [103] That may infringe the freedom of establishment.[104]

All things considered, while balanced allocation of taxing rights and cohesion of the tax system are plausible justifications, they may not be suitable justifications in the context of an implemented MNA regime based on the above case law. However, one other justification for invoking restrictive measures under EU law remains, which is the need to combat abuse that will be discussed next.

# 4 The MNA and the EU Concept of Abuse

## 4.1 Abuse under EU Law and the MNA

A key legal development in the EU is that "*the general principle of EU law cannot be relied upon for abusive or fraudulent ends…*"[105]. Such a principle can be used as justification to restrict fundamental freedoms through otherwise incompatible measures. The need to combat abuse therefore acts as a legitimate aim under EU law.

The MNA itself contributes to the fight against aggressive tax planning and base erosion as part of the OECD BEPS project. However, BEPS Action 5 has developed its own vision of

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[98] *Danon* (n 48), 28.
[99] *Arginelli* (n 9) 56-58.
[100] Chu Shi, (n 60) 3.2.2.2.
[101] Edoardo Traversa, 'Tax Incentives and Territoriality within the European Union: Balancing the Internal Market with the Tax Sovereignty of Member States' (2014) 5 World Tax J. 3, 327.
[102] *Schoueri* (n 62) 116.
[103] ibid 117.
[104] ibid.
[105] Judgment of 26 February 2019, *N Luxembourg 1,* (N Luxembourg et al) Case C-115, EU:C:2019:134 para 122.

substance as defined by the OECD. At the EU level, it becomes the acceptable method of implementing IP regimes among Member States.

The EU however, has developed its own doctrine of abuse and substance particular to its legal order. Legislation impeding fundamental freedoms for example, could only be justified if it targets arrangements that are not reflecting economic reality and setup with the aim to obtain a tax advantage. [106] To determine abuse, intent and circumstances of the allegedly abusive tax arrangement can also be considered using a mix of subjective and objective factors. [107] In essence, EU case law provides the available reasoning to deny tax benefits where they are abusively obtained.

*T Danmark et al* and *N Luxembourg et al* (hereinafter '*Danish cases')* is one such contributor to the development of substance and the anti-abuse principle under EU law, incorporating past elements of abuse. Because the recent cases include and build upon previous concepts of abuse, it acts as a prime benchmark to which the MNA can be compared to.

It is worth revisiting the concept of combatting abuse, as after the *Danish* cases it is arguably different based on its more fine-tuned concept of substance. If the MNA concept of substance differs from its EU contemporary as it stands after the *Danish* cases, the consequence is a potential incompatibility with EU law. The problem then becomes that complying with the OECD MNA approach could still lead to an arrangement being considered abusive.

### 4.2 The Facts of the *Danish* Cases

On February 19th, 2019, judgments were ruled for the grouped cases *T Danmark et al* and *N Luxembourg et al,* opening a new chapter in the EU in the realm of abuse. Part of the novelty of the cases lies in redefining what abuse meant, as an intermediary was deemed to be abusive even though it managed to fulfil substance requirements in Danish legislation.

C-117/16 Y Denmark Aps and C-116/16 T Danmark was the first case grouping which had a situation where benefits were denied under the Parent-Subsidiary Directive. The PSD aimed to exempt taxation of distributions from subsidiaries to parent companies to promote tax neutrality in cross border cases. The problem lied in the placement of an EU-based intermediary company (conduit) which allowed beneficial owners to benefit from a withholding tax exemption, that the Danish authorities considered abusive.

*N Luxembourg et al* was the second case grouping, but instead dealing with the IRD which aims at eliminating taxes on interest payments in intra-group cases.[108] There, the Danish authorities likewise deemed abuse to exist as the entities in the case were not the beneficial owners of the interest but were rather conduit companies.[109] Both cases substantially overlap in the issues being dealt with, which are not worth repeating.

[106] Judgment of 12 September 2006, *Cadbury Schweppes,* Case C-196/04, EU:C:2006:544, para 55.
[107] Case C-115 *N Luxembourg et al*, para 124.
[108] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (2003) OJ L 157, para 10.
[109] Case C-115 *N Luxembourg et al.* para 27.

Essentially, the cases dealt with four main findings. The first finding is that for the IRD to apply, the beneficial owner of the interest had to be established in another Member State.[110] A beneficial owner under the IRD was defined as one that benefits from the royalties or interest for their own use.[111] IRD-based benefits could therefore be denied where the person is not the beneficial owner of the interest or royalty.

