AN ANSWER FOR AGGRESSIVE TAX PLANNING WITH INTANGIBLES

Analysis of royalty deductibility barriers and other anti-avoidance measures against BEPS on IP

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Analysis of royalty deductibility barriers and other anti-avoidance measures against BEPS on IP

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List of Abbreviations

AbgÄG	*Abgabenänderungsgesetz* (Tax Modification Act)
AG	Advocate General
AktG	*Aktiengesetz* (Stock Corporations Act)
AStG	*Außensteuergesetz* (German Foreign Tax Act)
ATAD	Anti Tax Avoidance Directive
ATO	Australian Taxation Office
BAO	*Bundesabgabenordnung* (Austrian Federal Tax Code)
BEFIT	Business in Europe: Framework for Income Taxation
BGB	*Bürgerliches Gesetzbuch* (German Civil Code)
BGBl	*Bundesgesetzblatt* (Federal Law Gazette)
BIT	Bilateral Investment Treaty
CCCTB	Common Consolidated Corporate Tax Base
CUP	Comparable Uncontrolled Price
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
DSB	Dispute Settlement Body
DTA	double taxation agreement
DTT	double tax treaty
EStDV	*Einkommensteuer-Durchführungsverordnung* (Regulations for the Implementation of Income Taxation)
EStG	*Einkommensteuergesetz* (Income Tax Act)
ETR	effective tax rate
FDI	foreign direct investment
FET	fair and equitable treatment
FHTP	Forum on Harmful Tax Practices
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GloBE	Global Anti-Base Erosion

GmbHG	*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* (Limited Liability Companies Act)
HTVI	hard-to-value intangibles
IAS	International Accounting Standard
ICSID	International Centre for Settlement of Investment Disputes
IFRS	International Financial Reporting Standards
IP	intellectual property
IRD	Interest and Royalties Directive
IStR	Internationales Steuerrecht (*periodical*)
KStG	*Körperschaftsteuergesetz* (Corporation Tax Act)
MET	minimum effective tax
MFN	most-favored nation
MLI	multilateral instrument
MNE	multinational enterprise
MS	Member State
NT	national treatment
OECD	Organization for Economic Co-operation and Development
OECD-MC	OECD Model Convention
PE	permanent establishment
PPT	principle-purpose test
R&D	research and development
STTR	Subject-to-Tax Rule
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
TO	treaty override
TP	transfer pricing
TPSM	transactional profit split method
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UNCITRAL	United States Commission On International Trade Law
UNCTAD	United Nations Conference on Trade and Development
US-MC	United States Model Convention

UTPR	Undertaxed Payments Rule
WHT	withholding tax
WTO	World Trade Organization

Introduction

In recent times, it has become clear not only to multinational companies, but also to the public in general, the relevance that intangible assets have for the modern business world. Companies commonly considered "successful" are no longer necessarily those with huge factories, thousands of employees and heavy machinery, but those with assets capable of generating value based on ideas, patents, software, know-how, etc. Intellectual property (IP) has therefore become today more than ever not only a type of asset linked to value generation due to its uniqueness, but also an extremely efficient mean for multinational enterprises (MNEs) to spare taxes internationally.

Such international groups use the possibility of easy transfer and difficult valuation of intangibles to (re)allocate ownership of their assets strategically to related parties in low-tax jurisdictions – be it tax havens or countries with special incentive regimes for IP. As a result, IP or research & development intensive businesses have a much lower effective tax rate than non-innovating companies. An analysis as early as the one by Grubert[1] shows that approximately *half of all profit transfers* from high-tax to low-tax jurisdictions can actually be traced back to tax structures in connection with intangible assets.

This occurs for several reasons and due to multiple factors, and while not every multinational uses exactly the same structure or techniques to shift profits, the strategies used follow some specific standards and have relatively well defined requirements. Yet, despite the rapid evolution of the importance of intangibles and a strong shift in the economic priorities and overall corporate structure of MNEs, the reaction of international tax law has been largely insufficient. While many countries and the OECD have been for years devising strategies to counter profit shifting that use *e.g.* transfer pricing arrangements or intragroup debt financing, by implementing rules in the likes of limitations to interest deductibility, controlled foreign company rules and transfer pricing documentation duties, strategies that use intangible assets and cross-

[1] Grubert, H. (2003): Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location. In *National Tax Journal* LVI (1), P. 221ff.

border royalty payments (or "license fees") due to licensing agreements have not been satisfactorily addressed.

This gap in the international taxation scenario has lead a few countries such as Germany, Austria and even the Ukraine to recently adopt *unilateral* measures, marginal to the international cooperative system of the OECD and the more recent GloBE proposal, to counter profit shifting through intangible assets, amongst which are the so-called royalty deductibility barriers.

This mechanism prevents, after meeting a variety of requirements, the deduction of intra-group international royalty payments, ensuring that the amount will be taxed at least once in a substantial manner in the country that introduced the rule. This doctoral thesis has at its core object the abovementioned rule, as well as any other instruments that may assist in the struggle against base erosion and profit shifting (BEPS) related to intellectual property, such as an inverted tax credit system, the (re)introduction of withholding taxes and so on, as well as the underlying issues such instruments bear. The importance of this analysis is manifest in that it seeks to find a definitive answer to a problem that, to date, has resulted in intense BEPS by multinationals and has not been adequately handled neither internationally nor domestically.

The present work is to the best of our knowledge the first monographic study in English with this methodological cut-out in royalty payments. Through a deductive-analytical methodology, each of the different legislative measures that can be employed to combat the artificial shifting of profits and the erosion of the tax base through cross-border intragroup royalty payments will be thoroughly dissected from this particular perspective. The final objective will be to present a normative solution in the form of a best-practice approach for a (realistic) resolution of the problem with this sort of aggressive tax planning structure.

To this end, the initial part of this thesis will assess the definition, conceptual differentiation and fundamentals of the levies on intangible assets and IP tax planning. Special attention is given to the international literature on the subject, considering the plurality of concepts and the need to precisely delineate intellectual property as an object of taxation and international tax planning, in order to establish the internal boundaries for the research framework within the context of tax law. This can be summarized as the reallocation by multinational companies of the ownership of their intangible assets to related parties in low-tax jurisdictions. Commonly, there will be only one company in the business group that will hold ownership and therefore be responsible for the

administration of the group's intellectual property. This structure is known as the “license model”, another tool used by internationally active companies to gain a fiscal competitive advantage.

From this conceptual summary highlighting the problem at hand, this research firstly concentrates on the main problematic of general measures such as GAARs, transfer pricing and CFC rules, with the intention of appraising differing methods directed towards the same end, under the lighting of the issue with the payment of royalties. In addition, the shortcomings and inconsistencies inherent to their respective systems will be emphasized, in order to demonstrate how these rules are, despite their broad spectrum, insufficient for various reasons to combat aggressive tax planning structures that (ab)use intellectual property. At the end of this chapter, a short excursus with the OECD nexus-approach is carried out in order to illustrate how this substantive approach focused on value creation is far from addressing IP concerns, legitimizing preferential regimes that continue to be used as part of tax saving schemes.

The following chapter will then do an assessment of specific measures – such as the relatively new royalty deductibility barriers, inverted tax credit systems, the GloBE proposal and even the US BEAT/SHIELD – through a holistic approach, in which the implementation of each measure is evaluated according to its working mechanisms, effectiveness and practical feasibility. This is one of the main cores of the project, since these specific measures should be *par excellence* a targeted solution to the problem, allegedly leading to its definitive resolution. However, each one of them has distinct issues to be addressed, ranging from its strong economic impacts and reduction of a country's competitiveness as a business location; its incompatibility with higher-ranking law; and even its difficulty in practical and political implementation.

Once a comprehensive analysis of each alternative for the addressing of BEPS through royalty payments has been carried out, the thesis will proceed to scrutinise the viability of these measures *vis-à-vis* higher-ranking law, from a strictly legal point of view. In the context of this compatibility of anti-tax avoidance measures concerning royalty payments with higher-ranking law, it is necessary to assess the respective interactions not only with regards to treaty law and model tax conventions, but also the relevant European legislation and, given the international nature of the task, the often forgotten WTO law and bilateral investment treaties. In this section, the consistency of the measures previously studied with the current international tax framework will be discussed, and eventual incompatibilities will be put to the test.

In recent years, a certain tax awareness regarding base erosion and profit shifting has grown in the international environment not only through projects of a more technical nature such as those of the OECD, G20 and the European Union, but also in the public milieu due to tax scandals of large companies such as Starbucks, Apple, Facebook, Amazon and so on. The proliferation of such tax outrages has recently revealed some tax avoidance practices at an international level with massive amounts of revenue, and their resonance in the media has exacerbated a legitimate sense of injustice on the part of citizens, which has increased public pressure on politicians to take up action against such arrangements. The issue with royalties goes beyond mere transfer pricing or GloBE minimum tax issues, and that is why a holistic approach to this specific problem must be adopted.

Thus, the final part and ultimate goal of this thesis will be to present a reasonable, balanced and technical solution to the specific problem of base erosion and profit shifting arising from aggressive tax planning schemes involving payments for the right to use intellectual property. In order to do so, each of the available measures must necessarily be evaluated individually in its various dimensions, taking into account the different interests that countries in distinct economic circumstances may have in solving this issue.

Zusammenfassung – German Abstract

In jüngster Zeit ist nicht nur multinationalen Unternehmen, sondern auch der breiten Öffentlichkeit deutlich geworden, welche Bedeutung immaterielle Vermögenswerte in der modernen Geschäftswelt haben. Unternehmen, die für die normalen Bürger als „erfolgreich" gelten, sind nicht mehr notwendigerweise solche mit riesigen Fabriken, Tausenden von Mitarbeitern und schweren Maschinen, sondern solche mit Vermögenswerten, die in der Lage sind, auf der Grundlage von Ideen, Patenten, Software, Know-how usw. Werte zu schaffen. Geistiges Eigentum (IP) ist daher heute mehr denn je sowohl eine Art von Vermögenswert, der aufgrund seiner Einzigartigkeit mit der Schaffung von Werten verbunden ist, als auch ein äußerst effizientes Mittel für multinationale Unternehmen (MNEs), um international Steuern zu sparen.

Solche internationalen Konzerne nutzen die Möglichkeit der einfachen Übertragung und der schwierigen Bewertung immaterieller Güter, um das Eigentum an ihren Vermögenswerten strategisch auf verbundene Parteien in Niedrigsteuerländern zu übertragen - sei es in Steueroasen oder in Ländern mit besonderen Fördermaßnahmen für geistiges Eigentum. Infolgedessen haben IP- oder forschungs- und entwicklungsintensive Unternehmen einen viel niedrigeren effektiven Steuersatz als nicht-innovierende Unternehmen. Eine bereits von Grubert durchgeführte Analyse zeigt, dass etwa die Hälfte aller Gewinnverlagerungen von Hochsteuer- in Niedrigsteuerländer tatsächlich auf Steuerstrukturen im Zusammenhang mit immateriellen Vermögenswerten zurückzuführen ist.

Dies geschieht aus verschiedenen Gründen und infolge einer Vielzahl von Faktoren, und obwohl nicht jedes multinationale Unternehmen genau die gleichen Strukturen oder Techniken zur Gewinnverlagerung einsetzt, folgen die verwendeten Strategien einigen spezifischen Standards und haben relativ gut definierte Anforderungen. Doch trotz der rasanten Entwicklung der Bedeutung immaterieller Güter und einer starken Verlagerung der wirtschaftlichen Prioritäten und der allgemeinen Unternehmensstruktur multinationaler Unternehmen wurde im Bereich des internationalen Steuerrechts bisher nur unzureichend reagiert. Während viele Länder und die OECD seit Jahren Strategien entwickeln, um Gewinnverlagerungen entgegenzuwirken, welche z.B. Verrechnungspreisvereinbarungen oder konzerninterne Fremdfinanzierung nutzen, indem sie Regeln wie die Beschränkung der Abzugsfähigkeit von Zinsen, CFC-Regeln und Dokumentationspflichten für Verrechnungspreise einführen, wurden Strategien, die immaterielle

Vermögenswerte und grenzüberschreitende Lizenzzahlungen (oder "Lizenzgebühren") aufgrund von Lizenzvereinbarungen nutzen, nicht zufriedenstellend behandelt.

Diese Lücke im internationalen Steuerszenario hat einige Länder wie Deutschland, Österreich und sogar die Ukraine dazu veranlasst, in letzter Zeit am Rande des internationalen kooperativen Systems der OECD und des neueren GloBE-Vorschlags unilaterale Maßnahmen zu ergreifen, um der Gewinnverschiebung durch immaterielle Vermögenswerte entgegenzuwirken, zu denen auch die sogenannten Lizenzschranken gehören.

Dieser Mechanismus verhindert nach Erfüllung einer Reihe von Anforderungen den Abzug konzerninterner internationaler Lizenzgebühren und stellt sicher, dass der Betrag zumindest einmal in erheblichem Umfang in dem Land besteuert wird, das die Regel eingeführt hat. Im Mittelpunkt dieser Dissertation stehen die oben genannte Regelung sowie alle anderen Instrumente, die im Kampf gegen die Aushöhlung der Bemessungsgrundlage und die Gewinnverlagerung (BEPS) im Zusammenhang mit geistigem Eigentum hilfreich sein können, wie z. B. ein umgekehrtes Steuergutschriftensystem, die (Wieder-)Einführung von Quellensteuern usw., sowie die mit diesen Instrumenten verbundenen Probleme. Die Bedeutung dieser Analyse zeigt sich darin, dass sie versucht, eine endgültige Antwort auf ein Problem zu finden, das bis heute zu intensiven BEPS-Aktivitäten multinationaler Unternehmen geführt hat und weder international noch im Inland angemessen behandelt wurde.

Die vorliegende Arbeit ist unseres Wissens die erste monographische Studie in englischer Sprache mit diesem methodischen Ansatz bei Lizenzgebühren. Mittels einer deduktiv-analytischen Methodik wird jede der verschiedenen gesetzgeberischen Maßnahmen, die zur Bekämpfung der künstlichen Gewinnverschiebung und der Aushöhlung der Steuerbemessungsgrundlage durch grenzüberschreitende konzerninterne Lizenzgebühren eingesetzt werden können, aus dieser besonderen Perspektive gründlich analysiert. Schließlich soll eine normative Lösung in Form eines Best-Practice-Ansatzes für eine (realistische) Lösung des Problems mit dieser Art aggressiver Steuerplanungsstrukturen vorgestellt werden.

Zu diesem Zweck werden im ersten Teil dieser Arbeit die Definition, die begriffliche Abgrenzung und die Grundlagen der Abgaben auf immaterielle Wirtschaftsgüter und der IP-Steuerplanung untersucht. Besonderes Augenmerk wird dabei auf die internationale Literatur zu diesem Thema gelegt, wobei die Pluralität der Konzepte und die Notwendigkeit einer genauen

Abgrenzung des geistigen Eigentums als Gegenstand der Besteuerung und der internationalen Steuerplanung berücksichtigt werden, um die internen Grenzen für den Forschungsrahmen im Kontext des Steuerrechts festzulegen.

Ausgehend von dieser konzeptionellen Zusammenfassung, die das vorliegende Problem hervorhebt, konzentriert sich diese Untersuchung zunächst auf die Hauptproblematik allgemeiner Maßnahmen wie GAARs, Verrechnungspreise und CFC-Vorschriften, mit der Absicht, unterschiedliche, auf das gleiche Ziel ausgerichtete Maßnahmen zu bewerten, und zwar unter Beleuchtung des Problems der Zahlung von Lizenzgebühren. Darüber hinaus werden die Unzulänglichkeiten und Unstimmigkeiten der jeweiligen Systeme hervorgehoben, um zu zeigen, dass diese Regeln trotz ihres breiten Spektrums aus verschiedenen Gründen nicht ausreichen, um aggressive Steuerplanungsstrukturen zu bekämpfen, die geistiges Eigentum (aus-)nutzen. Am Ende dieses Kapitels erfolgt ein kurzer Exkurs zum Nexus-Ansatz der OECD, um zu verdeutlichen, dass dieser auf die Wertschöpfung ausgerichtete Ansatz weit davon entfernt ist, den Belangen des geistigen Eigentums gerecht zu werden und Präferenzregelungen zu legitimieren, die weiterhin als Teil von Steuersparmodellen genutzt werden.

Im folgenden Kapitel werden dann spezifische Maßnahmen - wie die relativ neuen Schranken für die Abzugsfähigkeit von Lizenzgebühren, umgekehrte Steuergutschriften, der GloBE-Vorschlag und sogar das US-amerikanische BEAT/SHIELD - anhand eines ganzheitlichen Ansatzes bewertet, bei dem die Umsetzung jeder Maßnahme nach ihren Funktionsmechanismen, ihrer Wirksamkeit und ihrer praktischen Durchführbarkeit beurteilt wird. Dies ist einer der wichtigsten Kernelemente des Projekts, da diese spezifischen Maßnahmen das Problem gezielt und angeblich endgültig lösen sollten. Jede von ihnen hat jedoch ihre eigenen Schwächen, die von starken wirtschaftlichen Auswirkungen und der Minderung der Wettbewerbsfähigkeit eines Landes als Wirtschaftsstandort über die Unvereinbarkeit mit höherrangigem Recht bis hin zu Schwierigkeiten bei der praktischen und politischen Umsetzung reichen.

Nach einer umfassenden Analyse der einzelnen Alternativen zur Bekämpfung von BEPS durch Lizenzgebühren wird in dieser Arbeit die Vereinbarkeit dieser Maßnahmen mit höherrangigem Recht aus rein rechtlicher Sicht untersucht. Im Rahmen dieser Vereinbarkeit von Steuervermeidungsmaßnahmen bei Lizenzgebühren mit höherrangigem Recht ist es notwendig, die jeweiligen Wechselwirkungen nicht nur mit dem Vertragsrecht und den Musterabkommen,

sondern auch mit der einschlägigen europäischen Gesetzgebung und - angesichts des internationalen Charakters der Aufgabe - mit dem oft vergessenen WTO-Recht und bilateralen Investitionsabkommen zu bewerten. In diesem Abschnitt wird die Vereinbarkeit der bisher untersuchten Maßnahmen mit dem aktuellen internationalen Steuerrecht erörtert und eventuelle Unvereinbarkeiten werden auf den Prüfstand gestellt.

Der letzte Teil und das letztendliche Ziel dieser Arbeit besteht daher darin, eine vernünftige, ausgewogene und technische Lösung für das spezifische Problem der Aushöhlung der Bemessungsgrundlage und der Gewinnverschiebung aufgrund aggressiver Steuerplanungsmodelle, die Zahlungen für das Recht auf die Nutzung geistigen Eigentums beinhalten, zu präsentieren. Dazu muss jede der verfügbaren Maßnahmen notwendigerweise einzeln in ihren verschiedenen Dimensionen bewertet werden, wobei die diversen Interessen zu berücksichtigen sind, die Länder mit unterschiedlichen wirtschaftlichen Gegebenheiten bei der Lösung dieses Problems verfolgen können.

Chapter 1: Definition, conceptual differentiation and fundamentals of the taxation of intangible assets and IP tax planning

As previously outlined, the object of this study is restricted solely to the treatment of intellectual property and, more specifically, royalty payments in an international taxation scenario. Therefore, even prior to determining how these assets are used – and maybe abused – as an integral part of tax planning opportunities by multinational companies, it is necessary to define more precisely the contours of IP and of the transactions in the form of royalty payments that are potentially carried out.

The conceptual bases are always of paramount importance in any legal-economic analysis of a problem; however, this is of unique relevance in this case given the innovative nature inherent to intellectual property. The recent development in its significance is evident when we analyze the exponential growth of value attributed to intangible assets and companies associated with them since the end of the last century,[2] as well as their systematic use in tax avoiding mechanisms.[3]

This initial chapter will discuss the framework of intangibles and inherent boundaries with respect to similar concepts, the basis of their taxation, as well as the treatment given nationally and internationally in the field of tax law to intellectual property and royalty payments. This will all be done in order to demonstrate that intangible assets are much more than just your average asset, since their utility goes beyond simply increasing a company's profitability and competitiveness *per se*, but can also be easily employed strategically as a means of saving taxes with complex transnational structures.

[2] The share of value associated with intellectual property within companies has risen dramatically, which also quickly changed the scenario of the most valued companies and brands worldwide by itself. For reference, see the work since 1996 of Brand Finance (2019): Global 500, 2019. Available online at https://brandfinance.com/images/upload/global_500_2019_locked_4.pdf, checked on 15.01.20.

[3] As mentioned, an early analysis by Grubert shows that approximately half of all profit transfers from high-tax to low-tax countries can be traced back to tax structures in connection with intangible assets. Grubert, Harry (2003): Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location. In *National Tax Journal LVI (1)*, P. 221ff

1.1 Overview and definition of the research objects

When dealing with the definition given to intellectual property and what royalty payments derived from its use may be, it is of utmost importance to remember that several valid sources can be used for this same delineating purpose. The first and most obvious option would be to analyze the definition chosen by the legislator as the most appropriate, according to the dictates of each country's domestic law. It should be noted that the definition for purposes of intellectual property protection, company accounting and/or for tax purposes may all be slightly different, depending on the legal framework employed.[4] That is to say that alongside categories naturally found in a civil law context, there can be substantial distinctions in the respective national tax and accounting legislation – whether based on International Financial Reporting Standards (IFRS) or not.