Secondly, there was a requirement for domestic transposition of EU law to prevent abuse. The court reiterated the general principle of EU law that it cannot be relied upon for abusive or fraudulent ends[112]. Setting up financial arrangements whose sole aim is to benefit from the IRD's tax advantages would undermine the EU's economic cohesion.[113] Therefore, even without national law in place transposing the IRD, IRD-based tax benefits could be denied.[114]

Thirdly, the court discussed the constituent elements of abuse.[115] To determine the existence of abuse, the ECJ took the liberty to provide indicators to guide a national court in determining its existence. The criteria particularly deal with intermediaries (conduits) which are put in place to seek a tax advantage[116]:

- Passing all or almost dividends after receipt to entities not entitled to PSD benefits, including those in third countries.
- An insignificant amount of taxable profit is made by the conduit entity by virtue of passing on dividends received to a third company.
- Sole activity is receipt and transmission of dividends to beneficial owner or other conduits.
- Contractual arrangements that determine use of dividends.
- Close timing between transaction structuring and adoption of new legislation.

The above are only guiding indicators, as determination of economic activity should be done considering all relevant factors including management, balance sheet, costs and expenditures, staff, premises, and equipment.[117]

Finally, and arguably most importantly, is the finding that a new obligation for Member States was invoked. In cases where abuse exists, benefits *must* be denied as opposed to *could* be denied.[118] Curbing abuse was therefore no longer an option, giving Member States the green light to address it within the broader bounds provided by the ECJ.

[110] ibid para 86.
[111] ibid para 88.
[112] ibid para 96.
[113] ibid para 107.
[114] ibid para 117.
[115] ibid para 124-139.
[116] ibid para 101-106.
[117] ibid para. 131.
[118] Gonzalez-Barreda, 'Holding Companies and Leveraged Buy-Outs in the European Union Following BEPS: Beneficial Ownership, Abuse of Law and the Single Taxation Principle (Danish ECJ Cases C-115/16, 116/16, 117/16, 118/16, 119/16 and 299/16)' (2019) European Taxation, 419 .

### 4.3 IP Regimes as Abusive Practices under the *Danish* Cases

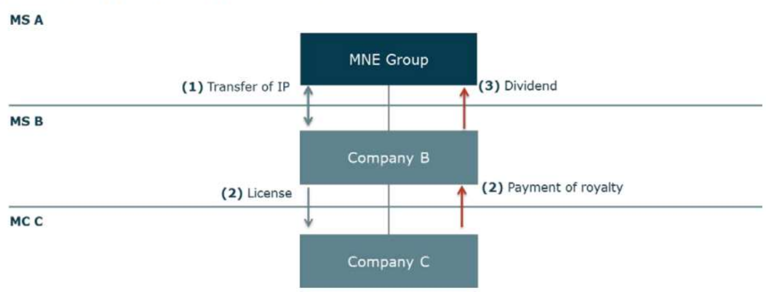
Because the *Danish* cases do not explicitly deal with IP regimes, it becomes relevant to clarify if there is any overlap between the two. This section aims to bring an IP regime into the scope of the *Danish cases,* meaning such a regime would be subject to both the OECD's MNA and EU substance requirements, allowing to determine any incompatibilities where one deviates from the other. This is done first by looking at an IP structure considering the *Danish* cases, and then determining whether it may be abusive based on subjective and objective elements.

<u>IP structure and royalties as abuse</u>

As the *Danish cases* revolve around dividend distributions by intermediary companies in abusive scenarios, it may seem there is no affiliation with preferential IP regimes. However, the underlying legislation in question was the IRD and PSD. The IRD aims to exempt withholding taxes on cross-border payments between affiliated entities, both for dividends and royalties. Royalties are in fact, the linking element to patent regimes.

The relevance of royalties in abuse can be illustrated by the following generic structure:[119]

**Figure 2.5: Patent box ATP structure**




The above scheme demonstrates an intermediary (Company B) which has an IP asset initially transferred to it by the MNE Group. Company B proceeds to license out the asset for use by Company C, which in turn pays royalties that accrue to Company B. Company B may then pay dividends out to the MNE Group.

Countries would generally have various specific requirements which may aim to curb the existence of such intermediaries such as Company B, whose sole function is to possess an IP right and license it out to subsidiaries in other countries and accrue untaxed benefits. But, the more lenient jurisdictions such as Luxembourg or the Netherlands did not have the particularly strict requirements for substance. The Netherlands had an older IP regime where intangibles were taxed at an effectively reduced rate of 10%, and it was not necessary to have premises located in the Netherlands to benefit from the regime. [120]

[119] European Commission, 'Study on Structures of Aggressive Tax Planning and Indicators' (2015), 43.
[120] J. Schaffner, K. Manhaeve & F. Trouiller, 'New Luxembourg Tax Regime for Intellectual Property Income' (2009) 49 Eur. Taxn. 7*,* 229.

Attractiveness of IP regimes therefore manifests itself in little or no taxes on income derived from its exploitation, including tax free royalty distributions. Through tax planning, an MNE can rearrange its tax affairs such that licensing and exploiting IP income through royalty payments is untaxed, increasing the MNE's profit margins. In the Dutch and Luxembourgian structures, IP intermediary structures were previously feasible as the substance criteria at the time differed from its modern contemporary, allowing limited substance in the territory where the tax advantage was being sought.

Looking at this structure from a structural perspective, an intermediary can be interposed between companies which aims to collect royalties. The distribution of royalties through intermediary structures could occur just as with dividends in the previously mentioned *Danish* cases.

Subjective and objective intent

Proving abuse under EU law generally requires presence of a subjective and objective element. The subjective element is fulfilled when the intent is to achieve a tax benefit through artificial creations, whereas the objective element requires that despite formally observing the rules, the purpose of the rules has not been achieved.[121]

Regarding subjective intent, the ECJ helpfully outlined various scenarios to determine subjective intent previously mentioned in section 4.2. To reiterate indicators of abusive subjective intent in relation to IP boxes, this could include a situation where the company has the sole function of receiving interest and sending it on to a beneficial owner.[122] Additionally, contractual arrangements between the companies which aim at shifting profits from a company to shareholders at a minimum or no tax rate may be reflective of abusive intent.[123]

Based on the subjective elements found in the *Danish* cases, the findings start to cast light on their application to preferential IP regimes. Where pure IP structures are put in place only to benefit from a regime, and their function consists of solely collecting royalty income based on its leased-out IP rights as a conduit entity, there could be evidence of abuse. IP intermediary companies of this sort would fulfil the subjective abuse element as provided in the guidance from the *Danish cases*.

The other part of the equation is the objective factor which pertains to situations where despite formal adherence to the conditions of the law, the law's purpose has not been achieved.[124] Difficulty exists in applying this in practice, as it requires looking at a given provision's intent and purpose.[125] If applied to the IRD, which is aimed at removing taxes on royalties and interest payments, the inclusion of an anti-abuse provision[126] indicates that the aims of the Directive could be frustrated if they were extended to transactions motivated by tax evasion or abuse.

[121] Case-C-115 *N Luxembourg et al,* para 124.
[122] Case C-115 *N Luxembourg et al*, para 131.
[123] ibid para 132.
[124] Case C-115 *N Luxembourg et al*, para 124.
[125] Filip Debelva, Joris Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive'(2015) 55 European Taxation 6, 227.
[126] Interest Royalty Directive, Article 5, para 2.

Setting up a structure in a jurisdiction purely to exploit IP rights and receive tax-free royalties could be such an example.

Therefore, while IP box regimes have not been explicitly dealt with by the ECJ, the *Danish case* guidance does provide enough information to plausibly classify certain IP structures as abusive. Even though the cases dealt with abusive intermediaries and beneficial ownership, the same abusive intermediaries can be present in IP regimes. Intermediaries can be setup purely to achieve a tax advantage, which is the accrual of royalty-free income derived from licensing out IP rights, which is then distributed to other companies through dividends, or passed further along the company through royalties. IP holding intermediaries established for the purpose of benefiting form a preferential regime could fulfil the two-prong objective and subjective test. With previous regimes (now reformed due to the MNA) in Luxembourg or Netherlands, this accrual could have been done without requiring physical presence of R&D activity.

On the topic of the IRD, The European Council discussed a proposal to amend it and insert a minimum tax clause. However, it was identified that enacting a minimum effective tax clause would impede the Member State's ability to draft their own policies with respect to R&D. [127] Effectively there would be no WHT on royalty payments to the beneficial owner, *unless* the effective tax rate on such payments in that regime was at least 10%.[128] One consequence of the post-BEPS amendments is that double non-taxation is a possibility due to the legitimization of patent box regimes.[129] It seems the use of the IRD combined with preferential patent box regimes may explain the decision for the proposal.

As a result, the *Danish* abuse criteria and definition of substance can bring IP intermediary structures into its scope. However, development of the MNA in 2015 has led to IP box reforms since that time. The next question is to see how if the *Danish cases* and the MNA, both now capable of governing IP regimes, conflict with each other.

### 4.4 Substance as defined by the MNA and the Danish Cases

As IP regimes are covered by the MNA and the *Danish* cases, this section aims to compare the substance definitions outlined by both.

Under the MNA, substance aims to link expenditures with a tax benefit in a given preferential regime. R&D expenditures end up being utilized as a proxy for substantial activity in the context of IP box regimes.[130] A company seeking an IP benefit but with no expenditure within a country – and hence no substantial activity - is unable to have its income subject to the preferential regime. As mentioned earlier, the OECD did not carefully consider IP regimes

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[127] Paolo Arginelli, 'Chapter 5: The Interaction between IP Box Regimes and Compensatory Tax Measures: A Plea for a Coherent and Balanced Approach' in Dennis Weber, *EU Law and the Building of Global Supranational Tax Law: EU BEPS and State Aid* (IBFD, 2019), 18.