1.1.1 Analysis through an international outlook

In particular when it comes to international trade and taxation, it is essential that there be some consistency and harmony between the classifications of different countries.[5] This would, for instance, avoid possible asymmetries in the treatment of the income received by the payee and the deductions obtained by the payer. Thus, instruments of a supranational nature – next to the IFRS such as the OECD working papers and its BEPS project, as well as European legislation on the subject – facilitate and standardize the conceptualization and delineation of the boundaries of intangible assets.[6]

Given the international character of this work, our focus will be, in particular, on rules and definitions established internationally through consensus, since, in order to elaborate a specific solution to the problem of profit shifting with intangibles,[7] this should be adequate to parameters

[4] While intellectual property law issues are linked to the ownership and protection of exclusivity rights linked to IP, the tax and accounting aspect deals almost exclusively with the economic benefits that derive from the usage of this IP, and to whom such revenue should be assigned to. This leads oftentimes to undesired gaps between definitions.

[5] It makes perfect sense to wish to interpret notions widely used internationally as intellectual property and royalties in line with common global usage, as indicated by Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 294f.

[6] This harmonization at an international level is essential and can in many cases be decisive for the resolution of a legal issue. This occurred recently in the long dispute between Amazon.com and the U.S. IRS, where the central point of the discussion was focused on the definition given to intangible assets and intellectual property. See for instance the work on this case by Engelen, Christian (2020): Definition immaterieller Wirtschaftsgüter. In *Der Betrieb* (6), P. 252ff.

[7] Seen in further detail on Chapter 1.4.

widely accepted within the OECD and/or the European Union.[8] The OECD BEPS Action Plan 8-10, which deals with transfer pricing issues, has as one of its main objectives to establish a broad and clearly delineated definition of intangibles in order to avoid the occurrence of profit shifting through uncontrolled movement of intangibles between countries.[9] The concept of "intangible"[10] is therefore used to designate something that is not a physical or a financial asset[11], but that has value because it can be used – either through ownership or mere control – in different ways in commercial activities, whose use or transfer would necessarily give rise to some kind of pecuniary compensation in the event of a transaction between independent parties.[12] Obtaining precision in this type of classification is essential as there may be an entirely different tax treatment for initially similar transfers based on whether or not the goods involved are classified as intangible assets.[13]

Moreover, the glossary of statistical terms[14] of the OECD – used to obtain analytical data regarding this area and others – complements this concept and indicates, promptly, that there are different ways of subdividing and classifying these intangible assets, which are broadly typified by being non-financial assets without physical presence. Nonetheless, they can also be, in principle, (a) non-produced assets that entitle their owners to engage in certain specific activities or to produce certain specific goods or services and to exclude other institutional units from doing so except with the permission of the owner, as is the case with patents; or (b) produced fixed assets, which are basically software, entertainment, literary or artistic originals intended to be used for a longer time period.[15] A similar definition is adopted by the World Intellectual Property

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[8] In order to facilitate the convergence of national systems, as well as allowing for the steering towards "best practices". See Barrett, William C. (2019): Using IPA 2015 as a Model for OECD Market Intangible Consultation. In *Tax Notes International* 95 (5), P. 427f. for more on this discussion.
[9] For further information on this matter, OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports. Available online at http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm, checked on 04.10.18, P. 63.
[10] *Ibid*., P. 67.
[11] By "financial assets" are meant here cash or equity instruments and derivatives such as stocks, bank deposits, shares, forward and future contracts etc.
[12] Many are, however, critical of this concept given its broadness. See for example Ditz, Xaver; Pinkernell, Reimar; Quilitzsch, Carsten (2014): BEPS-Reformvorschläge zu Lizenzgebühren und Verrechnungspreisen bei immateriellen Wirtschaftsgütern aus Sicht der Beratungspraxis. In *IStR* (2), P. 49f.
[13] As seen, for instance, on the long discussions between Facebook and the IRS due to cost-sharing agreements for the transfer – and later licensing – of IP in Europe. Refer to Sarfo, Nana Ama (2020): Facebook and the IRS Tangle Over Meaning of Intangibles. In *Tax Notes International* 97 (10), P.
[14] This database utilizes the classification obtained from multiple other reliable sources, such as documents from the UN, ILO, OECD, Eurostat etc. Available at https://stats.oecd.org/glossary/, checked on 16.01.22.
[15] See United Nations (2008): System of National Accounts. United Nations Statistical Commission (UNSC). Available online at https://unstats.un.org/unsd/nationalaccount/docs/SNA2008.pdf, checked on 16.01.20., P. 196.

Organization (WIPO), which characterizes the aforementioned assets as *industrial property* and *copyright*,[16] respectively as categories of intellectual property.

1.1.2 The correlation between internationally discussed standards and national concepts

Nevertheless, it should not be overlooked that establishing objective criteria for gauging what would be considered intangible, although essential, is extremely difficult given not only the abstract nature of IP, but also the double-sided risk of obtaining either an unduly narrow, or too broad a definition of the term.[17] This occurs because, if a broad definition is chosen in order to encompass as many assets as possible by the rules that may affect intellectual property – such as the possibility of expense deductions, transfer pricing, CFC rules etc. in the tax world – there is for instance a risk that the eventual use of, or transactions involving, objects covered by the definition may give rise to a requirement of compensation between related parties when, in the case of use or transaction of IP between independent entities, this would not occur. On the other hand, if the definition adopted is too restrictive, there may be dissatisfaction in the opposing direction on the part of both taxpayers and tax authorities, since benefits would possibly not be granted to items that fall outside the scope of the definition, and/or transactions involving such items between related parties would not be properly offset.

1.1.2.1 Perspective from different areas of law: civil law and national tax law

Therefore, there is a clear trade-off to be considered by the national legislator when implementing or mirroring internationally developed definitions. As a rule, intellectual property is firstly spoken of from a *civil* and *commercial law* perspective, as these are the areas in which there is the greatest initial interest in this type of asset. Only in the background emerges the conceptualization from the *tax* and *accounting* point of view, in the event it has any specific differentiation. In some cases there is not even a clear legal definition of the characteristics and framework of intellectual property through national civil law – as was the case of Germany for a long time[18] – but rather a mention to the link between possibility of ownership and the exclusive

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[16] For more information on their work and this classification, please refer to World Intellectual Property Organization (2004): What is intellectual property?, P. 2ff.
[17] OECD, *op. cit.*, Fn. 9. P. 67.
[18] See Heinze (2012): Kapitel 2: Zivilrechtliche Grundlagen, in: Haase (Ed.) - Geistiges Eigentum. Nationales und Internationales., P. 24.

rights typical to tangible property, guaranteed both nationally by §§903 and 90 of the German BGB (Civil Code) as well as by the German Constitution in its Article 14.[19] This is furthermore ensured at the European level regarding intellectual property through Article 17 para. 2 of the Charter of Fundamental Rights of the EU.

Of course, case-law is ultimately responsible for establishing, even if indirectly, the contours of concepts not laid down in the national legislation. Nonetheless, specifically in the German case, for instance, the concept of "asset" is consistently very broadly formulated by the Federal Tax Court (*Bundesfinanzhof*, BFH). Thus, an asset of any nature – be it intangible or not – is in the foreground from the moment on that a legal object with value that can be autonomously defined exists, being negotiable and having a lasting usability.[20]

Thus, the German choice in both civil and tax law was to draw up rules with a simple enumeration of the assets included in the protective scope of copyright and competition rules.[21] The idea is that what is considered intellectual property should be explicitly recognized as such, and by a process of exclusion anything that is not acknowledged as one of the elements listed in this list or analogously compared to one of them should not be considered IP. This ensures greater legal certainty and predictability regarding the specific (tax) effects of the use or transfer of intangibles, at the cost of restricting the scope of these rules to the legislator's creativity in listing all to date known possibilities of intangible assets.

1.1.2.2 Perspective from different areas of law: accounting standards

While definitions of intangible assets from a civil or tax law perspective can be widely different when evaluated in different countries, there is one specific area where international standards ensure greater harmonization of the concept of intangibles: accounting law through the International Financial Reporting Standards. Used in about 87% of profiled jurisdictions for all

[19] More recently, however, the German parliament decided to introduce such a definition alongside the OECD DEMPE concept following the OECD transfer pricing guidelines through the AbzStEntModG, as discussed in Stein, Stefan; Schwarz, Christian (2021): Verrechnungspreise immaterieller Werte im Lichte des DEMPE-Konzepts. In *Der Betrieb* (24), P. 1292ff.

[20] See for the concept of autonomous intangible assets BFH, 20.03.2003 - IV R 27/01, BStBl II 2003, 878; as well as BFH, 28.05.1979 - I R 1/76, BStBl II 1979, 734.

[21] Heinze, *op. cit.*, Fn. 18, P. 31.

companies operating in national territory,[22] according to the International Accounting Standard (IAS) 38 an intangible asset will be identified as such to the extent that it meets the definition[23] provided by IFRS *and* if it can be recognized[24] as such. Of course, these definitions may only apply to accounting law depending on the country, or they may also serve as a general parameter for other areas of law such as civil or tax law. It should also not be forgotten that these standards, although widely applied, are not unanimous worldwide, and each country is free to diverge from these definitions not only in adjacent areas of law, but also in the use of other accounting standards altogether.

This is the case of the United Kingdom and its common law system, which has greater freedom in the elaboration and updating of the concepts used. This occurs because the definitions concerned are established in this case by a specific body for the analysis of accounting and trade balance issues, of which intangible assets are an integral part of. Thus, in this particular example, the Financial Reporting Council (FRC) expressly defined intangible asset in its Financial Reporting Standards[25] in section 18.2 – until an update in 2017 – as being an identifiable non-monetary asset without physical substance, which must either be necessarily separable, *i.e.* capable of being separated from the entity as a whole and have its use or property transferred through a commercial transaction; or must arise from contractual or legal rights, regardless of whether they are transferable or not. A concept, nevertheless, relatively in line with IFRS standards.

Currently, after a triennial review in 2017,[26] this definition is no longer present in the body of the British Financial Reporting Standards, but only as a clarification in the glossary of the

[22] See IFRS Foundation (2018): Use of IFRS Standards around the World. Available online at https://www.ifrs.org/content/dam/ifrs/around-the-world/adoption/use-of-ifrs-around-the-world-overview-sept-2018.pdf, checked on 03.05.22, P. 2.

[23] Similarly as seen above, that of an identifiable non-monetary asset without physical substance. Refer to IFRS Foundation (2020): IAS 38. Intangible Assets. Available online at https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2021/issued/part-a/ias-38-intangible-assets.pdf, checked on 03.05.22, P. 7.

[24] Which means that it should be probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and that the cost of the asset can be measured reliably. *Ibid*., P. 10.

[25] For the latest version, see Financial Reporting Council (2022): FRS 102 - The Financial Reporting Standard applicable in the UK and Republic of Ireland. Available online at https://www.frc.org.uk/getattachment/c66c1d97-5943-413c-b354-f122e07f144d/Redacted-FRS-102-(January-2022).pdf, checked on 03.05.22.

[26] On Financial Reporting Council (2017): Amendments to FRS 102 - The Financial Reporting Standard applicable in the UK and Republic of Ireland. Triennial review 2017. Incremental improvements and clarifications. Available online at https://www.frc.org.uk/getattachment/9be202ba-351d-4e38-9d09-1982cb20d666/Amendments-to-FRS-102-Triennial-Review-2017-(Dec-2017).pdf, checked on 20.01.20, P. 75.

document in its Appendix I.[27] This does not necessarily mean that the concept has been changed or expanded. However, these simple modifications either to national accounting standards or – preferably – to the IFRS in countries using them, allow greater flexibility in the interpretation of the concept by not restricting it to a single civil and/or tax law-established definition, allowing it to be made in a much more straightforward manner than in countries that have stricter requirements of legality and predictability.[28] Therefore, the conceptualization of the term may evolve in a way that is more synchronized to commercial and technological advances instead of always being one – or more – steps behind, which is certainly of great help in combating the most innovative forms of BEPS.

It is also important to emphasize that, in many cases – as well as in this work –, the terms "intangible assets" and "intellectual property" are commonly used as synonyms. Be that as it may, some authors see fit to make a slight differentiation between the terms,[29] being the former considered broader than the latter, encompassing it in its entirety. In general, intangible assets would cover a wider range of assets than purely intellectual property, even though this is, as a rule, the main asset that generates value beyond a common profit margin in a business and is therefore used for profit shifting.

What is crucial to grasp is that the concept of intangibles can vary from one country to another, and the greatest risk this offers is that such asymmetries may allow for and lead to abuse by internationally active taxpayers due to different classifications in different countries. However, as clarified above, there are relatively prevailing international criteria that allow for further clarification of the terms used, although it is essential that countries use and interpret these concepts widely employed internationally – for example in double taxation agreements and accounting standards – in a unique and harmonious way.[30] This, combined with the delimitation of intangible assets relative to other distinct terms, allows for a greater understanding of the diverse forms and characteristics intangible assets can have, which aids in determining how they are being

[27] See P. 309 of the Financial Reporting Standards for reference.

[28] To the dismay of tax practitioners wishing for more concrete standards, as seen in Hickman/Rockall (2008): Intangibles in the UK - too. In: Lillian Adams (Ed.) - Transfer Pricing aspects of IP., P. 44f.

[29] Such as Fairpo (2016): Taxation of Intellectual property., P. 3.

[30] This holds true in our case not only for IP, but also royalty payments in general. For more on this opinion, see Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) - 100 Jahre Steuerrechtsprechung in Deutschland., P. 926ff.

used to generate income and return on investments, as well as to shift profits. This is what we shall see in the following sections.

1.1.3 Conceptual differentiation of "intangible assets"

While some legal systems establish approximate contours, and others elaborate lists containing possible intangible assets, one can also use as a criterion the *difference* of those with respect to other assets that have some features in common. This is a way of further narrowing down this relevant concept and avoiding risks of confusion with other legal objects.

It should naturally be noted in this hypothesis that, depending on the domestic legislative choice, these distinctions may be greater or lesser, as well as their corresponding significance in determining what should or should not be considered IP in a given business. For this reason, the German example will be once more highlighted here, given that despite the existence of lists with the names of possible intellectual property items in the tax law field, the general definition on the matter is lacking, leading the overall understanding given by the courts of what are assets to be extremely broad – and to a lack of differentiation with respect to other legal concepts.

1.1.3.1 Intangible *vs.* tangible assets

While it is true that intangible assets also possess several characteristics attributable to tangible assets – such as their appraisability, autonomy and negotiability – their difference is also *prima facie* apparent: intangible assets lack corporeality and are therefore not physically graspable.[31] However, the concept of tangibility in business and tax law is not always black and white. It will also include, for example, financial assets, which despite also representing relatively abstract concepts such as cash, equity instruments, shares etc., have their value derived directly from tangible property.[32]

Even more problematic is when there is a mixture between material and immaterial assets in a single object or transaction, in which there is no clear separation between the two. This occurs when there is, for example, the transfer of a software connected to a hardware, and it is essential to determine which of the two aspects of the object is the more responsible for its worth, that is,

[31] In Germany, for instance, this was recognized as of the last century by the German Federal Fiscal Court, on BFH, 03.07.1987 - III R 7/86.
[32] See Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern., P. 14f.

which of the two is paramount for the determination of market value.[33] Such a differentiation is crucial insofar as the transfer of an intangible good and that of a tangible good can produce different results in terms of their valuation, form of remuneration and applicable legislation, both at national and international level. Therefore, as a rule, what is observed in hybrid cases is the choice of distinguishing between tangible and intangible goods on the basis of its primary aspect, *i.e.* which generates the highest market value for the good.

1.1.3.2 Intangibles *vs.* Goodwill

By drawing a parallel between intangibles broadly considered and goodwill, one notices that the line separating them is much narrower than between tangible and intangible assets. In fact, goodwill is generally seen as an intangible asset as well,[34] however it is usually differentiated from intellectual property and other intangible assets as, unlike the others, it cannot be individualized and valued separately as an entrepreneurial component. One of the most common definitions used to differentiate goodwill from these other assets is that it is always calculated in a way to reflect the difference between the aggregate value of an operating business and the sum of the values of all tangible and intangible assets that can be individualized and assessed by themselves. This highlights the difficulty in classifying and appraising goodwill, since it accounts for all the value that an operating business possesses that cannot be remitted specifically to any of its assets.[35]

This difficulty in valuing goodwill and intellectual property as a whole has been recognized for almost half a century,[36] although considering the increasing participation of goodwill in the creation of value within the balance sheet of a company,[37] it is necessary to understand how to identify it and determine its worth, separately from the other intangibles. Thus, only the elements that cannot be evaluated independently, that is, those that constitute the value of the business as a whole, but are not specifically linked to any asset, compose the goodwill. The greatest emphasis given to this type of intangible asset is usually linked to the acquisition of a business – as goodwill

[33] See also Reichl (2013): Verrechnung immaterieller Wirtschaftsgüter im internationalen., P. 10ff.
[34] This will be discussed from an international perspective and clarified in-depth on Section 1.2.2.4, for now I will restrict myself to the delimitation between concepts.
[35] OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports. Available online at http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm, checked on 04.10.18, P. 72f.
[36] See Moxter, Adolf (1979): Immaterielle Werte im neuen Bilanzrecht. In *BB* 10 (22), P. 1102ff.
[37] As ascertained by Leibfried, Peter (2016): Goodwill, die Gretchenfrage des Accounting. In *Zeitschrift für Internationale Rechnungslegung*, P. 353.

can be a very significant part of a whole – but its usefulness is not only restricted to this type of transaction: for accounting and taxing purposes this type of asset must also be taken into consideration.

Elements such as the internal and external corporate structure, trained and qualified workers for specific internal company tasks, etc. are commonly considered goodwill according to this definition. In other instances, this separation is not so clear and must be evaluated in each case, as is true for example with the customer base that a company has due to its previous services and reliability, as well as the future profit outlook that a particular company has. Such concepts are extremely abstract and difficult to outline and appraise, but special attention is given in some legal systems specifically to the so-called "business opportunities", given their commercial relevance, which will be discussed and further differentiated below.

1.1.3.3 Intangibles *vs.* Business Opportunities

In contrast to tangible assets, a more abstract question is the inclusion or not of business opportunities as immaterial assets that should be analyzed independently of goodwill. There is no strict definition of what a business opportunity might be;[38] however, it is generally understood as being the prospect of a business – whether in its initial stages or not – to produce revenue from its activities.[39] However, this possibility has to be clearly recognizable and independent from other business assets in order to be regarded by itself, and this "opportunity" needs to be endowed with profit potential. The main consequence of treating a given business opportunity as an independent asset is that, *e.g.*, when an (international) reallocation of functions on a given business is carried out, this opportunity would have to be assessed according to arm's length parameters[40] and duly compensated separately to avoid profit shifting, increasing the taxable income arising from the transaction.[41]

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[38] For comprehensive information on this topic, see Wassermeyer, Franz (1997): Die neuere BFH-Rechtsprechung zu Verstößen gegen ein Wettbewerbs- verbot durch den Gesellschafter-Geschäftsführer einer GmbH – Anmerkungen zum BFH-Urteil vom 13. 11. 1996, BFH 13.11.1996 Aktenzeichen I R 149/94. In *DStR*, P. 681ff.
[39] See Gosch (2015): § 8 Ermittlung des Einkommens. In: Gosch (Ed.) – Körperschaftsteuergesetz., paragraph 850a.
[40] Further discussed on Chapter 2.1.1.
[41] For more information, Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern., P. 17f.

The OECD acknowledges this possibility,[42] however without specifically deciding on whether to independently recognize a business opportunity as an intangible asset. In some jurisdictions, it is seen as one in relation to goodwill, as is the case in the United Kingdom given the broad definition given to the latter;[43] while in others it is expressly accepted by the tax authorities as being an asset of its own and having independence[44] and therefore must have its value properly assessed and compensated in any transaction of which it is a part of.[45]

Regardless of the approach adopted nationally to classify business opportunities as an intangible asset that can be transferred independently or not, the key factor is that there is consistency in the application of this classification, *i.e.*, from the moment this asset is considered to be independent, that it is adequately appraised in the relevant transaction. The OECD has, however, attempted in some cases to indicate what would be the appropriate or most indicated classification with respect to intellectual property, which serves as the basic parameters for implementation in domestic legislation of how to categorize and, consequently, value and tax specific assets. This international perspective, which can serve as a model for further evaluations, now becomes the focus of debate.

1.2 An international perspective through the OECD

As noted earlier, the concept and specific categories of intangibles will be varied and may have different outlines grounded on distinctions between contrasting legal systems. To avoid asymmetries in the international tax treatment of intangible assets and transactions involving them, the OECD has seen fit to present its own classification, which, despite in some cases not opting for any specific path to define a certain asset, lists the different possibilities of classification and conceptualization, presenting viable options that serve as a basis for countries that have an interest in implementing the BEPS project.

[42] OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports. Available online at http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm, checked on 04.10.18, P. 72f.
[43] See Fairpo (2016): Taxation of Intellectual property, P. 30.
[44] As is the case in Germany, expressed by the Federal Ministry of Finance in 13.10.2010 – IV B 5 – Section 2.1.4.3, paragraph 37.
[45] A deeper insight can be found on Dieck (2008): Besteuerung grenzüberschreitender Funktionsverlagerungen im Wandel, Paragraph 3.1.5ff.

Special attention was also given to the so-called "hard-to-value intangibles", a specific category of assets that, given their unprecedented and innovative character, do not have minimum comparison parameters so that their value can be satisfactorily determined through the traditional rules of transfer pricing. They make up a specific category of intangibles that has an even greater difficulty of valuation in relation to others, and shall also be further discussed in detail.[46]

1.2.1 Main OECD goals and endeavors on intangibles so far

The most recent and comprehensive OECD work dealing specifically with the classification of intangibles is that of the BEPS project's Action Plans 8-10,[47] *i.e.* those related to transfer pricing issues and problems. Originally, a specific work with guidance on transfer pricing aspects of intangibles was presented in 2014,[48] which in the meantime had to be reformulated and updated for release as a final report of the BEPS project in 2015. This liaison between intangible assets and transfer pricing is not surprising, considering that one of the greatest challenges regarding intellectual property is its valuation, combined with its high mobility, which leads to many concerns in the application of traditional transfer pricing parameters, that often rely on comparables to successfully apply the arm's length principle.

Therefore, the OECD's attempt to promote an alignment of transfer pricing outcomes with value creation is mainly dedicated to intangibles, how to identify them and which transactions are relevant to this type of asset. The purpose of this approach is ultimately to ensure that the profits associated with the use and sale of intangibles are made in accordance with basic value creation parameters,[49] with special attention to the so-called hard-to-value intangibles.[50]

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[46] See Section 1.2.3.

[47] Available online at http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm, checked on 04.10.18.

[48] OECD (2014): Guidance on Transfer Pricing Aspects of intangibles. Action 8: 2014 Deliverable. Available online at http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm, checked on 04.10.18.

[49] Even though, in more recent OECD works, the concept of „value creation" has fallen into ostracism, disappearing much in the same way as it appeared: out of the blue, as mentioned by Hey, Johanna (2018): "Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative. In *Bulletin for International Taxation* 72 (4/5), P. 205f. This probably happened due to recent criticism, especially by developing countries. See the discussion by Das, Rasmi Ranjan (2020): The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights? In *Bulletin for International Taxation* 74 (3), P. 134ff.

[50] OECD, *op. cit.*, Fn. 42. P. 63f.

This would provide greater legal security both for multinational companies that use transactions with intangibles as part of their business – whether be it for criteria of bookkeeping or tax purposes, since these do not necessarily coincide – and for the tax authorities, which as a rule suffer from an asymmetry in the access to information regarding companies,[51] thus making it difficult to assess the trustworthiness of the information upon which the taxpayer estimated the value of a given transaction.

While the OECD has been dealing with the issue of intangibles for a while[52] – recognizing its importance both for economic growth and in the case of base erosion and profit shifting – it was from the second half of the last decade that more intense work was undertaken in this respect, insofar as it was perceived that intellectual property was increasingly being used for profit shifting opportunities. Thus, after the final report published in 2015, two more significant modifications were made in 2018, one specifically aimed at tax administrations, indicating what would be the ideal unified approach to handle hard-to-value intangibles;[53] and the other, a review carried out on one of the transfer pricing methods, more specifically the transactional profit split method,[54] which would be one of the most efficient to deal with IP, indicating how and when to use it properly. However, all this work is still based on the classification adopted in 2015 for the different forms of intangible assets by the OECD.

1.2.2 Specific categories

When talking about specific categories of intangible assets, it is worth mentioning that this classification is not universal or definitive, especially because (1) this document only has a recommendation nature, and each country was and still is free to define and classify intangible assets as they wish; and (2) any categorization related to innovation, development and technology

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[51] *Ibid*.
[52] See for instance OECD (2011): New sources of growth: intangible assets. A New OECD Project. Available online at https://www.oecd.org/sti/inno/46349020.pdf, checked on 04.10.18.
[53] OECD (2018): Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles. Inclusive Framework on BEPS: Action 8. Available online at https://www.oecd.org/tax/transfer-pricing/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf, checked on 10.12.19.
[54] OECD (2018): Revised Guidance on the Application of the Transactional Profit Split Method. Inclusive Framework on BEPS: Action 10. Available online at https://www.oecd.org/tax/transfer-pricing/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf, checked on 10.12.19.

must always be able to evolve according to scientific advancements and possible new commercial structures and transactions performed with intangible assets.

Nevertheless, the OECD recognizes the risk that inconsistencies between the legislation of particular countries on this issue could lead to double non-taxation or double taxation, both of which have undesirable effects on the international taxation scenario. Therefore, despite the attempt to restrict this classification to transfer pricing purposes only[55] – independently, for example, of the concept of royalties seen in Article 12 OECD-MC[56] – the usefulness of having an internationally acknowledged document with a classification of transferable intangibles in order to determine its value is undeniable.

More importantly, this classification deviates from the commonly established pattern of differentiation between *trade* or *marketing* intangibles, as well as *routine* and *non-routine* or *soft* and *hard* intangibles. This allows a more individual evaluation of each asset, according to general classification parameters, in order to have a less abstract representation of the contours of intangibles as a whole. This does not mean, of course, that this list is comprehensive. It does, however, cover the most important intangible assets in the production of value within a company, as well as those commonly used in licensing structures, the core issue at hand.

1.2.2.1 Patents

One of the most famous assets linked to intangibles and intellectual property are patents. These are, typically, a legal instrument that ensures an exclusive right to its owner and can be used for the production and sale of certain products; or the sale or licensing of the exclusivity right in itself, which is limited to a specific period of time for a defined geographical location.[57] Its forms of exploitation are directly linked to the possibility of taking advantage of this physical object or innovative work process in an exclusive manner, as a compensation for the time and resources invested in the research & development related to this patent.

Considering the risk and uncertainty of results when developing a patentable technology, it may be difficult to assess at an early stage the value it has considering the possibility or not of a

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[55] See OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 68f.

[56] Refer to Section 1.1.2.

[57] OECD, *op. cit.*, Fn. 55, P. 70.

significant commercial advantage arising from its use. Thus, in many instances it is necessary for the outcomes of a patent to be properly inserted into the market to determine its *de facto* value. In some circumstances, such a patent may not directly yield any positive return to its owner; however, given the need for disclosure of technical information about the product or process to the public as a requirement for obtaining the patent, its development may generate spillover to society[58] and the geographical location in which it is placed, one of the reasons why there are commonly tax incentives for investment in research & development of new knowledge and patents.

1.2.2.2 Know-how and trade secrets

Similar to patents, know-how and trade secrets represent the ownership of a specific knowledge or information that directly or indirectly has value for the commercial activity of a given company. However, the greatest distinction that can be made between these and the former is that there is no formal registration of this knowledge, that is to say, there is no direct legal protection for the use and replication of this information.[59] This allows, on the one hand, for this information not to have to be disclosed in any way to the general public, which ensures its "secrecy" character, not allowing, for example, competing companies to develop alternatives for the use of a possible patent. On the other hand, if the information is made public by any means, it will lack the protection conferred by the patent registration.

It should be noted, however, that it is possible that know-how and trade secrets may be indirectly protected through non-disclosure agreements of its employees and/or competition law. The use of the information potentially obtained by competitors may also be hindered to the extent that this information of a commercial, industrial or scientific nature may offer technological or economic barriers to its application,[60] given that the know-how and trade secrets arise from previous experiences of a business, having practical application theoretically only in the development of that specific activity of that particular company.

[58] See, for example, Theophilou, Christos A. (2019): Patent Boxes: The Rise, the Change or the Fall? In *Bulletin for International Taxation* 73 (5), P. 286ff.
[59] OECD, *op. cit.*, Fn. 55, P. 70f.
[60] *Ibid*.

1.2.2.3 Trademark, trade names and brands

When evaluating the definition of trademarks, trade names and brands, the outlines of each of these intangible assets become more and more blurred, being used in some cases interchangeably as synonyms. Of these three, "brand" is what is most often used as a synonym of the other two, being in some cases employed as a trademark or trade name that *possesses a social and/or specific commercial significance*.[61] In this specific case, a brand would therefore represent not only a trademark or trade name, but an amalgamation of intangibles, including, among others, the company's reputation, customer relationship and trust, etc. In this case, the individualization of the assets that make up a brand is difficult to achieve, resembling for example the characteristics of goodwill.[62]

The trademark, on the other hand, represents a logo, name, figure or symbol used by the owner to distinguish his product or service from others. It may be used for a single product or service or for a particular segment of these. Similarly to a patent, the owner of the trademark generally has exclusive rights to it, by means of a legal registration limited to a specific jurisdiction, but which may be extended indefinitely over time while the trademark is in use. The main purpose behind this exclusivity is to restrict the use of similar visual resources by competitors, which could lead to confusion in the marketplace and generate unfair competition among companies, as well as misleading the consumer.

Finally, the trade *name*, if used as a term separate from the trademark, is the concept that usually coincides with the market name of a given business, which is also commonly registered and protected legally. It is the business denomination used in its commercial and marketing relations, to be readily recognized by business and consumers alike.

As all these assets also represent forms of intellectual property, it should be noted that they may of course be transferred and/or sold as well. However, unlike patents, they are directly linked to a product or service and are therefore usually transferred together with the ownership of a business as a whole or through the selling of this product or service – with all names and logos assigned to it – linked to a trademark, for example.

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[61] *Ibid*., P. 71.

[62] For a full comparison, see the next Section 1.2.2.4.

1.2.2.4 Goodwill

Despite the many different meanings given to goodwill – which were previously mentioned in the parallel between this and other intangibles – the OECD saw fit to indicate in its document the possible relevance it may have in business transactions. More than establishing a precise outline of this type of intangible, it is rather necessary to recognize the monetary and economic value that it can represent. From the moment that the assets that might compose the goodwill, regardless of the "labeling" they bear, have commercial value, these must be taken into consideration in order to properly remunerate a transaction or transfer they are a part of.

In this sense, it is clear that the OECD's intention, given the different concepts used for this intangible, was to limit itself to the commercial and economic effects that it may eventually have in transactions and for transfer pricing purposes.[63] Depending on the interpretation chosen by a country, goodwill is commonly seen as (1) the difference between the value of a given business as gestalt and the sum of the values of all individually identifiable assets; but it is also described as (2) a representation of the possible future economic benefits that can be expected from the non-individually identifiable assets of a given business; and also (3) expectations of future profit founded on the customer base of a given company.[64]

Another term often used in conjunction with goodwill and similar to one of its definitions, making it even more difficult to define the concept, is that of ongoing concern value.[65] This is usually recognized as the excess value of the sum of assembled assets of a given company over the value of the assets measured individually.[66] Once again it is valid here to bear in mind that, regardless of the nomenclature or appearance of a certain intangible asset, it should be duly appraised and compensated for in the event of a transaction. This appraisal becomes, however, more complicated in cases of goodwill and/or ongoing concern value as these cannot be transferred independently of other business assets, being always linked to other tangibles and/or intangibles, or even the business as a whole.

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[63] See OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 72f.

[64] Which coincides partly with the business opportunities concept seen previously in Section 1.1.1.3.

[65] Also referred to as "*going* concern value", with different contours. See, for instance, Bärsch, Sven-Eric; Erb, Carsten (2018): Bestimmung fremdüblicher Verrechnungspreise bei der Übertragung von Marken. Die Markenbewertung im Blickwinkel aktueller internationaler Entwicklungen. In *DStR*, P. 631.

[66] OECD, *op. cit.*, Fn. 63, P. 72.

This makes the usage of internal business valuations for accounting purposes useful, but not decisive, in establishing the value of these assets for a transfer between companies of the same business group in a domestic or international transaction.[67] Depending on the circumstances and facts involving a particular transaction of these assets, accounting records can serve as the basis for determining their worth based on transfer pricing standards. As there is no single or precise definition of what these assets are, each individual case should be analyzed separately, and it is essential that both the tax authorities and the taxpayer take into consideration whether and how independent companies would remunerate a certain asset, regardless of the legal or economic definition adopted for goodwill and ongoing concern value.[68] In short, this means that if the specific characteristics of a business, such as the production of high quality products or the prestige of its services, allow, for example, a particular company to charge on these grounds more for its products or services, this added value should be taken into account when any alienation or transfer of the business, regardless of whether the denomination given to these assets is wholly or partially seen as goodwill, ongoing concern value, etc.

1.2.2.5 Limited rights in intangibles

Limited rights in intangibles are a highly interesting category of intangibles, as they virtually represent what a "metaintangible" would be, *i.e.* an intangible asset that arises from the existence of another intangible asset. These rights are of limited nature because there has not been a complete disposal of the asset in question, with a mere *license* of use and exploitation of an intangible asset. This license ensures the total or partial exploitation of an asset for a previously determined period of time, with or without restrictions in relation to its form of use, geographical area and entry market. This contract of use and (partial) allocation of rights constitutes, on its own account, an intangible of value for a given business, and its use should be duly rewarded. This is usually done in the form of royalty payments, that represent the core of this thesis.

1.2.2.6 Rights under contracts and government licenses

[67] *Ibid*.
[68] *Ibid*., P. 73.

Government licenses, unlike the ones seen above, are specific to a contractual relationship between public authorities and a company, which may represent a wide variety of corporate connections. The most common are the authorizations to develop a certain restricted economic activity or the rights to exploit a certain market and/or area, as well as its natural resources.[69] What ensures the value of these intangible assets is that the company will have a license granting a commercial advantage unavailable or available only after the fulfillment of certain requirements to its competitors, whose obtaining as a rule involves a cost for the company. It should be noted that these government licenses do not include the basic obligations to register a certain business, as these are essential requirements for the operation of a company, unlike the licenses described here, which grant an edge coming from the public authorities to the company that owns it.

The same can be said about specific contracts between individuals – despite having a different weight from a government license – in which these rights under contracts increase the value of a certain business by including, for example, agreements with important customers, suppliers, service providers, etc. Their values should certainly also be taken into consideration when selling a business, since the possibility of licensing these contracts on an individual basis is commonly forbidden or factually unfeasible, being thus very uncommonly used for profit shifting opportunities with royalty payments.

1.2.2.7 Group synergies

The so-called *group synergies* represent cooperation and cost reduction bonds within a given economic group. These relationships can contribute substantially to the level of income earned by a multinational corporation's group to the extent that the overall administrative costs can be reduced and borne cooperatively by the whole group, enabling for instance the use of integrated information systems, reducing inefficiencies in the form of duplicated efforts between different companies, etc.[70] In other words, any economic advantage that derives from the mere fact of being part of a group and acting – at least to some extent – as a unit should be taken into consideration when determining the arm's length conditions for transactions carried out.

[69] *Ibid.*, P. 71.
[70] See OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 73.

However, it is of paramount importance to note that, despite the economic importance of group synergies and their use as a comparability factor, they are *not* considered by the OECD to be an intangible asset.[71] This occurs because these synergies cannot be directly controlled or owned by a company, but rather arise almost naturally from the interactions coming from parts of a business group, combined with deliberated concerted group actions. Therefore, given their nature of an (incidental) benefit directed through synergetic and coordinated actions of a group, these synergies can and should be duly compensated financially in the case of a business transaction, although it is not feasible for them to be the object of a licensing agreement, being therefore of a rather limited relevance to the current work.

1.2.2.8 Market specific characteristics

Finally, it is worth mentioning the market specific characteristics, which as its name already indicates, represent the peculiar characteristics of a market that differentiates it from others, impacting the conditions of transactions carried out within its scope. These characteristics may be the most diverse, ranging from low prevailing labor costs, climatic conditions, general purchasing power of the target population, product insertion in the market, etc. All these factors can directly influence the pricing of a given product or service in a specific business. This occurs because, in order to establish prices and profit margins, factors such as the expansion or contraction of the market; presence or absence of competition; consumer preferences and other similar factors must all be taken into consideration to ensure a company's success and profitability in a market.[72]

As with group synergies, these specific characteristics of any given market cannot be directly controlled or owned by any single company or group thereof, even though they may have a substantial impact on the value and prospects for success of a particular business, and must be duly compensated in the event of a transaction. However, given the relatively independent nature of these market specific characteristics in relation to the venture, it is again not regarded as an intangible asset along OECD lines, and thus it is not possible for these characteristics to be licensed on an individual basis, leaving no room for the question of compensation through royalties.

1.2.3 Hard-to-value-intangibles

[71] *Ibid*.
[72] *Ibid*., P. 44ff.

Of all the categories of intangible assets seen so far, there is an overarching classification derived from the possibility of an intangible asset impacting, directly or indirectly, the difficulty of its valuation. These assets are creatively called hard-to-value intangibles (HTVI), and designate the intangibles or rights in intangibles for which, at the specific time of a transaction between companies of the same business group, cumulatively meet the requirements of (a) not having any other satisfactory object of comparison – as a rule due to the uniqueness of the asset at hand; and (b) that the premises used in the valuation of the intangible *or* the projections on the possible earnings and future cash flows at the time of the transaction are all highly dubious.[73] It is important to note that these requirements are relatively common to intangibles in general, which leads to many being immediately classifiable as "hard-to-value".[74]

Once these requirements are met, it is extremely difficult not only for the tax authorities, but even for the business group in question, to determine in advance the possible degree of success that the intangible asset will have in the long term. This therefore makes it particularly cumbersome to value and compensate for the intangible properly at the time of the transaction, since every time an intangible asset is transferred within a corporate group, whether by a complete transfer or by licensing, then an adequate remuneration has to be paid.[75] This of course does not mean, however, that there is complete freedom to establish the value of an agreement involving HTVI, and in this sense there is an exacerbated difficulty for the tax administration in determining the correctness of the arm's length bases employed to determine the value of the asset.

This challenge manifests itself in the form of an acute asymmetry of information between the business group and the tax authorities, in which it may not be clear which factors are used by the taxpayer to determine the value of the transaction in question, thus generating an enormous risk of profit shifting by the business group, especially in international negotiations.[76] This occurs to the extent that, even in cases where there formally is data on the proceedings and investments that lead up to the development or transaction of the intangible asset, this will not necessarily imply

[73] See Koch, Manuel (2016): BEPS und Intangibles oder die Grenzen des Fremdvergleichsgrundsatzes. In *IStR*, P. 887f.
[74] Refer to the case of the Netherlands, as discussed in Konings, Bart; Morren, Driek (2021): Hard-to-Value Intangibles: How Hard Can It Be? In *International Transfer Pricing Journal* 28 (1), P. 22f.
[75] As argued by Renaud, Simon; Werner, Maximilian (2018): Hard-to-value intangibles - ein Überblick über die neue Implementierungsrichtlinie vom Juni 2018. In *IWB* 18, P. 676f.
[76] For more information on this topic, see in depth Section 1.4.

that the tax authorities have the specific technical knowledge to identify the *relevance grade*[77] of each of these events or progress to establish the price and degree of success of the intangible or rights in intangibles concerned.

The common finding related to HTVI is that there will be an aggravated difficulty for the tax authorities to prove that there is an unjustified disparity between the *ex ante* forecasts for the value of the intangible prior to the transaction and, oftentimes, prior even to its insertion in the market; and the value finally expressed *ex post* by the asset, which would be the value that ideally should have been originally determined by transfer pricing criteria.[78] In this sense, the tax authorities are almost hostages to the correct and accurate provision of information by the taxpayer, with a tough opportunity for the treasury to challenge the value originally conferred on the hard-to-value intangible. This occurs especially in cases where the intangible still is, for example, in a development phase; or even when it will be exploited in an innovative manner in the market at the time of the transfer[79]; or still when its commercial exploitation is only envisioned in the long run, many years after its transfer. All these factors make it extremely complicated for the tax authorities to value and evaluate intangible assets, giving innovative business groups a huge tax edge.

It is for this reason in particular that the OECD has taken the lead in discussions to expose the HTVI problem in a systematic way, in order not only to present its own suggestions and solutions in the form of its transfer pricing guidelines,[80] but also to receive feedback from the most diverse taxpayers and tax administrations on how best to deal with the problem. Thus, two years after the presentation of the final report of the BEPS project actions 8-10 in 2015, there was the elaboration of an open discussion draft for public discussions,[81] in which there was a substantial contribution of various members of civil society with interest and knowledge on this matter.

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[77] As in OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 109f.

[78] *Ibid*.

[79] This happened for example with many of the modern tech giants, that developed software and platforms with no comparable assets.

[80] These received, in 2017, the OECD contribution on HTVI presented in the BEPS Action plan in 2015. See, for more information, OECD (2017): OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Available online at https://www.oecd-ilibrary.org/docserver/tpg-2017-en.pdf?expires=1582192902&id=id&accname=ocid57015174&checksum=0D2DD83E5CEBF686E35BB5044FDA4A2B, checked on 28.08.18, P. 308ff.

[81] See the full document by different contributors, OECD (2017): Public comments received on the BEPS discussion draft on the Implementation Guidance on Hard-to-Value Intangibles. Available online at http://www.oecd.org/tax/transfer-pricing/public-comments-received-on-the-beps-discussion-draft-on-the-implementation-guidance-on-hard-to-value-intangibles.htm, checked on 04.10.18.