[128] ROOM DOCUMENT # 2 Working Party on Tax Questions - Direct Taxation Interest and Royalties Directive (2016).

[129] Adolfo Martin Jimenez, 'BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties', (2018) 46 Intertax issue 8 & 9, 622 – 623.

[130] Lisa Evers, 'Intellectual Property (IP) Box Regimes' section 6.2.2.4.3.1 also *para 72 BEPS Action 5 Report.*

themselves and simply recognized its contribution to tax competitiveness but allowing their existence in the MNA form.[131]

With the Danish cases, the EU similarly wishes for a company to engage in substantive activity and not utilize abusive intermediaries. In the case of a holding company for example, it should meet basic minimum requirements and have its own staff and premises to conduct its activity.[132] In that sense, both approaches are trying to align tax benefits with their respective view of adequate substance. The novelty of the *Danish* cases was that artificiality was present when the constituent elements of an activity do not equate to what is usually necessary to carry out the activity in the respective business sector.[133] In other words, purely meeting substance could still indicate abuse depending on the activity in question.

According to the ECJ, an arrangement may be artificial "where it is not set up for reasons that reflect economic reality, its structure is purely one of form and its principal objective or one of its principal objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law."[134] Aside from the more clearly abusive conduit structures, it would be difficult to classify entities under MNA regimes as artificial. To qualify for a preferential regime, the entity would have to undertake most of the costs of R&D itself as outsourcing and acquisition is limited. Paying for supplies, wages, and other R&D costs purely to have 30% of income qualifying under the regime would be quite unlikely and would rather indicate economic reality over an artificial arrangement. According to the court, economic activity should be inferred from relevant factors including management, the balance sheet, structure of costs and expenditure, staff, premises, and equipment.[135] Indeed, the process of R&D would result in such expenditures which would heavily hint towards a with economic reality, or at least not completely void of it.

On the other hand, it may be that an entity does incur expenditures, but such costs are not priced to reflect economic reality. For example, prioritizing payroll expenditures (as one example of R&D substance) could lead to arbitrary profit margins, not reflecting the true value of the R&D functions performed and distorting the income subject to the preferential regime.[136] Secondly, revenue is often embedded in the transfer price of goods and services, which may make it difficult to track and trace such revenue in detail.[137] "Correctly" pricing intangible-related creations is rather difficult,[138] possibly resulting in over or under-qualifying income subject to an MNA IP regime which may be done with tax-motivated and abusive intent. However, it would be up to the governing transfer pricing rules to make sure the pricing of these internal

[131] n 34.
[132] Joined Cases 116/16 and C-117/17 *T Danmark et al.* EU:C:2019:135, para 104.
[133] Joakim Englisch, 'The Danish tax avoidance cases: New milestone in the Court's anti-abuse doctrine' (2020) 57 Common Market Law review, 529.
[134] Case C-115*, N Luxembourg et al,* para 127.
[135] Luc De Broe, Sam Gommers, 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' EC Tax Review, 2019-6, 284.
[136] Romero Tavares, Jeffrey Owens, "Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook" (2015) 69 Bull. Intl. Taxn. 10 (2015), footnote 26.
[137] ibid.
[138] Philipp Sandner, *The Valuation of Intangible Assets: An Exploration of Patent and Trademark Portfolios* (Springer, 2010), p 2.

R&D expenditures is at arm's length. The consequential threat is the potential shifting of revenue to specific R&D-focused jurisdictions to maximize its preferential tax treatment, which may or may not be done with abusive intent or with valid economic justifications.

On the notion of abusive R&D shifting, abuse may be evident where an entity may decide to have outsourcing above the 30% uplift done by a foreign PE. The country of the head office cannot restrict such foreign outsourcing, where an entity chooses to simply restructure to have outsourcing over the 30% threshold done by another PE.[139] What results is that a group may maintain an overall low tax liability in multiple MNA regimes by restructuring such that 30% of a given PE engages in R&D, which may lack economic reality. Likewise, there is the possibility of shifting most R&D to non-MNA compliant regimes which may exist outside the EU.

But the *Danish* cases carried even broader findings relating to the general principle of abuse under EU law, which indicated that fulfilling formal legal requirements is no longer an indicator of real economic activity, and therefore legitimate substance.[140] As put by Schön, the ECJ now focuses on "whether the 'reasons' for which the transaction has been set up 'reflect economic reality'".[141] From this perspective, economic reality itself has a reduced function in determining abuse.