Among the many points observed and discussed, there was a general recognition that the critical point of the asymmetry of information between tax authorities and taxpayer in relation to HTVI is not *per se* in its existence – which is a common peculiarity of the dynamics between these two entities – but rather the inability or restricted possibility of independent appraisal, by tax authorities, of the valuation report handed over by the taxpayer trading the hard-to-value intangible.[82]

Therefore, one of the factors indicated as being of greater relevance for determining the appropriateness of the information would have in fact to be, as previously mentioned, the gap between *ex post* outcomes and the pricing arrangements made *ex ante* between the parties involved. Despite the difficulty in demonstrating an unjustified disparity between the two, these factors are the most objective ones in a transaction with so many subjective factors tied to legal and economic uncertainty, and may serve as presumptive evidence of the suitability of the appraisal of the intangible.[83]

These recommendations culminated in the elaboration of a new document, in 2018, specific for the HTVI treatment, complementary to the previous work of the BEPS project.[84] By being inserted as an annex in the OECD transfer pricing guidelines, this document ensured that the recommendations and considerations made by the interested parties that expressed their views on this matter could be included in the form of general recommendations from the international body.[85] Special attention should be given to the confirmation of the possibility of use by the tax administration of *ex ante* and *ex post* values in the determination of the adequacy of the transfer pricing arrangements – heavy artillery to compensate for the information asymmetry between taxpayer and tax administration – which will however only have the character of a *presumptive* evidence, and not of a *conclusive* one, as the taxpayer should be guaranteed the possibility of

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[82] OECD (2017): Public comments received on the BEPS discussion draft on the Implementation Guidance on Hard-to-Value Intangibles, P. 5f.
[83] *Ibid*., P. 59ff.
[84] Published as OECD (2018): Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles. Inclusive Framework on BEPS: Action 8. Available online at https://www.oecd.org/tax/transfer-pricing/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf, checked on 10.12.19.
[85] These works have borne fruit, in which various countries have updated their national legislation to better deal with the challenge of intangibles hard-to-value, such as Japan, in 2019. See Hagelin, Johan; Muto, Shunichi (2019): The OECD/G20 Base Erosion and Profit Shifting Initiative and the 2019 Tax Reform in Japan: Revisions to the Earnings Stripping Rules and the Introduction of Hard-to-Value Intangibles into Transfer Pricing. In *Bulletin for International Taxation* 73 (5), P. 231ff.

proving, through documents in an adequate rebuttal, the reliability of the information initially provided to support the transfer pricing methodology adopted at the time the controlled transaction occurred.[86]

In addition, in order to ensure predictability and legal certainty in transactions between companies of the same business group, it is recommended specifically for large transactions that the taxpayer reaches a previously established mutual agreement with the tax authorities.[87] This would practically eliminate the risk of a business being caught by surprise by a retroactive revaluation of payment flows due to differences in the *ex ante* and *ex post* calculations of a disposal or licensing of HTVI, for example. These considerations ultimately have a direct bearing on how transfer pricing standards are used in transactions involving intangibles, which will be discussed further on.[88] Finally, it should be noted that although these relatively new provisions apply fundamentally to hard-to-value intangibles, given their broad definition it is highly likely that several intangibles will be directly affected by these recommendations.

1.2.4 A step further: an international concept of transactions with intangibles in the form of royalty payments

It should be noted that the definitions seen so far deal with how and what intangibles might be, but not with the nature or characteristics of the *transactions* that involve them. As previously mentioned, the commercial use of IP may occur through its ownership or control, and in the hypothesis of its use or transfer, there must be compensation for this transaction, as a rule in the form of royalty payments.

Royalty payments is the term commonly used to designate the remuneration due for the use or right to use some specific types of intangible assets that are not fully owned by oneself. The form of use and compensation – which can be of any kind, not just monetary – is variable depending on the contract and the type of intangible involved.[89] However, these royalty payments are, regardless of their distinct features, the core of this work, as well as the tax planning

[86] OECD (2018): Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles. Inclusive Framework on BEPS: Action 8, P. 9ff.
[87] As pointed out by Renaud, Simon; Werner, Maximilian (2018): Hard-to-value intangibles - ein Überblick über die neue Implementierungsrichtlinie vom Juni 2018. In *IWB* 18, P. 678.
[88] Refer to Chapter 2.1.1.3.
[89] See the comments on OECD (2019): Model Tax Convention on Income and on Capital 2017 (Full Version). OECD Publishing. Available online at http://dx.doi.org/10.1787/g2g972ee-en, checked on 03.05.19, P. 271.

possibilities arising directly and indirectly from their use. For this reason, it is necessary to understand in depth its signification and usages – directly dependent on the classification of intangible assets of the previous subsections – which will be the focus of the discussion in this and the next subsections.[90]

One of the most widely accepted and employed documents to classify and regulate these transactions and corresponding compensation is the OECD Model Tax Convention on Income and on Capital[91], which deals in its article 12 with the taxation of royalties. Although the OECD expressly states that its work and comments on Article 12 are largely independent of the classification of intangibles presented in Action Plans 8-10 of the BEPS project,[92] there is direct correlation between all the terms used. Thus, when this model convention refers to royalties, it is mentioning financial transactions – as a rule licensing, which will be seen below – involving the use or permission to use intangible assets. Article 12 para. 2 OECD-MC defines royalties as payments of *any kind* received as compensation for the use of, or right to use, intangible assets such as copyright, patents, trademarks, know-how, etc. Although it does not specifically mention some subspecies of intangible assets and copyright, leaving for example the concept of software *prima facie* out,[93] this definition is relatively broad and covers basically any consideration for the transfer of use of an intangible asset established for a specified timespan by means of a contract.[94]

This contract is characterized by being a letting of the right of use of an asset, and although it is commonly performed between companies focused on a specific activity – as are the cases of interest for this work, between companies of the same business group – it can also perfectly occur independently by a private individual.[95] This definition will not be applied, however, in the hypothesis of payment being made, either to a company or to a private individual, to someone who

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[90] For the different transactions available with intangibles and the role of royalty payments, see Section 1.3; for tax planning opportunities and the usage by corporate groups, see Section 1.4.

[91] OECD (2017): Model Tax Convention on Income and on Capital: Condensed version. Available online at https://www.oecd-ilibrary.org/docserver/mtc_cond-2017-en.pdf?expires=1579104442&id=id&accname=ocid57015174&checksum=200E9FF99711033C8A7CF51EE5CC6B95, checked on 15.01.20.

[92] See OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 68.

[93] It is, however, recognized as a form of intellectual property by the OECD as of the comments of 1992. The treatment given to it, however, varies greatly from country to country. Refer, for example, to the Indian case in Colón, Annagabriella (2021): Payments for App Software Aren't Royalties, Indian Tribunal Says. In *Tax Notes International* 102 (4), P. 513f.

[94] See also the definition by Dorn (2012): Kapitel 9: Geistiges Eigentum im. In: Haase (Ed.) - Geistiges Eigentum. Nationales und Internationales. P. 520f.

[95] *E.g.* when an invention is patented by an individual, transferring its right of use.

is not the owner of the right to use the intangible. The same applies to cases where a transfer of full ownership of the intangible as a whole is sought, the remuneration for which is much closer to the business profit cases of Article 7 of the OECD-MC or the capital gain cases of Article 13 of the same model.[96]

It is important to emphasize that the definition of royalties contained in this article of the model convention has an *autonomous* character in relation to the national legislation of the countries involved in the treaty.[97] This is because Article 12 para. 2 OECD-MC expressly defines the outlines of what would be a royalty payment and Article 3 para. 2 OECD-MC, which refers to the respective national laws of contracting states, is not applicable.[98] Thus, the interpretation of the outlines of what would constitute a royalty payment is relatively straightforward, since all signatories to the double taxation agreement will have the same definition for this kind of payment.[99]

Nevertheless, this does not apply to the definition of the intangibles covered by the royalties – whose transfer of use constitutes the specific reason for the payment – since there is no explicit concept in the model convention itself of what would copyrights, trademarks, or patents be. These concepts depend, as previously discussed, on the respective national laws, which may cause conflicts in the terminology used and, as a consequence, asymmetries in the application and interpretation of the rule on royalties contained in the treaty, which may even lead to cases of double non-taxation.[100]

It is true that the international definition by the OECD of these intangible assets, as seen previously, helps to achieve a certain uniformity and harmonization of the concept also at the national level. This, however, does not ensure that the formulation and contours of each intangible asset for royalty payments are exactly the same in each country, since the OECD's work in this

[96] OECD (2019): Model Tax Convention on Income and on Capital 2017 (Full Version). OECD Publishing. Available online at http://dx.doi.org/10.1787/g2g972ee-en, checked on 03.05.19, P. 274ff.
[97] See Dorn (2012): Kapitel 9: Geistiges Eigentum im. In: Haase (Ed.) - Geistiges Eigentum. Nationales und Internationales. P. 521.
[98] As stated on the article by itself, the treaty has precedence over domestic legislation. This can, however, be used in cases where the treaty is silent.
[99] Interpretation can, however, be different in some cases depending on which methods are used. Especially troublesome are the cases in which the definition of intangibles diverges from one country to the other.
[100] For a broad definition, see Roser (2015): KStG § 26 Besteuerung ausländischer Einkunftsteile. In: Gosch (Ed.) – Körperschaftsteuergesetz, paragraphs 30ff; and Lang, Michael (2010): Qualifikations- und Zurechnungskonflikte im DBA-Recht. In *IStR*, P. 115ff.

area merely serves as suggestions of non-binding value for countries. Other problems may arise when, on a national basis – whether or not derived from a supranational elaboration – countries issue norms that conflict with the definitions presented in an international treaty, incurring in a so-called treaty override.[101]

However, at least at the level of European secondary legislation the definition of royalties provided for in article 2(b) of the Interest and Royalty Directive (Council Directive 2003/49/EC)[102] is basically the same as the one present in the OECD model convention, also expressly including in the definition of royalties the payment arising from a transaction involving software. Nevertheless, there are also some dubious interpretative issues in European legislation, such as the influence or not of domestic legislation on the interpretation of the Directive; as well as the possible influence of the OECD's own work on the subject, in the form of the model convention and the relevant comments on it.

Indeed, the tendency is that the interpretation of European legislation in this area will also be made in an autonomous and uniform manner with regards to the domestic legislation of member countries, since a coherent structure in the definition of royalty payments, for example, contributes immensely to a greater level of legal certainty and predictability of this type of transaction, in particular at the international level. The influence of the OECD model convention on the drafting of European legislation is therefore immediately apparent, not only because of the wording of the directive's definition, but also due to the comments on the original proposal from the last century in the discussions to draft this legislation,[103] which took into account not only the work carried out under Article 12 of the OECD-MC, but also the discussions and work of the OECD Committee for Fiscal Affairs. This will certainly have at least an indirect influence on the decisions of the European Court of Justice.[104]

1.3 Development, taxing and resource management of intangible assets and royalties

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[101] For a deeper analysis of the relation between treaty overriding and royalty payments, refer to Section 4.3.
[102] Available online at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32003L0049, checked on 10.08.2018.
[103] See European Commission (1998): Proposal for a COUNCIL DIRECTIVE on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. Available online at https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:1998:0067:FIN:EN:PDF, checked on 15.09.19, P. 6ff.
[104] For more on this discussion, refer to Section 4.2.

As noted, the concept of royalties is much more harmonized and standardized internationally than any of the possible classifications and definitions of intangible assets. While both are directly linked, the research object of this study focuses exclusively on the use of royalty payments for tax planning opportunities, and as long as a transaction with an intangible asset occurs – in this case broadly considered, regardless of its classification, as a valuable asset, but that has neither material nor financial nature, being able to be regarded and controlled as property for commercial purposes and for which third parties would pay a fee deriving from the use or transfer of the asset under otherwise comparable circumstances – and results in a compensation for the use or right to use it, this payment *will* be considered a royalty payment.

However, there are several transactions and ways of developing an intangible, and not in every such hypothesis will a royalty payment occur. Therefore, this section will address the different factual and legal possibilities that a given company or business group has to develop and value, on its own account, an intangible asset, and to engage in transactions that may or may not result in royalties for its use. The most important observation to be made is that, depending on how and where a certain intangible asset is developed in a given business structure, the tax results might be quite distinct from one another, even if from an economic standpoint the outcome of developing a new asset is essentially the same,[105] improving by itself and through its market application the business situation of the firm.

Accordingly, not all transactions with intangibles result in a payment of royalties, and it is important to understand their different forms to delimit the object of relevance to this research. Bear in mind that, since these are assets owned by a company much like any other, intangibles can possibly enter into nearly any transaction normally performed by a particular business. However, there are transactions that are deemed the most common and relevant in this environment, given the specifics of this type of asset.

1.3.1 Self-development

As the name itself indicates, the decision for the self-development approach represents the option of research & development undertaken by the company itself, leading to the creation of a specific type of intellectual property, typically in order to allow its exploitation in the market. For

[105] See, for more information, Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern, P. 42ff.

this, the legal entity has to assume the risks of this R&D, being responsible for the required elements for this new development, such as financial investment, labor force, use of other intangibles, know-how, etc.[106]

From a tax point of view, this own development is of high relevance, since the expenses with this type of activity can, as a rule, be deducted as operating expenses of a business.[107] But more than that: in many countries there are generous tax incentives[108] for this type of investment, since, despite the uncertain returns that would usually take place in the medium or long term, representing a risky investment for a business, there are many benefits obtained by society such as the creation of new jobs and through spillover from the production of new knowledge – even if patented – which can be and is commonly rewarded in this way by the State.[109]

Thus, the research & development expenditures incurred by a given business in the elaboration of new knowledge and intellectual property, provided that the requirements of the relevant national legislation are met, may enjoy, for example, a tax benefit when deducting the expenses involved, as well as at the time of their commercialization in the form of, *e.g.*, the so-called IP-Boxes.[110]

1.3.2 Licensing

A distinct option from the self-development of a certain intangible asset is the possibility of licensing it from another company in the same business group. This may occur for the most distinct reasons, since it may be *v.g.* of interest to the group to concentrate the research & development functions in a single entity, which will work on the development of new methods and/or technologies, which in turn will be licensed for a fee to the other members of the group who, in effect, carry out the core activities of the business. Another common motivation are tax reasons, in order to reduce the general fiscal burden of the business group, which can easily be

[106] *Ibid*.
[107] It can, however, be limited in some specific cases, as seen in depth in Section 3.2. See the insight, for example, of Kramer, Jörg-Dietrich (2017): Germany's New Royalties Barrier Rule: Preventing Tax Evasion By Limiting Deductibility in Specified Cases. In *Tax Notes International* 88, P. 879ff.
[108] As highlighted by Fairpo (2016): Taxation of Intellectual property, P. 148ff.
[109] See many of its advantages – and reasons of recent implementation in Germany – in Falck, Oliver; Fichtl, Anita; Lohse, Tobias (2019): Steuerliche Forschungsförderung: Wichtiger Impuls für FuE-Aktivitäten oder zu wenig zielgerichtet? In *ifo Schnelldienst* 72 (9), P. 3ff.
[110] For a deeper discussion and explanation on IP-Boxes, refer to Section 2.2 and Chapter 3.

planned in the hypothesis that the entity that owns the intangibles and is, therefore, licensor, is in a jurisdiction of lower taxation in comparison to the licensees of a given intellectual property.[111] This allows the license holder to reduce its taxable income to the extent that it has to pay a royalty for the use of the asset that is not its own property, normally having the possibility of deducting these amounts in the form of business expenses.

What is important to highlight in this case is that there is no transfer of property over the intangible, but merely the use or right to use it, an essential characteristic to configure the realization of a royalty payment. Apart from that, an eventual licensing agreement may have the most diverse characteristics, whereby the intangible asset may have its use restricted in relation to the form or time of use, persons who may use it, etc.[112] Consequently, when licensing intellectual property, the owner ensures that he will retain the rights to that property while receiving royalty payments from third parties for its use, and may even, depending on the conditions of the contract, continue to exploit this property on his own, either in another territory or at another time, directly or indirectly.[113]

Thus, the licensing possibilities are commonly classified as being (a) exclusive, which, as the name already indicates allows the licensee to explore the intangible asset without any kind of challenge or competition from the owner or third parties, and may be restricted only with respect to a specific territory or time; (b) sole license, which possesses generally the same characteristics as an exclusive license, with the distinction that the licensor may also directly use the intangible asset, so that it may possibly generate competition with the licensee, despite the impossibility of granting the license to third parties; and (c) non-exclusive licenses, in which the license simply grants the right to the taker to exploit the intangible in question, but does not restrict the owner's use or the granting of further licenses to third parties.[114] The latter category is usually common in transactions between business and consumers, such as downloading software, music, shared databases, etc., where many simultaneous individuals have access to the license, and has little

[111] Which is the main issue at hand, to be seen along with tax planning opportunities on Section 1.4.
[112] See Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern, P. 43f.
[113] As indicated by Fairpo (2016): Taxation of Intellectual property, P. 369ff.
[114] *Ibid*.

relevance to the present work in this respect, since the ones of interest for this research are those made between entities within the same business group.[115]

Regarding the taxation of this type of transaction, it can be said in a simplified manner that, instead of receiving revenue from sales, the amounts received by the company are royalty payments for the licensing of intellectual property, both being as a rule taxed in the same way.[116] On the other hand, the licensor can – when there are no existing deductibility barriers – deduct the amounts paid for the use of the license, and may even, if there is a license box, claim the tax relief arising from it for the revenue obtained by using the IP.[117]

1.3.3 Ownership transfer

Also known as "assignment", this consists of the entire transfer of ownership of the intangible asset from one company to another. Of interest for this transaction is the conveyance of property of the asset according to the dictates of national civil law, in which the transferor gives up his legal status of ownership in exchange for an offset.[118] The form of compensation – be it a one-off sum, installment payment or any other form other than pecuniary – is generally irrelevant, whereas it is relevant to determine whether or not there has been a transfer of the full ownership, and not merely of the right of use, of the intangible asset.[119]

This has very different legal and tax consequences from the simple licensing of a certain intangible asset, as it is generally treated as a capital transaction.[120] After the transfer, all revenue obtained from the use of the asset will be the responsibility of the receiving legal entity, with a

[115] It is important to delineate the object of this study to the maximum degree, since the issues arising from this kind of licensing with consumers are entirely distinct from the fiscal ones between related companies.
[116] Be it in developed or developing countries. See Abdellatif Khalil (2013): Taxing intellectual property transactions in., P. 93ff.
[117] As explained and discussed in Rolim/Fonseca (2016): O Plano de Ação n. 5. In: Gomes/Schoueri, A Tributação Internacional na era., P. 348ff. It is interesting to point out, however, that this relief possibility through IP-Boxes is restricted in many countries to *exclusive licenses only*, such as in the UK. See, for more information, Fairpo (2016): Taxation of Intellectual property, P. 370.
[118] On international tax law, refer especially to articles 7 and 13 of the OECD Model Convention, differently from article 12, that applies to licensing and royalty payments.
[119] See for more on the transfer of intellectual property Maume, Phillip (2017): Geistiges Eigentum in der Unternehmensfinanzierung. In *Neue Zeitschrift für Gesellschaftsrecht*, P. 249ff. and Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern, P. 44f.
[120] Refer to Fairpo (2016): Taxation of Intellectual property, P. 111f.

clear-cut moment in time in which this separation in income liability for tax purposes between distinct taxpayers occurs. All profit potential with that asset passes to the entity that acquired the intangible, and belongs no longer to the one that initially owned it, a feature that distinguishes the ownership transfer from a mere licensing.

As there is a "definitive"[121] transfer of ownership, the counterpart to this transfer is not considered a royalty payment, and is therefore not a part of the methodological scope of this work. This occurs especially because the tax consequences of this type of transaction are very different from those obtained from a license, and although there may be other problems with an ownership transfer, such as questions about the adequacy of the payment under the point of view of transfer pricing, the possibilities for tax planning are not the same as those allowed by a license of intellectual property. Finally, it should be noted that the determination of whether a transaction will be characterized as a sale/exchange or a license will depend rather on the facts and circumstances of the transaction, and not on the terminology used in the transfer agreement. This is to ensure that there will be no manipulation of the format of the transaction to obtain the desired results, whether in its economic or fiscal nature.[122]

1.3.4 Project development by contract

In addition to the traditional possibilities of development by the business group itself or purchase/licensing of intellectual property, a relevant alternative is that of a contractually established project development between companies of the same business group. In this case, similar to a self-development, one company of the group will be responsible for the development of the intangible, however this will be carried out on a commissioned basis made by another member of the group, which will establish in advance what are the characteristics, criteria and format of the research developed for the asset in question.[123] While this kind of contract may be a contract with an obligation to deliver results – where the service provider has an obligation to provide a specific result in the development of the asset – or with an obligation of means[124] – where there is no obligation to deliver a specific result but to use the appropriate means to achieve

[121] This can, of course, be reversed by future transactions, but it is by itself definitive based on its effects.
[122] For more on this discussion, see Maine/Nguyen (2015): Intellectual property taxation, P. 176ff.
[123] As indicated by Broemel, Karl (2013): Konzerninterne Auftragsforschungsverhältnisse im Spannungsfeld aktueller Entwicklungen bei der Zurechnung von immateriellen Wirtschaftsgütern. In *IStR*, P. 249f.
[124] For a definition of private law on those terms, see Moons (2018): The Right to Housing in., chapter 4.

this result – in both cases the ownership and right of use of the asset belong to the contracting entity that has delegated the development of the specific asset.

On the other hand, the one who performs the research & development activities on the basis of this contract must be adequately compensated based on the capital invested for the activity, as well as on the risks assumed that may not be covered by the contractor, depending on the nature of the agreement concluded.[125] Establishing the values of this kind of relationship in accordance with transfer pricing standards is much easier than valuing the intellectual property itself after it has been developed, since contracts of the same nature between independent parties for carrying out similar activities can be used as a comparative factor in determining what an appropriate remuneration would be.

However, it is important to emphasize that there is a general understanding[126] that a profit margin should be charged even in a relationship between companies of the same group, since this would necessarily exist in an independent contract between third parties. Even so, considering that it is a mere hiring of a research & development service for intangible assets, the payment made between these entities does not have the nature of a royalty payment, and may lead to tax planning opportunities of characteristics different from those relevant to this research.

1.3.5 Joint development research

A conclusive alternative for the development of intangible assets within a corporate group is the possibility of joint development and research. This form represents a hybrid of self-development and a project development by contract, since it is based on the combined elaboration by different entities of the same (final) intangible.[127] This option is especially interesting when different legal entities act in different stages or areas of the development of a final product, dividing the activities in a specialized way. Thus, two or more parent companies join together not only for the development, but also for the use and exploitation of a certain asset, which should as a rule be established contractually based on the activities performed, risk division, capital and personnel

[125] Usually, this value is defined with aid of the OECD DEMPE-standards, which stand for Development, Enhancement, Maintenance, Protection and Exploitation. For more on the compensation and the OECD take on this topic, see Puls, Michael; Heravi, Semera (2018): DEMPE-Funktionen und wirtschaftliches Eigentum an immateriellen Werten – Plädoyer für eine differenzierte Betrachtung. In *IStR*, P. 725ff.
[126] Not only internationally by the OECD, but this is also confirmed nationally in Germany, for example, as soon as in 1962. See BFH, 18.09.1962 - I 113/61 U, on DB 1962, 1558 (Full text).
[127] See the definition by Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern, P. 48ff.

investment, etc. in order to determine the proportional participation in the ownership rights of the asset of each party involved, as well as the final participation in the revenue arising from the use of the intangible in question.

Regardless of the choice of how the intangible will be used later, *i.e.* whether directly by the parties involved or through a licensing or disposal in full, the expenses that each company actually has with the development of the asset can commonly be deducted as business expenses. From then on, its use may be any of those already seen previously, thereby complementing the possible ways of designing and using a given intangible asset.

As one can see, there are several ways in which an intangible asset can be created and used to produce revenue. Even when a company is merged or acquired by another company,[128] these may have great value and must be taken into consideration at the time of the transaction, be it with full-fledged intangibles or with intangibles on undergoing development. All these forms have different economic and tax impacts on a group of companies, but the most relevant are those obtained from the licensing of an intangible asset by another company, regardless of whether it was created jointly or individually within the business, since it is precisely the existence of a royalty payment that generates profit shifting opportunities in a unique way.

1.4 Identifying tax planning opportunities on royalty payments: (ab)using low-tax countries and IP-Boxes

So far, the *object* of this work has been extensively addressed, namely, the intangible assets in their various guises and the possibility of compensation for their use or right of use in the form of royalty payments. Although there are many different types of intangible assets that a given business may produce or own, as well as the possibility of carrying out with IP virtually any of the traditional transaction relating to assets, the act of licensing an intangible allows for aggressive tax planning opportunities by companies, exploited in an attempt to reduce the business' tax burden and maximize its profit.

Thus, this section will put the *problems* related to the taxation of these assets and their transfers, specifically of the right to use, in the spotlight, indicating how and why it is possible for

[128] As indicated by Fairpo (2016): Taxation of Intellectual property, P. 7f.

multinational business groups to use and eventually abuse their international structures to shift profits by using licensing transactions between parent companies. For this, it is even more necessary to understand precisely the national treatment given to this type of asset and transactions, which will be seen in more detail below.

1.4.1 Overall tax treatment

Given the international character of this work, no specific focus will be made on the national legislation of any particular country. However, there are some general trends that can be found around the world, particularly considering the influence that the OECD's work has in an international context, even if it is not of a binding nature.[129] As a rule, the owner of an intangible asset is considered to be responsible for the revenue arising from intellectual property, and it is therefore logically the owner who will be taxed for the revenue arising from it.[130] The same occurs in the case of a transfer in a sale or exchange of intangible assets, in which the transferor must determine the gain or loss[131] obtained through the transaction.

This revenue arising from IP usually falls within the same tax regime as other common assets, typically linked to income taxes. This happens firstly because there is no real reason to differentiate the taxation of intangibles in relation to tangible assets, for example, and secondly because it is a simpler way to deal with assets within a company, regardless of its form or origin. However, considering some of the difficulties inherent to the valuation and identification of intangible assets, the OECD recommends a two-step test for the assignment and taxation of its revenue,[132] in which initially the intangible would have to be properly *identified* and individualized as such and, in a second step, the *allocation* of the value contributions arising from the exploitation of the asset, which have to be apportioned within a business group on the basis of the so-called DEMPE rules.[133] There would also be primarily two groups in which the profits from the

[129] By this, not only the OECD work on transfer pricing issues or the BEPS project is meant, but also the OECD Model Convention, that is indeed widely used throughout the globe.
[130] See Maine/Nguyen (2015): Intellectual property taxation, P. 190.
[131] This gain or loss will depend, *e.g.*, on the difference between the amount realized by the transaction and the (adjusted) basis of the property. See once more, Maine/Nguyen (2015): Intellectual property taxation, P. 178.
[132] For more on this process, see the insightful contribution of Stein, Stefan; Schwarz, Christian; Burger, Silvan (2020): Die Besteuerung immaterieller Werte in multinationalen Unternehmensgruppen. Eine Analyse des Referentenentwurfs für ein ATADUmsG. In *IStR* 29 (3), P. 84ff. The ATAD implementation act has already been put into force so far.
[133] For more on DEMPE, refer to Jochimsen, Claus (2018): Nutzung von Intellectual Property im Lichte des DEMPE-Funktionskonzepts. In *IStR*, P. 670ff.

intangible could be divided into, since they might on the one hand arise directly from the use of the asset by a company, or from the use by third parties who do not also own the asset and therefore had to obtain a license for its use.[134]

However, there are some countries that decided to implement a differentiated regime for intellectual property, which as a rule occurs in the form of tax incentives for research & development activities, which would supposedly result in the creation of more patents, job generation, spillover of knowledge, etc.[135] These rules would deviate from the standard norm in order to grant more favorable treatment to the income arising from the elaboration and use of intellectual property. It is then essential to determine which regime is applicable in each case in order to avoid, for instance, abuses by companies of a preferential tax rate or other forms of tax incentives.

1.4.1.1 General income tax or specific rules?

The traditional tax treatment of intangible assets depends primarily on whether or not a particular company (a) owns the asset; and (b) uses the asset directly for its own purposes, or is licensed in whole or in part to third parties. If a company owns the IP and uses it in the development of its activities and, therefore, earns profit from its use, this revenue will usually be taxed through regular income taxes and rates in the absence of an incentive regime, and the expenses incurred in the development of the intangible are typically deductible as business expenses. In the case of a licensing of the use of intellectual property to a third party, the third party should tax the profits assessed from the use of the asset normally, again through general income tax rules, whereas the payment of royalties due for the licensing will be taxed at the level of the licensor – as it constitutes income arising from the intellectual property – while it will be deducted, in the absence of restrictions on the deductibility of payments, as business expenses at the level of the licensee.[136]

[134] This differentiation is, however, not strictly necessary within a given national tax law, even though common. See Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern, P. 18.
[135] As seen in Falck, Oliver; Fichtl, Anita; Lohse, Tobias (2019): Steuerliche Forschungsförderung: Wichtiger Impuls für FuE-Aktivitäten oder zu wenig zielgerichtet? In *ifo Schnelldienst* 72 (9), P. 3ff.
[136] For reference, see for instance the German example in Hofacker (2012): Kapitel 4: Geistiges Eigentum im, in: Haase (Ed.) - Geistiges Eigentum. Nationales und Internationales, P. 167ff.

This is the treatment given almost unanimously to intellectual property in the tax sphere,[137] modified only in jurisdictions where special provisions are to be found for the taxation of income deriving from this type of asset. These rules are commonly known as License- or IP-boxes,[138] which are preferential tax regimes created in order to encourage research and development (R&D) activities through targeted rewards and tax incentives for this type of venture. Those are basically tax regimes under which the income accruing to the beneficial owner of an intangible asset from either the use of the asset or allowing for its use by third parties through licensing is taxed at a lower rate than other types of income.[139]

There are basically two distinct ways of promoting a tax reduction for this type of incentive in intellectual property: (1) with a special tax rate, distinct and reduced from the general tax rate; or (2) (partial) exemption of the revenue directly tied to IP from the assessment basis for the tax. As indicated, the justification generally used for this type of incentive is linked to the possible benefits arising from the production of new knowledge related to intellectual property, as R&D is often seen as a kind of work undertaken on a systematic basis to increase the share of knowledge for the human race and society as a whole, leading to the usage of this acquired knowledge to devise new applications and promote development by stimulating social benefits.[140] Therefore, such incentives would be "justified", even though one might question the effectiveness of such regimes in the first place.[141]

However, it is worth mentioning that these IP-boxes are only one form of tax incentive, usually being structured in the format of an *output incentive*, that is, the benefits incur directly on the financial returns resulting from IP. It is also possible to directly encourage research and development activities that lead to the production of new intellectual property through other specific tax incentives, called *input incentives*, which may be (a) incremental based, as is the case

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[137] Seen in countries within and outside of Europe, this seems to be the most usual form of dealing with the taxation of IP, with small variations and specificities based on jurisdiction.

[138] But also sometimes referred to as innovation box, patent box, knowledge box regimes etc. All of those are and will be used interchangeably.

[139] Monteith, Christian (2014): Steuergestaltungen mit Lizenzboxen. In *StuB* (23), P. 883ff.

[140] See the excellent insight by Theophilou, Christos A. (2019): Patent Boxes: The Rise, the Change or the Fall? In *Bulletin for International Taxation* 73 (5), P. 286f.

[141] It is not entirely clear what are the impacts of such tax incentives on the actual development of R&D activities, and some argue that such regimes simply lower the costs of activities that would already have taken place to begin with. See the critical analysis of Titgemeyer, Marion (2019): Zur steuerlichen Förderung von Forschung und Entwicklung (FuE) in Deutschland. In *DStR*, P. 1276ff.

in the USA, which has as a parameter the relative increase in R&D investment from one tax period over to the other; or (b) volume based, which grants tax benefits on the total volume of the investment made.[142] Thus, the main tax questions that arise from a national perspective in relation to intangibles are usually regarding the deductibility of expenditures with (I) the *creation* of intellectual property, which usually allows the immediate deductibility of expenses incurred by the business, with the possibility of a tax relief for research and development activities depending on national legislation; (II) the *acquisition* of the intellectual property, which usually has stricter rules for its deductibility, having its value periodically written off over the useful economic life of the intangible asset;[143] and (III) if there are preferential regimes or tax rates in the form of IP-Boxes for the income arising directly from the intellectual property. This last question is valid not only for cases in which the owner uses the intellectual property in his own business, but also for cases of licensing, since despite not being the legal owner of the IP, the licensee has the right to use the property, earning profits directly linked to its use.

When comparing the treatment that several countries give to the taxation of residents on royalty income, it can be seen that, as with the taxation of IP, no separate category is usually created for this type of revenue. The amounts derived from royalty payments are commonly treated as overall business income, or property income, mobile capital income, and even self-employment income.[144] There are, of course, some exceptions. One of the most striking examples is Brazil, which diverges from the OECD recommendations in several areas, including transfer pricing. In this country, there is a specific category for royalty income that results in the collection of withholding taxes even in transactions that take place between residents within their national territory, something that as a rule is charged – if even charged at all – only in cross-border transactions.[145] Included in this specific scope of royalties in Brazil are also the so-called “mineral royalties”,[146] which represent the remuneration paid by a company or business group for the

[142] See Theophilou, Christos A. (2019): Patent Boxes: The Rise, the Change or the Fall? In *Bulletin for International Taxation* 73 (5), P. 286ff.
[143] See the discussion by Fairpo (2016): Taxation of Intellectual property, P. 208ff.
[144] For more information on distinct countries such as Germany, Brazil, Australia, France and so on, see Valta (2018): Chapter 1: Taxation of Intellectual. In: Maisto (Ed.): Taxation of intellectual property under., P. 11ff. For information on the treatment by the USA, see Maine/Nguyen (2015): Intellectual property taxation., P. 189ff.
[145] The international aspect of such transactions will be seen in the following section. On the Brazilian system and recent decisions, see Coêlho, Sacha Calmon Navarro (2020): O pagamento dos royalties é dedutível. In *Lex Magister*. Available online at http://www.lex.com.br/doutrina_27682966_o_pagamento_dos_royalties_e_dedutivel.aspx, checked on 06.02.20.
[146] As analyzed by Barbosa (2015): Novos estudos em Propriedade Intelectual., P. 525ff.

extraction of minerals in a certain area to the holder of the right over the ore and/or its area, a classification interestingly also used in Australia.

Another similar case is the Spanish one, which also has a specific regime for the levying of taxes linked to royalty payments, albeit not including the extraction of minerals – being as a rule related to the taxation of income from immovable property. These remain linked to the general rules of income tax, not having a specific rule for the withholding of taxes for transactions between residents.[147] The fact that some countries decide to charge withholding taxes on royalty payments made abroad, on the other hand, is linked to the essence of the problem of taxation of this type of transaction: the inherent possibility of profit shifting that they hold, especially in international transactions. This cross-border licensing has rather distinct characteristics from the licensing that occurs within only one jurisdiction, due to the asymmetries between different countries as a result of the different tax rates, which allows tax planning opportunities for transnational business groups, as dissected below.

1.4.1.2 Treatment on cross-border licensing and royalty payments

The tax treatment of royalty payments in cross-border transactions is, in principle, regulated both by double taxation agreements and by national law, since international treaties do not create tax obligations in themselves but only determine the allocation of taxing rights between the parties to the treaty.[148] In this sense, once again the OECD model takes the spotlight, determining as a general rule that the taxation rights will belong to the residence state of the licensor, in detriment of the residence state of the licensee or source state from the payment. The logic behind this division is to allow for a tax compensation in the country of origin of the intangible asset for the amounts that were deducted as business expenses when the research & development activities were carried out.[149]

There are, however, of course some exceptions. The rule contained in Article 12 (1) of the OECD-MC will only apply if the licensor does not possess, simultaneously with its physical presence in the resident state, a permanent establishment in the jurisdiction of residence of the

[147] See Valta (2018): Chapter 1: Taxation of Intellectual. In: Maisto (Ed.): Taxation of intellectual property under., P. 11ff.
[148] For more on this, refer to Frotscher (2015): Internationales Steuerrecht., P. 106ff.
[149] See the opinion on Dorn (2012): Kapitel 9: Geistiges Eigentum im. In: Haase (Ed.) - Geistiges Eigentum. Nationales und Internationales., P. 520ff.

licensee to which ownership of the intellectual property can be attributed to, which is an exception based on the prerogative of this permanent establishment.[150] All these rules will only apply, of course, when it comes to a royalty payment under the terms already seen above, which includes interestingly not only the payments made due to a license agreement, but also a possible indemnification that arises from the violation of the property rights of the license holder.[151]

In addition, the application of the overall standard of this model convention article – as well as the exception contained in paragraph 3 – will only occur when the person receiving the royalty payment is in fact the beneficial owner of the transaction, that is, not a mere intermediary receiving the payment.[152] The purpose of this provision is to avoid the interposition of a third party simply to receive the payment in a jurisdiction with more favorable tax conditions. This risk comes directly from the coordination of the very nature of international transactions with royalty payments and the OECD rule, which establishes beforehand which state will have the taxing rights over the value of the license, allowing the development of a tax planning strategy in the case of transfers within the same business group.[153] For this reason, many states[154] reserve the right, either through the DTA itself or through their national legislation by treaty overriding, to levy withholding taxes in this payment, to ensure that, in the event of a very discrepant asymmetry between taxation in the state of residence of the licensee and the licensor – which may even lead to double non-taxation –, there will be a minimum effective tax at the licensee level, commonly with a withholding tax rate restricted to around 10%.[155]

In an attempt to reduce the possibilities of aggressive tax planning between companies of the same group, there is also the presence of paragraph 4 in article 12 of the OECD-MC, which indicates the requirement to observe the principles of transfer pricing for this standard tax distribution to be applied. However, considering the difficulty of applying the arm's length principle in transactions involving intangibles,[156] this device loses much of its meaning and other measures are necessary to ensure adequate taxation of this type of payment.

[150] OECD (2019): Model Tax Convention on Income and on Capital 2017 (Full Version). OECD Publishing. Available online at http://dx.doi.org/10.1787/g2g972ee-en, checked on 03.05.19, P. 284ff.
[151] As in Groß/Strunk (2015): Lizenzgebühren, P. 601ff.
[152] Practical examples and explanation on the concept of beneficial ownership are given on Section 4.2ff.
[153] The exact structure of the tax planning opportunities will be explained thoroughly in the following Section.
[154] Such as Germany, Japan, Portugal, Spain, Australia etc.
[155] Withholding taxes and royalty payments will be dealt with in-depth on Section 3.1.
[156] More on this matter will be discussed on Section 2.1.1.

A similar rule and attempt to regulate the taxation of royalties is seen in another model widely used in particular by developing countries, which is the United Nations model convention. In its Article 12 para. 6 the same observations are made with respect to transfer pricing rules, as well as observations relevant to the prerogative of permanent establishments in the previous provisions. In the comments to the article there is explicit mention of the possibility of using substance over form rules, abuse of rights principles or similar doctrines to solve possible problems with arrangements between parts of the same business group beyond the provisions of the double taxation agreement.[157] These are, however, broad-spectrum responses that do not necessarily solve the problem, which has led many countries – despite the existence of DTA and general anti-abuse doctrines – to take unilateral action on tax issues involving royalty payments.[158]

All in all, the best-known double taxation agreement designs available, which are in particular the OECD and UN models, in addition to the US model and the German *Verhandlungsgrundlagen* (negotiation basis), are largely similar in the treatment of royalties, with relatively uniform handling of the division and distribution of their taxation at the international level. The greatest differentiation that can be perceived between these models is in the absence of the simple word "only" in paragraph 1 of Article 12 of the UN model convention as opposed to the OECD model: "royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable *only* in that other State".[159] This difference effectively ensures that in the UN model there is no *exclusivity* right of the residence country to tax the royalties, as it is also permissible for this taxation to take place at the source country level, *i.e.* where the royalty payment initially originated from.

This approach not only protects or allows for active safeguarding of the interests of developing countries, from where the bulk of royalty payments go to their industrialized counterparts,[160] but also reflects the thinking contained in the early models of the League of Nations and the follow-up work of the Organization for European Economic Cooperation (OEEC)

[157] United Nations (2017): Model Double Taxation Convention between Developed and Developing Countries. Department of Economic & Social Affairs. Available online at https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf, checked on 10.03.19, P. 317.
[158] As is the case with, *e.g.*, royalty deduction barriers, withholding taxes and so on, broadly discussed throughout this work.
[159] United Nations (2017): Model Double Taxation Convention between Developed and Developing Countries., P. 296f.
[160] *Ibid*., P. 299f.

as the precursor of the OECD, which did not unquestionably endorse the exclusivity of royalty taxation in the country of residence.[161] One might even see the model advocated by the United Nations and its constant evolution as a parallel model, and of relative opposition in some respects to the OECD work on the topic. The OECD, despite not making many formal direct modifications to the article on royalties since 1963, has been updating its comments in order to reduce its scope of application, of which the UN model ended up being a reaction to in this sense, despite broad similarities between both systems presented.[162]

Countries such as Portugal, Greece and even Austria had postures in this sense of defending a possible source taxation, whether total or partial.[163] Thus, it should be noted that the international decision for a royalty taxation in the country of residence is not one set in stone, despite being the practice widely followed today. Moreover, it is of course worth remembering that further differentiations will come from the treatment given to international transactions in other legal spheres, which directly include the national one – of jurisdictional responsibility of each country based on territoriality – and the supranational one, of great relevance for example in the European context.

From a European perspective, there are no rules that directly regulate the allocation of taxing rights in a harmonized fashion between Member States and third countries. Each EU country is responsible for its bilateral agreements and continues to have sovereignty to make decisions on tax matters that do not fall within the competence of the EU itself, such as the value added tax. In this regard, the most relevant European legislation for the payment of royalties is the Interest and Royalties Directive, nº 2003/49/EC,[164] which among several provisions has as a core rule the interdiction of any form of taxation in the source state, for example through withholding taxes, in the case of a transaction between companies of the same business group – with a minimum participation and control level of 25% between them. This implies a favorable choice for taxing in the licensor's state of residence, replicating the OECD logic of compensating the country where

[161] A historical aspect of this development can be seen with Sasseville (2018): Chapter 5: Source vs Residence. In: Maisto (Ed.), Taxation of Intellectual Property under., P. 97ff.
[162] On this opinion, see Jiménez (2018): Chapter 6: Article 12 OECD. In: Maisto (Ed.), Taxation of intellectual property under., P. 123ff.
[163] Sasseville, *op. cit.*, Fn. 161, P. 107f.
[164] Available online at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003L0049&from=EN, checked on 11.10.18.

the related expenditure with the costs of raising capital and carrying out research & development activities occurred, and where they would normally be deducted.[165]

Surprisingly, however, there is no general subject-to-tax clause, which ultimately does not guarantee that the amounts paid as royalties will even be taxed within the European Union once. As the Interest and Royalties Directive (IRD) has the general intention of eliminating double legal taxation and the administrative and cash-flow disadvantages of cross-border intra-group payments when compared to purely domestic situations,[166] it was expected that those rules would also aim to reduce international tax barriers in the market in order to promote the European single market.[167] However, the tax problems that could arise from a simple elimination of withholding taxes in cross-border transactions have always been relatively evident,[168] and measures such as the insertion of a subject-to-tax clause or the uniformity of the European position on withholding taxes (WHT) could solve or at least reduce the impact of the problem. However, despite attempts in recent years,[169] EU Member States, considering their different perspectives and interests, have not been able to reach an agreement on this issue, either in the form of a coordination of withholding taxes between countries or the incorporation of a minimum WHT, which shows the difficulty in modifying the Interest and Royalties Directive, considering the diversity of interests existing within the European Union.