Instead, the purpose of the legislation and commercial justification may play the major role in determining abuse.[142] If taking the principle objective of an R&D-related entity into account, it would be feasible that an entity forced to restructure would be attracted to a jurisdiction partly based on favorable R&D tax incentives. However, the incorporation of a rebuttable presumption of abuse would allow the taxpayer to justify their tax arrangement.[143] Even if the intent is tax-motivated, the amount of relevant expenditure would again likely indicate commercial justifications.

Abusive IP conduits would be less likely to exist under the MNA. Firstly, even if a conduit sets up a full-fledged R&D operation with premises and staff purely to attain a tax advantage, that could quite easily be viewed more of an indicator of economic substance than abuse. Secondly, if the conduit engages in some activity itself and outsources most of its R&D, only 30% of that income would be subject to the preferential regime. The conduit is unlikely to be attracted to having only 30% of its outsourcing expenditure qualify for a preferential regime, on top of actual R&D costs it must have incurred itself. Because they are unlikely to exist under the MNA, that would indicate one less avenue of conflict with the *Danish* cases.

The ECJ does not utilize the one-sided approach of costs (like the MNA) to determine substance in order deny benefits, but rather uses a wholesome review of economic activity.[144] Even though the MNA creates a narrow definition of substance for IP regimes, the overall

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[139] Antonio Ravelli, 'Hoe effectief is de modified nexus approach in EU-verband?' (2016) WFR 2016/110, 3.
[140] Case C-115, *N Luxembourg et al*, para 98.
[141] Wolfgang Schön, 'Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan.' (202) 74 Bull. Intl. Taxn. 4/5, 300.
[142] ibid.
[143] Case C – 115, *N Luxembourg et al*, para 142.
[144] ibid 129.

effect of requiring relevant expenditure to occur would in turn likely satisfy the ECJ's current view on substance. However, the definition of lack of economic reality starts to shift from one from wholly artificial arrangements, to one that is more subtle. The issue of legitimate abusive intent could occur where there are inadequate transfer pricing rules in place to value internal R&D expenditure. Activities *within* a company would become the indicator of economic reality. In practice, it would be interesting to see if tax-motivated restructurings which carry with them real expenditure, but with dubious economic justifications, can be considered abusive by the ECJ. All things considered, the MNA contributed to substance within preferential regimes in such a manner so as to not conflict with the *Danish* development of substance.

### 4.5 Circumvention of Anti-Abuse Efforts through Tax Treaties

An interesting question put forth is if the tax treaties may be affected by the application of the MNA.[145] Indeed, a situation can occur where benefits may be denied by the Source state where an entity benefiting from a resident State's patent-box regime does not fulfil substance requirements.[146] From an EU context, treaty benefits may also be affected. The *Danish* cases obliged to deny benefits stemming from abusive behavior. That obligation clearly differs from a situation where benefits "may" be denied as specified in DTTs.[147]

If the *Danish* cases obliged to deny EU-based benefits, that would indicate those sourced from IRD or PSD. Therefore, a double taxation treaty can still apply. Consistently relying on a DTT would undermine EU efforts to combat abuse through conduit entities as a switchover DTT may occur, particularly if the number of DTTs the country has concluded is large, and the anti-abuse clauses contained therein are lenient. EU interests would be at stake and therefore undermined.

Arguments have been put forth that this form of undermining would violate the principle of sincere cooperation.[148] As a result, Member States should avoid application of measures conflicting with the Union's objectives, such as combatting abuse.[149] Oddly enough, the argument seems to imply that benefits should be denied even when they do not have their source in EU law. It is the case that a double tax treaty is not EU law. But it is not obvious how similar the benefits contained therein must be to those found in EU legislation for refusal, if at all. An example is no withholding tax on dividends as in the IRD. Is it that by virtue of having no withholding tax on dividends or royalties, a DTT must be disapplied? If the DTT provides for a reduced withholding tax rate, can that be relied upon?

In context of the MNA, this means the obligation to combat abuse is now broad enough to transfer beyond specific EU legislation as IRD or PSD. The consequence of the ECJ's changing and developing concept of "abuse" requires Member States to dig into their DTT's and limit

[145] Robert J. Danon, 'Will nexus-based patent boxes be internationally safe?' (2015-2016) 84, 1-2, 184.
[146] ibid 185.
[147] ibid p 184 - 185, discussing amendment of the OECD MC Article 12 relating to royalties.
[148] Van Hulten, Korving, 'Svig og Misbrug: The Danish Anti-Abuse Cases' (2019) 47 Intertax Issue 8 – 9, 799.
[149] ibid 800.

benefits where abuse is found. Clauses in DTT's that state benefits "may" be denied are therefore incompatible with that obligation, and instead "must" be denied. A broader consequence of the obligation is that taxpayers under the MNA may see tax planning avenues being closed off by States in less predictable ways, without clear basis in EU law.

### 4.6 The MNA's Presumption of Abuse

Fulfilling substance as per the OECD MNA grants access to the preferential regime in a given jurisdiction. The logic of the BEPS project rests on preventing base erosion, so it follows that not fulfilling the MNA substance could indicate the existence of a harmful tax practice.[150]

The OECD cannot explicitly state that certain types of expenditures or activity are abusive where a tax benefit can be denied, as only the ECJ would have the ability to rule on such matters of EU law. Yet, the practical implementation of the MNA into an EU Member State's national law borders on the presumption of abuse.

The reason for this presumption lies in the MNA's classification of qualifying expenditures which will not qualify for the preferential regime. Because the MNA disallows outsourcing and acquisition expenditures, subject only to a 30% uplift, it presumes that costs over that amount are abusive and should not qualify for tax benefits.

In March 2015, the Federation of German Industries and Confederation of Dutch Industry and Employers mentioned that due to an "increasingly work-sharing environment it is nearly impossible to provide only local R&D".[151] Having legitimate R&D business intent therefore did not seem to automatically include all of the qualifying income per the MNA.

As in *Cadbury Schweppes,* if a state is justifying a measure on the need to combat abuse, a restriction may be allowed if the national provision targets wholly artificial arrangements. A 30% uplift could in practice be such a national provision, because its aim is to limit an entity's ability to excessively outsource while not engaging in R&D itself in sole pursuit of a tax benefit. However, a discriminatory measure that tackles both artificial structures and those with sound business reasons would not be justified based on the principle of combatting abuse.[152] Because there may be legitimate business situations where outsourcing fees constitute more than 30% of the total R&D costs, it is unlikely that such a measure could be considered as addressing wholly artificial arrangements and hence justified by an anti-abuse motive.[153] On the other hand, as pointed out by Englisch, the *Danish* findings may result in giving Member States more leniency in implementing measures against tax planning strategies by relaxing previously stricter concepts of abuse, which is relevant for BEPS Actions.[154] Still, the 30%

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[150] BEPS Action 5 Report, para 26.
[151] Ulrika Thomas, 'Dutch, German Firms Urge Fair Patent Box Changes' (*Tax-News, 2015)* <https://www.tax-news.com/news/Dutch_German_Firms_Urge_Fair_Patent_Box_Changes____67511.html> accessed May 3rd, 2020.
[152] Lang et al, *Introduction to European Tax Law: Direct Taxation* (Spiramus, 3rd edn, 2013), 75.
[153] Antonio Ravelli, 'Hoe effectief is de modified nexus approach in EU-verband?' (2016) WFR 2016/110, 6.
[154] Joakim Englisch, 'The Danish tax avoidance cases: New milestone in the Court's anti-abuse doctrine' (2020) 57 Common Market Law review, 536 - 537.

uplift is an arbitrary political negotiated mechanism, and its ability to affect legitimate business activity means it is unclear how it is not obvious how it can constitute a proportionate measure.

Loosely related to the presumption of abuse is the fact that Member States may decide to take anti-abuse measures when the MNA is *not* implemented by a jurisdiction. Having a non-MNA compliant IP regime could indicate a higher chance of abuse, where another State may attempt to levy a withholding tax on the related royalties going to the non-MNA jurisdiction. The result of doing so however, is akin to a likely unjustifiable presumption of abuse as substantive activities could still be carried out under a non-MNA compliant regime.[155]

The upside is that the OECD report includes the possibility for a state to use the MNA as rebuttable presumption. [156] In certain circumstances, taxpayers can claim that more income should be included in the nexus ratio where the outcome is not commensurate with existing levels of R&D activity.[157] Interestingly, this presumption is subject to a number of minimum requirements, including that the nexus ratio is above or equal to 25%[158]. One consequence of this could indicate that taxpayers believing that up to 24% of their expenditure should be subject to the regime are incapable of benefitting from the rebuttable presumption, which may not be proportional.

In any case, a rebuttable presumption is an appropriate addition which is supported by EU case law such as *Deister & Juhler Holding* and *Eqiom.* Those cases dealt with situations where taxpayers could not provide economic reasons for their activity, constituting an irrebuttable presumption of abuse which was contrary to EU law.[159] Similarly in the *Danish* cases, the burden of proof falls on the tax authorities to prove an abusive situation if they wish to deny benefits.[160] However, a taxpayer can only choose to benefit from the rebuttable presumption if they have not chosen the 30% uplift mentioned earlier.[161] Therefore, both cannot apply at the same time.