As it is, the taxation of royalties continues, therefore, to be in essence carried out exclusively by the residence state as established in double taxation agreements. In the absence of these, the source state may, for example, use withholding taxes, although naturally it has no obligation to do so, with the exception of cases internal to the EU that meet the requirements contained in the directive. This is done for example in countries such as Germany, that consider that the licensor has with his revenue from royalty payments a (limited) tax liability in German

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[165] See Cordewener (2018): The Interest and Royalty Directive. In: Wattel/Marres et al. (Eds.) - Terra/Wattel European Tax Law, P. 198, and the discussion carried on this topic on Section 4.2.1.1.
[166] *Ibid*.
[167] Arginelli (2018): Chapter 4: Open Issues of. In: Maisto (Ed.), Taxation of Intellectual Property under., P. 89.
[168] For more on this insightful observation, Easson, Alex (1996): Fiscal degradation and the inter-nation allocation of tax jurisdiction. In *EC Tax Review* (3), P. 112f.
[169] See the official documentation on Council of the European Union (2016): ECOFIN Report to the European Council on tax issues. 15254/16. Edited by General Secretariat of the Council. Council of the European Union. Brussels. Available online at https://www.parlament.gv.at/PAKT/EU/XXV/EU/12/65/EU_126531/imfname_10679895.pdf, checked on 07.01.19, P. 21ff.

territory, and therefore reserves the right to levy WHT on those payments.[170] It is finally worth remembering that, even if the definition of "royalties" is established autonomously in international treaties, the scope of the various types of IP is determined only nationally, which may also generate between some countries differentiated tax treatment due to the classification of royalties, which has to be based on each intangible asset.[171]

1.4.2 Tax concerns raised by aggressive tax planning with transactions involving IP

In recent years, a certain tax awareness regarding base erosion and profit shifting has grown in the international environment not only through projects of a more technical nature such as those of the OECD, G20 and the European Union, but also in the public milieu due to tax scandals of large companies such as Starbucks,[172] Apple, Facebook, Amazon and so on.[173] The proliferation of such tax outrages in recent years has revealed certain tax avoidance practices at an international level with massive amounts of revenue, and their resonance in the media has exacerbated a legitimate sense of injustice on the part of citizens, which has increased public pressure on politicians to take action against such arrangements.[174] Therefore, it has become a specific focus of public policy in several countries to actively combat the harmfulness of BEPS opportunities, in which one of its key points lies in the possibility of restricting the strategic use of intangible assets by multinational corporations for profit shifting purposes.

1.4.2.1 Tax structures involving easily movable assets

In short, it is widely recognized that multinational groups use the possibility of easy transfer and difficult valuation of intangibles to (re)allocate ownership of their assets strategically to related

[170] The rationale on this matter is widely discussed in Baumhoff, Hubertus; Liebchen, Daniel (2014): Seminar G: Steuerfragen im Zusammenhang mit immateriellen Wirtschaftsgütern. In *IStR* 19, P. 711f.

[171] As in Castro, Daiana (2019): Taxation of Software Payments: Multi-Jurisdictional Case Law Analysis. In *Bulletin for International Taxation* 73 (3), P. 116f.

[172] Whose specific case was dealt with thoroughly in Kleinbard, Edward D.: Through a Latte, Darkly: Starbucks's Stateless Income Planning. In *Tax Notes* 2013, P. 1515ff.

[173] A phenomenon also known as "tax shaming", as spread throughout the news. See for example the opinion of Hemmerich, Aaron (2019): Abzugsbeschränkungen im internationalen Steuerrecht. Analyse und Wirkungsvergleich der deutschen und österreichischen Lizenzschranke. In *IStR* (8), P. 294, and the article from the BBC available online at https://www.bbc.com/news/magazine-20560359, checked on 15.08.2019.

[174] The US tax reform in 2017 is a recent example of a particularly aggressive strategy to defend national interests, and although it appears to meet some of the BEPS' proposals, it can be seen as a one-sided protectionist attitude. See the opinions on Peyrol, Bénédite; Framon, Valentin (2019): Rapport d'information sur l'évasion fiscale internationale des entreprises. In *Fiscalité Internationale* (1), P. 218ff.

parties in low-tax jurisdictions – be it tax havens or countries with special incentive regimes for IP.[175] Commonly, there will be only one company in the business group that will hold ownership and therefore be responsible for the administration of the group's intellectual property. This structure is known as the "license model", [176] which leads to a situation where there is a concentration of the group profit in the company in charge for the intangibles, even if it may merely be a licensor and have few independent resources, as well as limited independent functional and financial capacity to accomplish anything else. These companies will, therefore, receive royalty payments from affiliates located in high-tax jurisdictions, which are commonly allowed to deduct the intellectual property licensing expenses in the form of business expenses. As a result, IP or R&D intensive businesses have a lower effective tax rate (ETR) than non-innovating companies.[177] That occurs mainly because, today, intellectual property has become another tool used by multinational enterprises to gain a competitive advantage.[178]

This approach has been studied and proven economically by several studies,[179] in which it is perceived that lower taxation for intangibles, regardless of their reason or origin, leads to an exponential growth of bilateral royalty flows with the country that has this lower tax rate in relation to others of higher taxation.[180] Furthermore, the reaction of MNEs to an incremental increase of the tax rate of a country show a much higher reduction of reported profits in IP-reliant companies, a strong indicator of profit-shifting.[181] This explains why, in the last decade, royalty payments

[175] There is growing empirical evidence that MNEs adapt their financial policies in tax-efficient ways, in which developed countries attract a higher amount of tax-deductible costs such as interests and royalties. See for example the comparative work of Weichenrieder, Alfons J.; Windischbauer, Helen (2008): Thin-Capitalization Rules and Company Responses. Experience from German Legislation. In: *CESifo Working Papers* Nº 2456 and the US reality in Oddleif (2016): Arm's length distribution of operating profits.
[176] The activities it undertakes are therefore commonly of an administrative nature, and not corporate undertakings. See Wilkie (2016): Transfer Pricing Aspects of Intangibles. In: Lang/Storck/Petruzzi (Eds.) - Transfer pricing in a post-BEPS., P. 66f.
[177] For more information, see the study from Heckemeyer, Jost H.; Spengel, Christoph; Richter, Katharina (2014): Tax Planning of R&D Intensive Multinationals (Discussion Paper 14-114), P. 1ff.
[178] In the last century, the companies considered most successful were those with the largest amount of tangible assets. Today, however, to adapt to the rapid changes in the market, the most prominent companies end up having few or no tangible assets, such as Airbnb, Uber, Facebook, etc. See Adegite, Victor; Ogueri-Onyeukwu, Nwakaego (2019): Transfer Pricing and the Right to Use Intangibles in Nigeria: Is the Arm's-Length Principle at Risk? In *Tax Notes International* 95 (2), P. 137f.
[179] See for instance Adams (2008): Transfer pricing aspects of IP., Maine/Nguyen (2017): The intellectual property holding company., and for a US perspective Clausing, Kimberly A. (2016): The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond. In *National Tax Journal* 69 (4), P. 905ff.
[180] A 1% discount on the taxation of intangible assets leads to around a 6% increase in bilateral royalty flows. See the excellent work of Dudar/Spengel/Voget (2015): The Impact of Taxes on., P. 2.
[181] Refer to Beer, Sebastian; Loeprick, Jan (2015): Profit shifting: drivers of transfer (mis)pricing and the potential of countermeasures. In *International Tax and Public Finance* 22 (3), P. 426–451. DOI: 10.1007/s10797-014-9323-2.

made to countries like Ireland or the Netherlands have dramatically increased in recent years, while only steadily grown for developed countries like Germany, France and the USA.[182]

The attractiveness of royalty flows for IP-Boxes in particular occurs in a very pronounced way when this preferential regime allows the application of reduced rates for *acquired* IP – which is generally considered as a harmful tax practice by the OECD[183] – since it is thus possible for a company to acquire an intangible asset for which it was not even responsible for the development of and still obtain favorable taxation for the revenue arising from its use, both nationally and internationally. Therefore, MNEs face strong incentives to shift profits from a high-tax country to a low-tax country, since these are economically "rational" decisions under a tax aspect for these companies and, as a rule, legal,[184] since they merely take advantage of the asymmetries between the different tax systems in the international framework. As a matter of fact, tax planning is not only legal when taking into consideration international tax law, but is also *prima facie* compatible with the fundamental freedoms of the European Union if legitimately aimed at reducing the tax burden.[185] These planning possibilities that may result in tax avoidance,[186] as is easily perceived, are not only the result of the aggressive tax planning of business groups, but also of the harmful tax competition carried out by the states involved, in which one posture fosters the other.[187]

1.4.2.2 Interplay between multinationals and States

In spite of the fact that tax havens have been considered in the international scenario as "perpetrators" of these harmful tax practices, there are advocates of their usefulness as a way to allow for the optimization of production costs, which would be precisely the objective sought by

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[182] *Ibid*., P. 3ff. However, more recently available data suggests that Ireland and the US have been competing more fiercely for IP onshoring as of the TCJA, in 2017. See Sullivan, Martin (2022): Ireland Rivals United States For Onshoring IP. In *Tax Notes International* 105 (5), P. 487f.; and Sullivan, Martin (2022): Irish Data Confirm Tech IP Shift From Havens to the United States. In *Tax Notes International* 105 (3), P. 281ff.

[183] When one takes into consideration their work on the nexus-approach under Action 5, discussed further in Section 2.2.

[184] As stated by Dourado, Ana Paula (2015): Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6. In *Intertax* 43 (1), P. 43f.

[185] Abuse would then occur in cases where a person tries to circumvent the provisions of domestic law and at the same time takes an improper advantage of the fundamental freedoms, by exercising the right to a fundamental freedom in an artificial manner. *Ibid.*

[186] For a deeper insight on the usage of the term, see Öner, Cihat (2018): Is Tax Avoidance the Theory of Everything in Tax Law? A Terminological Analysis of EU Legislation and Case Law. In *EC Tax Review* 2, P. 96ff.

[187] Also discussed in another article by Dourado, Ana Paula (2019): Aggressive Tax Planning and Harmful Tax Competition. Discussions on the GREIT 11th Summer Course Lisbon. In *Research Handbook on EU Tax Law (to be published)*.

transnational groups that use the advantages of intellectual property to save revenue from taxes.[188] However, tax avoidance transactions are also seen as subverting equity among taxpayers – vertical equity in particular – in which wealthy multinational companies have more opportunities than others, national ones, to enter into tax avoiding transactions.[189] Similar problems of tax planning have long been seen also with other structures that take advantage, *e.g.*, of intra-group loans.[190] The logic between these two systems is relatively similar, however the specific characteristics of IP such as the difficulty of their valuation play a very relevant role in increasing the complexity of handling cases involving intangible assets.[191] This, together with the current natural tendency of countries to seek the reduction of barriers to economic integration – whether at a regional or global level, as is the case withholding taxes – coupled with a willingness to encourage research and development activities of intangible assets in the form of tax reliefs create the perfect scenario, is allowing these tax planning opportunities to occur more frequently and more easily in the international scene.

Although not every multinational uses exactly the same structure or techniques to shift profits from a high-tax jurisdiction to a low-tax one, the strategies used follow some specific standards and have relatively well defined requirements. One of the main requirements identified as necessary for the emergence of aggressive tax planning structures linked to intellectual property is the absence of withholding taxes at a value considered appropriate among the countries involved.[192] This does not mean that the country from which the royalty payments stem from cannot have any kind of WHT levying, but rather that there are provisions with one or more exceptions for the taxation of intra-group international royalty payments that allow this type of income to leave the country without substantial taxation, which allows, through complex chains

[188] See Johannesen, Niels (2012): Optimal fiscal barriers to international economic integration in the presence of tax havens. In *Journal of Public Economics* 96, P. 400ff.
[189] Refer to the opinion of Zimmer, Frederik (2019): In Defence of General Anti-Avoidance Rules. In *Bulletin for International Taxation* 73 (4), P. 220f.
[190] For more on the problematic with intra-group loans, see Schmidtpott (2010): Die deutsche Zinsschranke - ein Vergleich. These are, however, outside the methodological scope of this work, in spite of being oftentimes studied parallel to royalties, such as in Heckemeyer/Overesch (2013): Multinationals' Profit Response to Tax., P. 27f.
[191] See for example the observations of Oliveira/Canen (2016): Intangíveis na Esfera do Transfer. In: Gomes/Schoueri, A Tributação Internacional na era., P. 183ff. The high risk of mispricing with intangibles is also well recognized in Finley, Ryan (2018): Intangibles, Low-Tax Affiliates Are Key Risk Factors for Sweden. In *Tax Notes International*, P. 751f.
[192] As demonstrated by Ramboll Management Consulting; Corit Advisory (2016): Study on Structures of Aggressive Tax Planning Indicators. European Commission. Luxembourg (Taxation papers, Working Paper N. 61), P. 41ff.

of international corporate management, the outcome with the lowest possible tax burden for the business group to be achieved.

Some of the notorious models are, for example, the "double Irish Dutch sandwich", a structure employed until recently by Google Inc. to reduce its overall tax burden on income earned outside the United States.[193] As the name suggests, this scheme involves two companies present in Ireland – an Operating Company to develop the activities and an IP-Holding Company – and a Conduit Company present in the Netherlands, which until then had no form of withholding tax for royalty payments.[194] While the IP-Holding is a direct subsidiary of the US Parent, the former directly owns both others within the EU, being however supervised and controlled in Bermuda and therefore considered resident in Bermuda to define its tax liability in Ireland. In the US, on the other hand, the company is treated as Irish since it was incorporated in Ireland and this is the definition used by US tax law, which effectively circumvents CFC rules.[195]

A similar but not identical structure can be found in companies that decide to take advantage of a jurisdiction that has some kind of tax incentive in the form of an IP-Box, although they have several points in common. Both of these arrangements, when (a) a reasonable tax payment on the initial IP transfer is possible to set up the scheme,[196] and (b) through low taxation on the country of final consumption combined with (c) high royalty payments to erode the tax base of the operating company; allow for the multinational to drastically reduce the taxes paid at the end of these transactions. This is ensured to the extent that the interposition of a Conduit Company in a country that does not charge withholding taxes – in this case the Netherlands – allows this type of tax to be circumvented completely, which is made even simpler within the EU by the Interest and Royalty Directive.[197]

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[193] See the description by Kramer, Jörg-Dietrich (2017): Germany's New Royalties Barrier Rule: Preventing Tax Evasion By Limiting Deductibility in Specified Cases. In *Tax Notes International* 88, P. 880ff.

[194] This has been gradually changed in the last years, see Sprackland, Teri (2018): Netherlands to Introduce Withholding Tax on Royalties, Interest. In *Tax Notes International* 92, P. 748.

[195] See the excellent contribution by Fuest/Spengel/Finke/Heckermeyer/Nusser (2013): Profit shifting and "aggressive" tax., P. 6ff.

[196] For example through a cost-sharing agreement. Those have numerous advantages when setting up the transfer of intellectual property, and rarely have comparables in the form of research joint ventures. See, for example, Brauner (2016): Transfer Pricing Aspects of Intangibles. In: Lang/Storck/Petruzzi (Eds.) - Transfer pricing in a post-BEPS., P. 118ff. A better example on how partnerships avoid taxes in the U.S. through such agreements can be seen thoroughly in Horst, Thomas (2020): Using Partnerships to Avoid U.S. Tax on the Expatriation of Intangibles. In *Tax Notes International* 98 (13), P. 1481ff.

[197] Fuest/Spengel/Finke/Heckermeyer/Nusser, *op. cit*., Fn. 195.

From these studies and the usage conferred to intangibles in the different forms of tax planning, it can be seen that this is where intangible assets differ from others: they are much more than assets, since they not only increase and contribute to the competitiveness, innovation and profitability of a company, but can be used in an extremely strategic way for aggressive tax planning purposes. Precisely because of this, businesses that rely heavily on intangible assets in one way or another are highly sensitive to tax changes.[198] This is particularly so because of the twofold advantage companies have in allocating their intangible assets to an affiliate resident in a low-tax country: on the one hand, they will have an attractive tax saving strategy for the taxable income arising from intellectual property in that country; and on the other hand they will allow the reduction of the taxable income present in the affiliate resident in a high-tax country from which the royalty payment comes.[199]

States wish, therefore, on the one side, to encourage research & development activities in order to promote general macroeconomic welfare gains; with the inherent worry, on the other side, that the national tax revenue be diminished through the flow of royalty payments in even lower-tax countries.[200] The estimates of revenue loss especially for developed countries are extremely high, both within the European Union,[201] the United States[202] and countries that have markets of interest for IP-heavy multinational enterprises.[203] Therefore, most of these countries have been trying to combat the flow of royalty payments to countries with low tax burdens in a variety of

[198] As in Dudar/Spengel/Voget (2015): The Impact of Taxes on., P. 26f.

[199] Analyses suggest that, specifically with respect to patents, the corporate tax rate exerts a significantly negative impact on the number of applications for new patents of an affiliate. See Karkinsky, Tom; Riedel, Nadine (2012): Corporate taxation and the choice of patent location within multinational firms. In *Journal of International Economics* 88 (1), P. 177 and 182. And while the implementation of a patent box tends to attract IP from foreign entities, the overall tax revenue loss due to the lower preferential tax rate commonly leads to a net revenue loss, as indicated by Asen, Elke (2021): What We Know: Reviewing the Academic Literature On Profit Shifting. In *Tax Notes International* 102 (8), P. 1041f.

[200] Holle (2017): Besteuerung von IP - zwischen Förderung. In: Kraft/Striegel (Eds.) - WCLF Tax und IP Gesprächsband., P. 28f.

[201] See the interesting work of the EU in European Commission (2015): Communication from the Commission to the European Parliament and the Council: on tax transparency to fight tax evasion and avoidance. COM(2015) 136 final. Available online at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0136 &from=EN, checked on 17.03.19, P. 4f. It was also recently stated that the EU is more affected by profit shifting from multinationals than, for example, the US. See Paez, Sarah (2021): EU Member States Most Affected By Multinational Profit Shifting. In *Tax Notes International* 104 (1), P. 57f.

[202] For more information, see the economic studies of Clausing, Kimberly A. (2016): The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond. In *National Tax Journal* 69 (4), P. 918ff.

[203] It is important to note, however, that developing countries are often importers of technology, which results in significant capital outflows to developed countries in the form of royalty payments for the use of such IP. This puts them in an overall disadvantageous position. For more on this topic, see the excellent work by Abdellatif Khalil (2013): Taxing intellectual property transactions in., P. 370ff.

ways, either through internationally coordinated measures or, ultimately, through unilateral actions with often dubious effectiveness, compatibility with higher ranking law and design structures, to say the least. However, as indicated above, these forms of planning are only possible to the extent that countries deliberately – in general – use tax incentive systems in order to attract investments so as to develop new technologies, generate jobs and attract skilled labor.

While it is clearly in the interest of countries to encourage the production and development of new technologies, many adopt a dual stance of competition on the one hand, where for instance individual OECD nations have competed by reducing their tax jurisdictions rates, directly or indirectly, in the field of intellectual property; while, on the other hand, they cooperate by banding together or even adopting individual postures of discouraging and penalizing the artificial allocation of income in tax havens.[204] In the context of recent OECD history, the concept of cooperation between those countries has been seen as a focus on targeting and punishing tax planning activities carried out through tax havens, usually organized via agreements between member countries, as is the case with the BEPS project itself. Thus, one perceives an approach not only against aggressive tax planning *per se*, but also against other countries that are considered practitioners of harmful tax practices.[205]

This is the other side of the coin, as companies cannot be solely and exclusively held responsible for designing and using aggressive tax planning schemes, as these opportunities only arise in the first place – or at least are greatly facilitated or expanded – to the extent that countries create asymmetric international tax systems for companies. On a side note, it is worth mentioning that it is out of the scope of the present work to discuss the criteria of *fairness* of the existence of aggressive tax planning opportunities, since it is debatable whether these are not simply a natural process of business internationalization and should not necessarily be addressed. This is true especially for those who indicate that opportunities to take advantage of differences in the legal system between countries are given to *any* company, regardless of size or branch, as long as they become internationalized.[206]

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[204] The US and Germany are recent examples of this, both on the TCJA and on the introduction of IP-related incentives, respectively. See Morse, Susan C. (2018): International Cooperation and the 2017 Tax Act. In *The Yale Law Journal Forum* (October), P. 372ff.
[205] *Ibid*.
[206] As in the contribution of Rassat/Lamorlette/Camelli (2010): Stratégies fiscales internationales.

More than that, this current outline aims at indicating the possible existence of a problem especially linked to the ease in tax planning offered by royalty payments, as well as feasible solutions from a practical point of view for those countries that do have an interest in fighting them, be it in an individual/unilateral or coordinated manner. International tax planning is actually an economically reasonable behavior of a company group to optimize costs, and while the aim for cross-border transactions will always be to achieve double non-taxation or taxation as low as possible – which does not imply a presumption of illegal conduct –, it is also only natural for new legal frameworks to make it more difficult for companies to achieve this objective.[207] To this end, it is also necessary to observe this problem from the perspective of countries that can be classified as tax haves or have decided to offer a preferential regime for intellectual property in the form of IP-Boxes.

1.4.3 Harmful tax practices through tax havens and countries with IP fiscal incentives

Just as there was an institutional reaction against aggressive tax planning opportunities, at the same time arose the need to tackle state initiatives that led to harmful tax practices, which was led both by the OECD and the European Union. The concept of tax haven was provided by the 1998 OECD Report[208], in which four criteria were to be met, to a greater or lesser extent: (a) the jurisdiction in question had no or very low effective tax rates; (b) a systematic lack of transparency; (c) no adequate exchange of information with other jurisdictions; and (d) no requirements as to the substance of the activity carried out on national territory.

The presence of preferential regimes also allows a jurisdiction to be more attractive for holding passive income – commonly linked to intellectual property – and book keeping profits.[209] Thus, the functionality of a tax haven and a country with a harmful preferential regime can be very similar, since the end result is the same, *i.e.*, allowing the multinational enterprises (MNEs) to be taxed at a level deemed as not appropriate, especially in relation to passive income with no substance requirements and with limited availability of information for other countries.

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[207] See Parada (2017): Double non-taxation and the use., P. 44f.
[208] See OECD (1998): Harmful Tax Competition. Regarding the European Union, the most relevant document is the 1997 Code of Conduct, which was recently supplemented, in 2017, with the EU black list - a mechanism of economic pressure from the European Union in jurisdictions deemed as non-cooperative.
[209] Dourado, Ana Paula (2019): Aggressive Tax Planning and Harmful Tax Competition. Discussions on the GREIT 11th Summer Course Lisbon. In *Research Handbook on EU Tax Law (to be published)*, P. 24ff.

With aims at establishing objective criteria for defining what would be an "appropriate level" of taxation, one can return to the beginnings of economic theory based on Adam Smith in the form of the *benefit principle*. This principle combines two basic ideas in determining what would be an appropriate tax, in which (a) tax rates should be proportional to the benefit obtained by the taxpayer due to the activities carried out by the State for support and infrastructure, directly or indirectly; and (b) the measure of the benefit obtained by each taxpayer individually is manifested by their income. Therefore, it is certain that jurisdictions that provide or wish to provide a higher level of services must also, consequently, raise more revenue to finance these activities. If there is a lack of proportion between the service rendered and the taxes charged, in which there are correspondingly more benefits than revenue arising from the tax rate practiced, the competition may be considered excessive and inefficient, in the form of a harmful tax practice.[210]

Furthermore, if a company has the possibility of shifting profits internationally from a jurisdiction from which it has made use of the benefits linked to it to another, with a lower tax rate, there may consequently be a mismeasurement of the marginal benefit provided by the former. This is due to the discrepancy between benefits presented and taxable income, where a jurisdiction with too low a level of taxation undermines the ability of other countries to set their tax rate at an appropriate level in order to compensate and finance their internal infrastructure and services.[211]

As many countries have now, under international pressure, changed their rules in particular with regard to the exchange of information and cooperation between jurisdictions,[212] the requirements for a legal system to be considered compliant with fair taxation are much more stringent. As a rule, only two basic criteria are considered: not to have preferential tax regimes which can be considered harmful; and not to facilitate the elaboration and interposition of offshore structures or arrangements aimed at attracting profits which do not reflect economic activity in

[210] See the insight from Junge, Aaron; Russo, Karl Edward; Merrill, Peter (2019): Design Choices for Unilateral and Multilateral Foreign Minimum Tax. In *Tax Notes International* 95 (10), P. 977f.
[211] The issue at hand is, however, a matter of territoriality, since each sovereign country has the right and power to establish taxes and taxes rates within national territory as they please, respecting of course its internal limitations. *Ibid*.
[212] As is the case with Country-by-Country reporting, for instance.

the jurisdiction.[213] Both requirements are extremely vague and broad, leaving a large margin of interpretation for what would or would not be considered a fair taxation of profits.

Despite this, many countries have been trying, as a way of attracting more investment, particularly in the sphere of intellectual property, to offer more attractive tax rates for income related to intangibles. As has already been proven, investments by IP-intensive firms are extremely tax sensitive, giving tax havens or countries that have a preferential treatment regime for this type of income an edge in terms of choice of location for these companies. By locating licenses in countries where license income is subject to lower taxation than other business income – or has low taxation in general – a company can reduce its effective tax rate whilst still benefitting from services on the countries and markets it effectively operates in.[214]

Thus, within the scope of intangible assets there is also the already known delicate relationship between industrialized countries and tax havens, with the aggravating factor that the existence of harmful tax practices linked to IP-Boxes – given the importance conferred to intellectual property – is not exclusive of the latter, since many OECD countries also have some form of incentive or preferential regime for this type of asset. Despite the fact that they are recognized as countries that have an active interest in combating base erosion and profit shifting, whether it be through tax havens or intellectual property boxes, countries such as France and Germany also have themselves some sort of preferential incentive regimes for research and development of intangible assets.[215] With the exception of Germany, which has only recently decided to adopt this type of more direct support, many are the countries that for more than a decade have already had some kind of preferential regime.[216]

However, considering the relatively recent work of the OECD in countering BEPS, minimum criteria have also been developed so that countries wishing to implement an IP-Box in

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[213] As established by the Council of the European Union (2016): Criteria and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes. Available online at https://www.consilium.europa.eu/media/24230/08-ecofin-non-coop-juris-st14166en16.pdf, checked on 27.03.19, P. 6f.

[214] Monteith, Christian (2014): Steuergestaltungen mit Lizenzboxen. In *StuB* (23), P. 885ff.

[215] For France, see Bogaert, Jérôme (2019): Le nouveau régime d'imposition des produits de la propriété intellectuelle: principaux changements et opportunités. In *Bulletin Fiscal* (12), P. 665f. and Clot, Laurence; Springael, Brent (2019): Très Bon: France's Appealing New Intellectual Property Tax Regime. In *Tax Notes International* 95 (1), P. 45ff; for Germany, Finley, Ryan (2019): German Government Submits SME-Focused R&D Allowance Law. In *Tax Notes International* 94 (4), P. 366f.

[216] For a full list, refer to Evers, Lisa; Miller, Helen; Spengel, Christoph (2015): Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations. In *International Tax and Public Finance* 22 (3), P. 505ff.

their jurisdiction may do so in a way that does not configure a harmful tax practice and, consequently, an international tax competition considered to be unfair.[217] Thus, not only a relative standardization and harmonization of the requirements and consequences of the implementation of an incentive regime for IP has been enabled, but also the identification of non-cooperative jurisdictions, either in the form of a tax haven or a country with a license box that does not comply with the nexus-approach suggested by the OECD.[218]

From that point on, many jurisdictions that already had some kind of incentive regime had to reform or repeal the provisions that would promote aforesaid harmful tax practice, leading to a moment of major changes in the national and international tax scenario.[219] In fact, quite a large number of countries have either introduced and/or reshaped their preferential regimes in recent times, which represents a remarkable upswing in such rules, especially in the past six years.[220] However, these reforms have had the important consequence of demonstrating that in countries that do have an interest in doing so, it is possible to simultaneously foster the important activities related to intellectual property and fight the artificial profit shifting between high and low-tax countries. That is, these activities are by no means mutually exclusive, but can and should be developed side by side.[221] This is in line with the most recent case law of the European Court of Justice, which confirms that the EU tax system should be designed so that the prevention of tax avoidance in the form of proportional anti tax-avoidance measures should go hand in hand with maintaining an attractive business and investments climate – in the form of preferential regimes and smart incentives for businesses.[222]

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[217] The so-called “nexus-approach”, dealt with on Section 2.2.

[218] The EU has recently exercised pressure on offshore jurisdictions to implement minimum substance rules, see for instance in Fife, Ashley (2019): The Real Deal: Offshore Jurisdictions Introduce Economic Substance Requirements. In *Tax Notes International* 93 (3), P. 314ff.

[219] Many reforms and new projects under these rules have been undertaken, see Silberztein, Caroline; Bricard, Rémy (2019): Reform of the French IP Regime: Overview of Conditions and Opportunities. In *International Transfer Pricing Journal* 26 (3), P. 205ff and Bärsch, Sven-Eric; Barbu, Yannick (2020): Steuerliche Förderung von FuE-Tätigkeiten nach der neuen Forschungszulage. In *Der Betrieb* (3), P. 70ff.

[220] As much as 50% of the countries that participated in the Taxand survey, see Taxand (2019): Global Tax & Transfer Pricing Guide on Licensing of Intangibles. TP Methods, Documentation & Practical Experience. Available online at https://www.taxand.com/wp-content/uploads/2019/09/Taxand-IP-Overview-2019-.pdf, checked on 03.03.20.

[221] As expressly stated, for example, in France in Commission Des Finances, De L’économie Générale Et Du Contrôle Budgétaire (2018): Rapport d'Information relative à l'évasion fiscale internationale des entreprises. Assemblée Nationale. Available online at http://www.assemblee-nationale.fr/dyn/15/rapports/cion_fin/l15b1236 _rapport-information, checked on 03.03.20.

[222] Such as through the Equiom (C-6/16); Deister Holding/Juhler Holding (Joined Cases C-504/16 and C-613/16) and Hornbach-Baumarkt (C-382/16). See the analysis by Kuzniacki, Blazej (2019): The ECJ as a Protector of Tax Optimization via Holding Companies. In *Intertax* 47 (3), P. 312f.

This unfortunately does not mean, however, that these recent reforms deal fully or even satisfactorily with the problems relating to tax planning opportunities seen in the previous section, as their existence has ultimately opened up margins and more concrete opportunities for other alternative tax avoidance paths. This is due, in particular, to a lack of proportion between the desire to encourage this type of activity and the fight against profit shifting, where anti tax-avoidance measures are either very specific and rigid or too broad and inefficient. Another recurrent problem of the OECD initiative that originally led to these reforms is that, in addition to being directed almost exclusively at intellectual property encouraging schemes, leaving tax havens out of their norms, many countries have been led, due to dissatisfaction with the results of work at the international level, to adopt general and specific measures of a unilateral nature outside the work of the OECD, functioning almost as a "BEPS override", which generates other asymmetries and confusion concerning the taxation of royalties, whilst also not necessarily solving the issue.[223]

1.5 Interim results

In this chapter, we discussed and defined (1) the *object* of the research, indirectly in the form of intangible assets and their variations, but more specifically cross-border royalty payments made between related parties; as well as (2) the *problem* arising from this type of transaction, which is the broad and virtually unrestricted use of these mechanisms as a strategy for aggressive tax planning by multinationals. This occurs, on the one hand, because, although jurisdictions are provided even by international treaties – such as the double taxation agreements that follow the OECD model – with a piece of the cake, they are not actually required to *eat* it. This means that countries, in seeking to encourage research & development activities, as well as the use of new technologies and intellectual property, end up promoting harmful tax practices that distort international tax competition, and are abused especially by companies that are heavy-IP reliant and develop international activities.

On the other hand, considering the specific characteristics that intangible assets hold, allowing their easy transfer overseas, high added value, but with a corresponding difficulty of valuation according to basic parameters of transfer pricing and arm's length principle, it is

[223] Titgemeyer, Marion (2017): Steuergestaltung bei multinationalen Konzernen: kritische Diskussion der deutschen Lizenzschranke. In *DStZ* 20, P. 746ff.

relatively simple to use them as tax avoiding mechanism. This occurs notably when there are asymmetries in the classification of what would constitute an intangible asset, which in turn may directly impact the royalty payments classification commonly adopted internationally. Although the latter is, as a rule, defined in double taxation agreements along the lines of the OECD, intangible assets are usually independently defined in the national legislation of each country, which can lead to enormous legal problems that can simultaneously bring tax saving opportunities, but also legal uncertainty for companies and for tax administrations alike. Therefore, MNEs develop increasingly complex structures to, taking advantage of the asymmetry of regulation and classification between the different countries involved, apply an extremely aggressive form of tax planning in order to reduce the overall tax burden of the business group.

In designing these tax-saving structures, the major factors companies have to consider when dealing with cross-border royalty payments between related parties are, of course, (1) transfer pricing rules, which have applicability in the form of the arm's length principle, despite the difficulty of their proper use, especially with respect to hard-to-value intangibles; (2) withholding taxes, whose absence or low tax rate is recognized as one of the main factors that allow for aggressive tax planning with IP, being directly influenced by double taxation agreements (DTAs); and (3) controlled foreign company rules, or CFC for short, especially relevant for outbound cases, in which jurisdictions may decide to tax companies controlled by related parties residing in their national territory, in order to avoid base erosion and profit shifting. These are some of the main measures employed in order to curb aggressive tax planning practices that (ab)use the lower tax rates of some countries, be it a harmful tax practice or not. There are, of course, other measures of either a general or specific nature that may represent, totally or partially, the *solutions* for the problem in question. These will be, from now on, the focus of this study.

Chapter 2: The employment of general measures in order to counter artificial profit shifting through royalty payments

2.1 Broad scope rules as a means of indirectly tackling the issue

The problem of profit shifting using intellectual property and royalty payments, as demonstrated above, is far from recent, although it has clearly become more dire in recent years. However, tax avoidance or abuse issues have existed in the international taxation scenario for

several years now, in many different forms and structures. Aware of the impossibility of the legislator to establish specific rules that can address any kind of unwanted arrangement that may arise – particularly when it comes to transactions of an innovative nature, such as those related to intellectual property – several broad-spectrum rules have been elaborated and perfected over time to try to reduce opportunities for base erosion and profit shifting.

The main and most relevant of those norms for international taxation and transactions involving royalty payments will be discussed in the following sections, such as transfer pricing and the arm's length principle, as well as controlled foreign company (CFC) rules and the broad scope rules par excellence: general anti-avoidance rules (GAARs). It is true that these mechanisms have multiple applications, having relevance in different areas of international taxation. However, the purpose of this work is not to cover these instruments in a comprehensive manner, but rather to understand their structure and operation in order to relate them directly and exclusively to the international remuneration – especially among related parties – of the use or right to use intangible assets in the form of license fees.

This analysis will allow a more precise cut of the relevant regulations for this specific theme, as well as aid in determining which are the characteristics apt to combat BEPS linked to intellectual property and to what extent they are in need for reform or restructuring on this matter.[224] Thus, with an in-depth study of these rules from this particular perspective, it will be possible through coordination with the specific anti-abuse rules to determine a path of concerted action that will obtain the most tangible results in order to avoid in a fair manner multinational companies from obtaining advantages considered undue in the context of international taxation.

2.1.1 Transfer pricing rules operating as a basic tool for a fair allocation of intra-group royalty payments

The first rule of clear significance for transactions involving intangibles are those related to transfer pricing. A transfer price is the price due in transaction between related entities, such as *e.g.* a parent multinational corporation and a controlled foreign subsidiary. Every single OECD and G20 country has some sort of transfer pricing regulation, with varying degrees of strictness,

[224] Furthermore, an analysis of the compatibility with higher-ranking law will be conducted where applicable, since this falls outside of the methodological scope of this work, and the in-depth study present in Chapter 4 is reserved for more specific and newer, more controversial rules.

to prevent firms from manipulating the price of related-party transactions for tax purposes.[225] While not being nowadays an anti-avoidance rule by itself,[226] from a perspective that is targeted towards intangible assets, one can imagine the difficulties inherent to the application of traditional transfer pricing rules and compliance with the arm's length principle, considering the innovative and often unique – and therefore of reduced comparability – element inherent to intellectual property. This difficulty is further increased in the hypothesis that, in a transaction between related parties, the intangible asset has not yet been placed on the market, since the uncertainties of a possible commercialization of a product or the use of a new technique may be considerable even for the owners of this novel knowledge.

Thus, in some cases, the appropriate value of a given asset can only be determined *a posteriori*, considering that its final value may differ immensely from the value invested in its elaboration through research and development activities. Due to these and other difficulties related to the use of transfer pricing rules and the arm's length principle, many experts are critical of the idea of maintaining the arm's length principle as the preferred method of determining the allocation of profits among companies of the same group, seeking alternatives to complex issues such as those involving intellectual property and the payment of royalties. Hence, in this section, the characteristics and methods of transfer pricing relevant to international transactions involving intangible assets will be discussed, as well as their strengths and weaknesses in combating aggressive tax planning in this manner.

2.1.1.1 Arm's length usage and overall relevance for licensing agreements

The general concept of applying transfer pricing rules and the arm's length principle is of manifest relevance to the problem of royalty payments in focus. This is because these rules are used for tax purposes in order to determine not only the price, but also the comprehensive conditions of transactions carried out within a group of companies that operates internationally,

[225] See Johansson, Åsa; Bieltvedt Skeie, Øystein; Sorbe, Stéphane (2017): Anti-avoidance rules against international tax planning (OECD Economics Department Working Papers, 1356). Available online at https://www.oecd-ilibrary.org/economics/anti-avoidance-rules-against-international-tax-planning_1a16e9a4-en, checked on 30.08.2018, P. 6f.

[226] Even though originally meant to be one, nowadays TP legislation morphed into a globally accepted means of allocating a "fair" share of profits, as discussed by Kofler, Georg; Verlinden, Isabel (2020): Unlimited Adjustments: Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the "Saving Clause". In *Bulletin for International Taxation* 74 (4), P. 269ff.; and in Hoffman, Simon (2020): Hard-to-Value Intangibles and the Pricing of Uncertainty. In *International Transfer Pricing Journal* 27 (3), P. 160f.

ultimately aiming at promoting a fairer taxation through a correct allocation of profits to group companies in different countries.[227] With the constant and exponential increase in the amount of international transactions,[228] especially those carried out internally by multinational groups,[229] often involving intangibles, today more than ever the correct determination of transfer prices is relevant – and, at the same time, challenging.

The difficulty of its application, and this not only for issues involving intangibles, can be traced back to its genesis in the 1920s, where it was in a way first cited in the commentary on permanent establishment in the income tax treaty draft model of the League of Nations, in 1928.[230] Its concept has since been considered inherently flawed,[231] with evident shortcomings in its use, since the process of comparison between controlled and uncontrolled transactions will inevitably pose difficulties, either due to the impossibility of comparing naturally distinct transactions – considering *e.g.* differences in access to information between the parties, or the impossibility of taking into account factors present only in integrated businesses[232] – or by the simple inexistence of satisfactory comparative standards.

Nevertheless, this method of evaluating intercompany transactions has gained worldwide acceptance, especially with the work of the OECD and its model convention, and much like democracy, transfer pricing might be the worst form of allocation of profits to group companies, except for all the others. Thus, the arm's length principle is still used today as the cornerstone of

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[227] See, for instance, the work of the OECD on the topic on OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports. Available online at http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm, checked on 04.10.2018.

[228] Today, one fourth of global production is believed to be exported, having grown exponentially since the 19th century. Refer to the work of Beltekian, Diana; Ortiz-Ospina, Esteban (2018): Trade and Globalization. Available online at https://ourworldindata.org/trade-and-globalization#trade-has-changed-the-world-economy, checked on 26.05.2020.

[229] The latest estimate from the United Nations on this topic is that about one third of world trade takes place internally to business groups, *i.e.* intra-firm controlled transactions. It should be noted that this work of the U.N. Conference on Trade and Development dates from 2013, and this percentage may well have expanded further. See the report on United Nations Conference on Trade and Development (2013): Report UNCTAD/PRESS/PR/2013/001. Available online at https://unctad.org/en/pages/PressRelease.aspx? OriginalVersionID=113, checked on 26.05.2020.

[230] For the original Treaty Draft, see it available online at https://www.uni-heidelberg.de/institute/fak2/mussgnug/historyoftaxdocuments/normtexte/voelkerrecht/V00021.pdf, checked on 26.05.2020.

[231] Kaeser, Christian; Owens, Jeffrey; Sim, Sam (2019): Going the Way of the Polaroid: Digital Taxation and the End of the Arm's-Length Principle? In *Tax Notes International* 95 (3), P. 212f.

[232] For more information on these reasons, see the contribution of Licollari (2017): Limiting Base Erosion by Improving. In: Pinetz/Schaffer (Ed.) – Limiting base erosion., P. 525ff.

transfer pricing rules, requiring transactions between associated companies to be priced as if the parties to the transaction were independent.[233]

The OECD's overall objective in employing this principle is to align transfer pricing outcomes with value creation, *i.e.,* to indicate an emphasis on the allocation of risk, functions and assets (including intangibles) in a way that fairly rewards the role of each party to the transaction in value creation, rather than for tax reasons. This is noticeable as one of the clear impetus of the OECD with its 8-10 BEPS Project Actions, especially in relation to intangibles, was to allow a reduction in the significance in the value chains of MNEs of intermediary companies that are merely responsible for the ownership of intangibles and the capture of licensing fees.[234] However, this alignment to value creation is being challenged even by the OECD itself in more recent projects,[235] such as via the GloBE proposal, which will be discussed later on.[236]

Many of the criticisms associated with transfer pricing rules have intensified with the emphasis given to intangible assets today, since more than ever the structure of this system has been subjected to stress and put to the test.[237] This, combined with a constant increase in the complexity of applying the arm's length principle made its practical employment extremely difficult, leading many scholars to seek alternatives for its usage.[238] It so occurs that the arm's length principle, used today as an essential rule in the taxation of cross-border transactions, inadvertently can backfire and provide multinational companies with a tax advantage that is not available to other companies that are not subject to transfer pricing rules.[239] Aforementioned complexity stems furthermore mainly from conflicting regulatory requirements for companies in

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[233] As is with the recent reforms in Poland, see for instance Halat, Robert (2020): Änderungen der Verrechnungspreisvorschriften und die IP-Box in Polen. In *IWB* (2), P. 73ff.
[234] This is one of the central problems when it comes to profit shifting through royalty payments, as seen in Chapter 1.4.2 and the concept of a "license model" structure. This means that MNE members connected between themselves have to have a reason as to which functions they develop and why their existence is economically rational. See Wilkie (2016): Transfer Pricing Aspects of Intangibles. In: Lang/Storck/Petruzzi (Eds.) - Transfer pricing in a post-BEPS., P. 94f.
[235] Heavily criticized by some, as in Goulder, Robert (2019): The End of Arm's Length as We Know It (and I Feel Fine). In *Tax Notes International* 93 (9), P. 1005ff.
[236] The proposed minimum tax through Pillar 2 would promote the levying of a tax at a minimum rate regardless of the realization of the transaction according to arm's length principles. For more, refer to Chapter 3.4.
[237] Intangibles are consistently used, as already demonstrated in previous chapters, as an opportunity for tax optimization, which occurs also through transfer pricing regulations. See some of the main structures in Rassat/Lamorlette/Camelli (2010): Stratégies fiscales internationales, P. 129ff.
[238] As seen thoroughly in Kroppen, Heinz-Klaus; Dawid, Roman; Keil, Viktoria (2019): Die Zukunft der internationalen Verrechnungspreise. In *IWB* 15, P. 590ff.
[239] For more on this opinion, see Brauner, Yariv (2014): Formula Based Transfer Pricing. In *Intertax* 42 (10), P. 615ff.

national law, which leads to a general lack of legal certainty and imminent risk of double taxation; and what is considered by many an excessive burden with documentation requirements.