### 4.7 Grandfathering of Previous Regimes

Under the MNA, grandfathering of previous regimes is an option. Grandfathering allows a regime to operate based on a previous rule for a given time period, making new rules that may apply to the situation inapplicable until the respective time period lapses.[162] Understandably, some time is necessary for new legislation to apply and for a degree of legal certainty to be afforded to those who could be negatively affected by an MNA regime. The problem with

155 Schoueri, Page 187 - 188.
156 BEPS Action 5 Report, para 67.
157 ibid.
158 ibid para 68.
159 Joined Cases C-504/16 and C-613/16 *Deister and Juhler Holding* AG, EU:C: 2017:1009 para 70 and Case C-6/16 *Eqiom and Anka* EU:C:2017:641 para 36.
160 Joined Cases 116/16 and C-117/17 *T Danmark et al.,* EU:C:2019:135. Para 117.
161 BEPS Action 5 Report, 42, para 21.
162 Grandfather clause: *Informal term for a provision in a statute or other body of rules under which certain cases are excepted by way of concession from the latter's coverage, typically in recognition of facts or circumstances existing at the time the rules in question generally take effect. Grandfather clauses are typically encountered in the context of changes to existing rules and permit reliance on the old rules for a limited period of time.* IBFD.

grandfathering is that it may afford protection to an otherwise abusive structure. After the *Danish cases,* Member States had the obligation to deny tax benefits in cases of abuse. It is therefore unclear how to balance that obligation with grandfathering rules.

According to the OECD, the MNA approach must apply to new IP regime entrants after 30 June 2016.[163] Furthermore, Member States can apply grandfathering rules to old regimes (pre-2016), allowing entities to operate under the non-modified nexus approach rules up until June 2021.[164] At the EU level, patent box regimes are accepted if they are MNA-compliant according to the EU Code of Conduct Group.[165] Regimes that are non-MNA compliant will be restricted by the Code of Conduct.

The grandfathering issue can be evident based on the existence of conduits. It has been established in the previous sections that conduit IP intermediaries set up purely to benefit from preferential regimes would be less likely to occur under the MNA, as they would have limited qualifying income under the nexus ratio. The issue is further aggravated when the EU prohibits new non-MNA compliant IP regimes, yet agrees to still allow non-MNA compliant regimes to exist until 2021. If MNA is an indicator of substance, the EU is allowing operation of potentially unsubstantiated IP companies.

Grandfathering does not seem to sit with the findings in the *Danish* cases which require Member States to combat abuse. Aside from affecting current and future legal assessments, the decisions of the ECJ have retroactive effect which can affect the interpretation of laws of previous years. [166] This retroactivity means that since the *Danish* cases of February 2019, and before, Member States were under the obligation to particular types of abusive arrangements which can be present in the IRD. Grandfathering potentially abusive IP regimes up until 2021 does not comply with that obligation.

One way of phrasing this situation is that "safe harbor" is granted to old IP regimes where a parallel can be drawn between grandfathering, and the safe harbor rules which were recently reformed in the Netherlands. Dutch safe harbor rules presumed non-abuse in case a legal entity fulfilled the minimum substance requirements to gain access to a tax benefit.[167] After the Danish cases, the ECJ effectively undercut legal certainty allowing challenging arrangements even though they complied with minimum substance. The Netherlands altered its incompatible legislation specifically based on those cases, leading to the denial of safe harbor to entities fulfilling substance requirements. The Dutch amendments reflected the new ability for a state to question *why* an entity was meeting the domestic legislation's minimum substance requirement in the first place.[168] Yet, grandfathering IP regimes seems to operate on equivalent logic as providing safe harbor. Both seem to afford protections to regimes that are otherwise

[163] BEPS Action 5 Report, p 34, para 63.
[164] ibid para 65.
[165] Ivan Zammitt, 'Centralized IP Business Models – Tax Implications of EU Patent Boxes,' (2015) Bull. Intl. Taxn. 9, 545.
[166] Lang et al, *Introduction to European Tax Law: Direct Taxation* (Spiramus, 3rd edn, 2013), 47.
[167] Present for example in the Dutch Dividend Tax Act (DB 1965) - Article 4 (3)(C).
[168] Fulfilling the minimum substance criteria now presumes non-abuse and the relevant tax exemption applies, unless the tax inspector justifies evidence of intent. In that case, benefits can be denied. See Article 4, point 12 of Wet DB 1965.

abusive. The conflict therefore lies in the shaky logic of disallowing safe harbor rules but allowing grandfathering of potentially abusive IP entities.

A pure IP conduit structure, created pre-2016 and grandfathered until 2021, exclusively acting as a conduit and passing on royalties or dividends to beneficial owners in third countries is therefore allowed to exist under the current MNA implementation. That same structure would be considered abusive under the *Danish* case findings, indicating these IP structures may have their grandfathering until June 2021 cut short if a Member State decides to exercise its obligation to combat abuse.

From the *Danish* cases, the EU utilized an OECD Model Convention based definition of beneficial ownership. Rationale for this decision was the historical development and connection between the IRD and the OECD MC. It was not deemed acceptable to have each Member State define beneficial ownership on their own terms,[169] as that could great exploitable gaps. This was a controversial decision as it imported external definitions into the EU legal order. Indeed, the EU has shown a recent trend towards interpreting directives and EU law considering the BEPS Action Plan.[170]

The practical question is then if the ECJ will utilize the MNA in determining an entity's substance. After all, the MNA is the supported method of implementing a preferential IP regime in the EU. In reality, it is unknown if the MNA carries any weight in determining abuse and if it will be used by ECJ.

The jurisdiction which has implemented the MNA, as opposed to one without, could point to a reduced likelihood of abuse occurring. That is because the jurisdiction with the MNA applies benefits to R&D activities and an entity's R&D costs. Conversely, a non-MNA compliant regime could still provide broad IP benefits which are open for misuse. It is more likely that the ECJ will completely ignore the existence of the MNA and only utilize the abuse criteria as formulated in the *Danish* cases (and in EU law). Even if the MNA is implemented and an abusive entity is benefiting from grandfathering, that safeguard will be effectively bypassed by the ECJ.

On a similar note, if the ECJ turned down a nexus-compliant IP box and deemed it capable of breaching EU law, this would affect international cooperation and raise questions on the interactions between the EU institutions. [171] After the Danish cases, the previously cited incompatibilities, and grandfathering of abusive regimes, that may lead to the ECJ doing precisely that. Additionally, grandfathering may itself undermine the project's goal of swift reforms in the international tax regime, which could spill over to delays in other BEPS outputs.[172]

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169 Case C-115, *N Luxembourg et al,* para 84.

170 Robert Danon, Wolfgang Schön, *"Foreword: Tax Treaty Interpretation after BEPS"* (2020) 74 Bull. Intl. Taxn. 4/5, c 5.

171 Pointed out by Faulhaber in "The Luxembourg Effect," footnote 112, 30.

172 Paolo Arginelli, 'Innovation through R&D Tax Incentives: Some Ideas for a Fair and Transparent Tax Policy' (2015) 7 World Tax J. , 64.

In any case, the *Danish* cases furthers the EU law-based concept of substance particular to its legal order it can rely on to define abuse. While the MNA is a significant and relevant development, it is difficult to predict if it would be considered by the ECJ, and if it even has anything to contribute to identifying abusive IP regimes. Grandfathering previous regimes, however, could conflict with the pressing obligation to combat abuse.

# 5 Conclusion and Final Remarks

Based on the previous sections, the implementation of the MNA carries incompatibilities with EU fundamental freedoms. Even though it was drafted with the aim of complying with EU law (which explains the two versions), the practical effects do result in differential treatment among entities that outsource and those who do not.

Chapter 3 discussed that the freedom of establishment and freedom to provide services is potentially restricted based on the way outsourcing and acquisition expenditure is treated in cross-border scenarios. Limited justifications for these restrictions would be applicable, based on the previous judgments of the ECJ.

Quite interestingly, the MNA was drafted as a starting point to combat tax base erosion. Yet, the EU has its own particular concept of abuse. Chapter 4 mainly revisited the notion of abuse and substance which had arguably been altered after the *Danish* cases, and applied it to the MNA to determine the MNA's compatibility if implemented.

To a large extent, the MNA overlaps with the *Danish* cases and creates a relatively robust concept of substance. IP conduits as discussed in the *Danish* cases would already be less likely to exist under the MNA. However, problems remain. There is the possibility that abuse may exist in cases of intra-group R&D expenditure mispricing, but that is to be governed by transfer pricing legislation. Abuse could likewise exist with tax-motivated restructurings but proving artificiality would be difficult when an R&D entity has expenditures and (even some) business rationale. Furthermore, the potential presumption of abuse (prohibited by EU law) present for costs over the 30% uplift is partly remedied by the inclusion of a rebuttable presumption. The new obligation to combat abuse also means tax treaties between states cannot instead be relied upon to undercut EU efforts at addressing tax avoidance and allow IP conduits to continue operating. Lastly, the obligation to combat abuse per the *Danish* cases would also indicate that grandfathering of potentially abusive regimes as the MNA allows (from pre-2016 until 2021) is hard to reconcile with EU law.

To summarize, the MNA is a step in the right direction. Patent regimes and IP has been in the spotlight of abuse, and EU and OECD efforts are closer than ever at wiping out wholly artificial arrangements, conduit intermediaries, and exclusive IP holding entities. Instead, the MNA may trigger a new wave of tax competition and economic distortion, affecting corporate tax rates or spurring tax-motivated restructurings for the IP and R&D industries.

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