2.1.1.1.1 Usefulness of the arm's length principle despite hardships

The aforementioned difficulties end up affecting both the companies and the tax administration responsible for analyzing such information, making the correct application of transfer pricing rules hard on both sides. Naturally, this applies especially to the interplay between transfer pricing rules and intangible assets, the relationship of which is viewed by some as dysfunctional in a globalized and high-tech economic environment.[240] The complexity of this interaction, coupled with enforcement costs on the one hand and compliance costs on the other, deters many of still pursuing the application of the arm's length principle.

This does not, however, reduce the relevance of such rules in other aspects of combating tax avoidance, and there is on the opposite side great resistance from some countries and scholars in abandoning the arm's length principle altogether.[241] That happens despite all the problems constantly indicated by the literature on the subject, since the reality is that there is no prospect of the end of the arm's length principle in the international scenario, precisely because finding a system that meets the necessary requirements for its replacement is nearly impossible. The longevity of the arm's length principle is certainly linked to its flexibility of operation with different methods while maintaining its principle-based characteristics.[242] For instance, to solve problems related to the lack of comparability for intangible assets – one of the most significant problems in the application of these rules to the work at hand – methods such as the transactional net profit were created in an attempt to work around its intrinsic weaknesses. In addition to the creation of new methods, the OECD also saw fit to adapt the use of arm's length to new business models and aggressive tax planning structures by MNEs, creating the so-called DEMPE functions,[243] which

[240] For more, Kofler, Georg (2013): The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard under Pressure? In *British Tax Review* (5), P. 2ff.
[241] As is the case with the United States, as clearly stated in Finley, Ryan (2019): Harter Says Tax System Will Not Abandon Arm's-Length Principle. In *Tax Notes International* 95 (4), P. 354f.
[242] See the insight of Kaeser, Christian; Owens, Jeffrey; Sim, Sam (2019): Going the Way of the Polaroid: Digital Taxation and the End of the Arm's-Length Principle? In *Tax Notes International* 95 (3), P. 214.
[243] As described in Oliveira/Canen (2016): Intangíveis na Esfera do Transfer. In: Gomes/Schoueri (Eds.): A Tributação Internacional na Era., P. 182ff.

aim at analyzing the relevant functions performed by each part of a transaction in order to have relatively objective criteria to determine more accurately the allocation of taxing rights.[244]

Furthermore, the costs associated with the transition from one transfer pricing system to another are too high, in which there will certainly always be resistance from states that have conflicting interests in international taxation, since any change in the allocation of taxing rights will invariably lead to a redistribution of taxation income, in which gains on one side inevitably lead to losses on the other.[245]

To this end, any minimally relevant alternative to replace the arm's length principle must necessarily meet at least three criteria: I) it must be capable of gaining international consensus, including from developing countries, no matter how difficult unanimity is to achieve – this is a *conditio sine qua non* for the implementation of any comprehensive reform; II) it has high flexibility, preferably being principle-based, to offer a longer-lasting and adaptable response to prospective problems; and III) it is linked to the lowest possible administrative strain, both for companies and for the corresponding public administrations, which should be able to make use of the system in an efficient manner and with the least possible staff and financial contingent.[246] As such, it is difficult to say that there is any plausible alternative to *replace* the arm's length as of now, even if there is evidently the possibility to *coordinate* it with other measures.

Therefore, regardless of the evident issues this system has, the determination of arm's length conditions in cases involving intangible assets is indeed feasible, and can directly and indirectly assist in the fight against BEPS. The inherent flaws in the application of the arm's length principle with respect to intangibles were, in fact, one of the main triggers of the BEPS project and the reforms that the TP rules received in the first place.[247] Overall, in order to help determine the

[244] Information on the concrete use of DEMPE can be seen, for instance, in Robillard, Robert (2019): Transfer Pricing in Canada and the U.S.: Intangible Property in Controlled Transactions. In *Tax Notes International* 95 (10), P. 996ff. More recently, the U.S. has seen in the *Coca-Cola* decision the usage of concepts akin to the OECD DEMPE doctrine without actually using the term, as discussed in Armitage, Clark; Schafroth, Heather; Stevens, Elizabeth; Rosenbloom, H. David (2021): Coke Concentrate: A Recipe for Understanding the IRS's Biggest Win in 40 Years. In *International Transfer Pricing Journal* 28 (2), P. 89ff; and Finley, Ryan (2021): After Coca-Cola, Practitioners See DEMPE As Part of U.S. Law. In *Tax Notes International* 102 (8), P. 1133f.

[245] A parallel of this gaining-losing paradigm can be made to Nash bargaining theory applied to transfer pricing, as seen in Satterthwaite, Benjamin (2019): Nash Bargaining Theory and Intangible Property Transfer Pricing. In *Tax Notes International* 95 (14), P. 1383ff.

[246] As discussed by Kaeser *op. cit.* Fn. 242.

[247] For more information, refer to Brauner (2016): Transfer Pricing Aspects of Intangibles. In: Lang/Storck/Petruzzi (Eds.) - Transfer pricing in a post-BEPS., P. 98.

correct transfer price in transactions involving intangible assets in a methodical manner, it is necessary to initially determine a) which are the relevant transactions involving the identified intangible assets in question; b) which entity(ies) is/are the legal owner(s) of the intangible asset; and c) what is the contribution of each one to the value of this asset – with emphasis on the DEMPE functions.[248] As intangible assets commonly possess, as seen in Chapter 1, attributes that can make the search for comparables too difficult, it is essential that all available aspects of the transaction be analyzed concomitantly, taking into account the perspectives of each of the parties involved.

When discussing a transaction that deals with licensing fees, this means observing the business interests and possibilities, on the one hand, of the legal owner of the intangible, and that transfers the rights to use the asset; and on the other hand, of the one that actually makes use of the benefits provided by the intangible, and must remunerate the owner for its use. The ideal scenario for the analysis of transfer pricing of an intangible asset in such cases is that, in addition to this information on the parties involved in the transaction, it is possible to contrast some of the "common" characteristics shared by intangibles with others in a similar context. These characteristics are directly related to the value that an asset has, such as the existence or not of legal protection, which would be the case for a patent; its stage of development and commercial applicability; presence of a limited useful life for the protection and/or commercialization of the asset; legitimate expectations of profitability with its use, etc.[249]

Profitability in particular is a very important factor in this analysis, since it represents the economic outcome of the use of the asset and, consequently, a measure of the marketable thresholds that can be reached with its use.[250] Finally, it is important to note that, although it is relevant to always observe who the legal owner of the intangible asset is, the current application of the arm's length principle requires, especially with regards to royalty payments, the determination of the *real* contribution of each part of a transaction to the value chain and the

[248] See OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 92ff. Some countries have recently decided to adopt these DEMPE functions as baseline parameters to move away from a narrow focus on legal ownership of intangibles in cases of transfer pricing, which has massive impacts in cases of cross-border royalty payments. See, for example, the case of Hong Kong in Finley, Ryan (2020): Hong Kong Aligns Guidance on IP Transactions With Amended Law. In *Tax Notes International* 99 (7), P. 944ff.
[249] *Ibid*., P. 95ff.
[250] To this profitability are linked several risks that will be assumed, to a greater or lesser extent, by the parties involved in the transaction, whether with the (future) development of the intangible, risks linked to its commercialization, etc. The analysis of these risks is, however, outside the methodological scope of this work.

economic benefit provided by the asset, which might lead to a case in which the legal or formal ownership of an intangible may be entirely different from its economic or real ownership.[251] This means that, notwithstanding being the legal owner of an asset, there may be cases in which the compensation for the right to use this asset is seen as wholly or partially improper.[252] The absence of a performance of any relevant functions or assumption of risk by one of the parties should, logically, lead to a result in which this party is not entitled to a portion of the returns deriving from the usage of the intangible.[253] This makes sense insofar as while the transfer of legal ownership – especially of intangible assets – can occur instantly,[254] the same does not necessarily apply to the economic ownership.

This means that, when trying to use the arm's length principle to determine the allocation of profits involving transactions with intangible assets, the most varied results may be obtained in each specific case, depending on the participation of each party and the approach used to analyze the relevant information. To this end, the classic transfer pricing methods proposed by the OECD can, to a greater or lesser extent, assist in obtaining more accurate and satisfactory results, especially in the – unusual – case of having comparable uncontrolled transactions.

2.1.1.2 Arm's length overview on methods and their effectiveness regarding royalty payments

Theoretically, any of the five main methods suggested by the OECD for applying the arm's length principle can, alone or in conjunction with some of the other methods, be employed in transactions involving intangible assets. The main concern is precisely the frequent lack of reliable comparative standards in uncontrolled transactions, which occurs in large part, but not only, owing

[251] See the contribution by Fedi, Alissa (2019): Transfer Pricing Aspects of Transactions with Marketing Intangibles in a Post-BEPS World. In *International Transfer Pricing Journal* 26 (6), P. 408f.
[252] A practical case was recently decided on royalty payments by a Danish court, refer to Finley, Ryan (2020): Danish Tax Tribunal Sides With Tax Agency in IP Valuation Case. In *Tax Notes International* 97 (4), P. 434f.
[253] This position is, however, criticized by some authors who see as a risk that the importance of legal ownership of intangibles is diminished, as this could lead to unforeseen negative effects. In addition, this would be tricky because it would give too much power to the tax authorities responsible for conducting the analysis of these criteria, who might use dubious concepts to obtain the desired result, reducing the overall legal certainty of these transactions. See for example Ditz, Xaver; Pinkernell, Reimar; Quilitzsch, Carsten (2014): BEPS-Reformvorschläge zu Lizenzgebühren und Verrechnungspreisen bei immateriellen Wirtschaftsgütern aus Sicht der Beratungspraxis. In *IStR* (2), P. 50f.
[254] Which is why the so-called DEMPE functions and the OECD methods of valuation are of the utmost importance, since the DEMPE approach is a means of replacing the distinction between legal and economic ownership. Refer to the analysis of Seve, Anthony; Austin, Peter; Wright, Ruth (2020): Australian Taxation Office Audit Focus on Arrangements Involving Intangibles. In *International Transfer Pricing Journal* 27 (3), P. 196f; and Hoffman, Simon (2020): Hard-to-Value Intangibles and the Pricing of Uncertainty. In *International Transfer Pricing Journal* 27 (3), P. 162f.

to the unique characteristics that this type of asset has. The absence of such comparables also occurs due to a general shortage of available data on this type of transaction, which occurs mostly between companies of the same group.[255] Thus, the OECD recommends in particular the use of the comparable uncontrolled price (CUP) method and the transactional profit split method (TPSM) among the five available for this analysis.[256] Interestingly, the CUP method, which evaluates the merit of a given controlled transaction from a direct comparison with the characteristics of an uncontrolled one, is rarely used in transactions with intangibles, even though it is generally the most reliable and accurate method, precisely because of the difficulty in finding adequate comparables. Therefore, this method is preferentially used in cases of sale of specific products or services, and not of intangibles.[257]

The comparable profits method, on the other hand, initially not even suggested as one of the preferred methods by the OECD, also encounters substantial difficulties in its application with IP. This method aims to evaluate controlled transactions based on a comparison with objective prospects of profitability derived from transactions involving independent taxpayers engaging in similar business activities.[258] However, the intrinsic nature of intangibles and the lack of proportion between the invested value *vs*. the profitability that characterizes their development and commercialization make the use of this method practically unviable.[259] Similar problems arise when one seeks to use the classic cost-plus method, which focuses primarily at pricing controlled transactions of unfinished goods through the addition of mark-up costs consistent with that of suppliers of uncontrolled transactions.[260] Nonetheless, once more the absence of comparables make this method extremely unreliable, especially when combined with the possibility of

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[255] This occurs because, given the potential for commercialization of new techniques or technologies, but with uncertain and often disproportionate results to the amount invested, it is usually in the interest of MNEs to keep to themselves the findings of their research & development. See the analysis by Grubert, Harry (2003): Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location. In *National Tax Journal* LVI (1), P. 225ff.

[256] Even though it is made clear that any of them might be adequate in obtaining arm's length results. See See OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 100f.

[257] As stated through practical experience in Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 386f.

[258] See Satterthwaite, Benjamin (2019): Nash Bargaining Theory and Intangible Property Transfer Pricing. In *Tax Notes International* 95 (14), P. 1387f.

[259] As was made clear in Swedish case law, intangibles are very high risk factors in transfer pricing due to, among others, profitability out of line with the rest of the industry. See Finley, Ryan (2018): Intangibles, Low-Tax Affiliates Are Key Risk Factors for Sweden. In *Tax Notes International*, P. 751.

[260] Centre for Tax Policy and Administration (2010): Transfer Pricing Methods. OECD. Available online at http://www.oecd.org/tax/transfer-pricing/45765701.pdf, checked on 29.08.2018, P. 5ff.

manipulating the final costs of a product due to *e.g.* different sources of investment in its development.

There would also be the possibility to employ a resale price method and calculate a gross margin by contrasting the price at which a good is purchased in a controlled transaction and the price at which it is sold to a third uncontrolled party, minus the costs related to the production of the good. This might be accurate for vertically integrated businesses like distributors and resellers,[261] but very difficult for intangibles, considering the unique nature of the transactions they are usually involved with.

It is worth noting that the methods described above are not *prima facie* unviable in each and every case involving intangible assets, although their applicability is so restricted that their use cannot be made in a reliable and systematic manner to determine the correct allocation of profits between related parties. What remains, therefore, is to analyze the last method suggested by the OECD, which is the transactional profit split method.

This method is the one used par excellence when there is no identifiable comparable uncontrolled transactions available, which is often the case with the licensing of intangibles, especially their hard-to-value variation.[262] Being a transactional profit method indicates that the most important factor for its use will be the profits arising from the relevant controlled transactions – in this case involving intangible assets.[263] These profits will therefore be split in a way that supposedly would have been determined in an uncontrolled transaction by non-related parties that were carrying out operations of the same nature.

The main difference of this method is, in fact, that the contribution of *both* parties to the transaction is taken into consideration in determining the allocation of these profits, being the only so-called "two-sided" method presented by the OECD. This means that the aforementioned methods highlighted only the position of one of the parties, being therefore considered *one-sided*.[264] Given the complexity of the transactions involving intangibles and the payment of

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[261] *Ibid*., P. 4f.
[262] For more reasons on this, see Chapter 1.2.3.
[263] See the definition on IBFD (2019): International Tax Glossary. IBFD. Available online at https://www.ibfd.org/IBFD-Tax-Portal, checked on 02.06.2020.
[264] Zucchetti, Simone; Piva, Caterina (2019): Revised Guidance on the Application of the Transactional Profit Split Method: Evolution or Revolution? In *International Transfer Pricing Journal* 26 (2), P. 97.

royalties, as well as the absence of comparative standards, the transactional profit split method (TPSM) aims at taking advantage of all available information that may assist in the analysis of the given case, resulting in a more complete investigation.[265] This also allows it to solve one of the main problems linked to transfer pricing disputes in cases involving intangibles alongside the lack of comparables and information, which is the use of different royalty rates in different countries for the same licensing scope.[266] The transactional profit split method is the only one that allows a country-specific analysis, since it is profit-linked and it is possible to obtain non-uniform results for the royalty rates in different countries.

Therefore, the application of the transactional profit split can be divided into two main stages,[267] one in which the combined profits to be split between the associated enterprises arising from the controlled transaction(s) are identified; and the other in which the profits are divided between the related parties according to an economically valid basis, that is, according to parameters determined by the market based on *e.g.* how the licensing between independent parties would be.

It is worth noting, however, that although TPSM is the theoretical method indicated by the OECD to solve problems involving transactions with intangibles, intercompany licensing issues are still commonly dealt with in practice using the comparable uncontrolled price (CUP) method – despite the absence of adequate comparables.[268] A large part of the countries' tax administration does not even have experience in the use of the transactional profit split, which probably occurs due to its high degree of complexity and need for information pertinent to both sides of the transaction, which in cases of interest are located in different countries.[269] Even those who have

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[265] The US has, however, many peculiarities concerning their own transfer pricing system and how to deal with intangibles. For more information, see, for instance, McClure, J. Harold (2021): CPM vs. CUT: Intercompany Royalties for Really Good Cookies. In *Tax Notes International* 104 (6), P. 645ff.

[266] See the report on the discussion by Dziwinski, Karol (2019): Transfer Pricing and Intangibles: Report on the WU Transfer Pricing Symposium. In *International Transfer Pricing Journal* 26 (3), P. 192ff.

[267] It is worth noting, however, that there are a few substantial differences to the approach of the OECD to the TPSM – the one adopted here since it serves as a more international standard – and the US one. For more on those differences, refer to Torvik (2016): Arm's length distribution of operating., P. 289ff.

[268] Even though many countries have tax authorities that expressely determined that the profit split method should be preferred, such as in Israel. See Haber, Lital, New York, Israeli Tax Desk (2021): Israel View on Profit Split Application for R&D centers. In *Journal of International Taxation* (5), P. 18.

[269] See the insightful study by Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 384ff.

experience in its use report that its employment is extremely unusual, which demonstrates the need for other (better) responses to this type of concern.

2.1.1.2.1 The OECD's response to arm's length difficulties with intangibles

In an attempt to remedy or reduce the practical difficulties encountered in the application of the transactional profit split, the OECD published in 2018 a revised guidance exclusively for the application of TPSM.[270] This revision was made with a view to safeguarding the use of this method, considering the importance given to its applicability in the absence of comparable uncontrolled transactions, an increasingly frequent reality. Among the main problems in its use, not only the complexity factor was highlighted, but also the presence of excessive room for maneuver for an arbitrary allocation of profits arguably in line with value creation standards, which would ultimately facilitate base erosion and profit shifting schemes.[271] Based on this reform, the European Union also issued a report on the coordinated usage of the TPSM by Member States one year later.[272]

This revised guidance reaffirms the appropriateness of this method for cases where there is a unique and valuable contribution by each party to a transaction, commonly found in transactions involving intangible assets.[273] Nonetheless, the ability of this form of analysis to be flexible and to encompass specific and unique features and circumstances that characterize the associated enterprises is both its strength and its weakness, as it addresses the uniqueness of IP while still leaving room for discretionary judgments that can give rise to disputes between tax administration and taxpayer. Thus, it is easy to perceive that one of the most significant challenges

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[270] OECD (2018): Revised Guidance on the Application of the Transactional Profit Split Method. Inclusive Framework on BEPS: Action 10. Available online at https://www.oecd.org/tax/transfer-pricing/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf, checked on 10.12.2019.

[271] Zucchetti, Simone; Piva, Caterina (2019): Revised Guidance on the Application of the Transactional Profit Split Method: Evolution or Revolution? In *International Transfer Pricing Journal* 26 (2), P. 97.

[272] European Commission (2019): EU Joint Transfer Pricing Forum. The application of the profit split method within the EU. European Commission. Available online at https://ec.europa.eu/taxation_customs/sites/taxation/files/report_on_the_application_of_the_profit_split_method_within_the_eu_en.pdf, checked on 10.06.2020.

[273] See OECD (2018): Revised Guidance on the Application of the Transactional Profit Split Method. Inclusive Framework on BEPS: Action 10. P. 12ff.

when dealing with the taxation of transactions involving intangible assets is the balance between flexibility to solve problems and combat abuses and to simultaneously ensure legal certainty.[274]

To increase the accuracy of TPSM, the OECD then proposes two different approaches, namely (a) the contribution analysis, which splits any relevant profit from the controlled transaction between the related parties, as supposedly would have been done between independent parties; and (b) the residual analysis, which performs the allocation of profits in two distinct stages, initially separating from the other profits those coming from the so-called "routine functions" performed by each party, that is, those that can be normally measured without major difficulties. In a second stage, only the so-called "residual profits" will be allocated among the related parties, those actually according to value creation and functions performed criteria.[275] Since it is relatively common for each party to perform both routine and unique functions in transactions with intangibles, the end result will be more accurate if each of these functions is analyzed separately and even possibly through the use of different transfer pricing methods, being the residual approach therefore the preferred pathway.

Subsequently, one point of emphasis is that while the OECD does not differentiate between "actual" or "anticipated" profits to be split, it gives practical examples in its Annex of how to make correct use of the TPSM, even though it is of course impossible to cover all the cases that may possibly occur beforehand. It is surprising to observe that the purpose indicated by the revised guidance is to approximate the allocation of profits to what would be established by independent parties, following the basic precepts of the arm's length principle. Yet, a focus on external comparable data is diametrically opposed to the main trait of the transactional profit split, which is precisely the possibility of solving problems where there are not enough comparative standards, which hampers the establishment of an adequate benchmark for transactions. The solution

[274] One possible solution that already exists for this conundrum might come immediately to mind: mutual agreement procedures (MAP) in cases of transfer pricing, which would allow greater legal security coupled with the flexibility of using this method. However, despite an exponential increase in MAP cases between 2010 and 2015 (more than 85%!), the average time for such a procedure in OECD-countries is still very long at around 17 *months if there are no transfer pricing issue*s, as it can last on average twice as long in more complex cases involving TP. In such a situation of delay, the arm's length principle is not exactly reliable, and therefore innefective and remains outside the methodological scope of this work. See Kroppen, Heinz-Klaus; Dawid, Roman; Keil, Viktoria (2019): Die Zukunft der internationalen Verrechnungspreise. In *IWB* 15, P. 602ff.
[275] OECD*, op. cit.*, Fn. 273, P. 19ff.

presented, therefore, would be through the election of an *allocation key*,[276] consistent with the individual input of each party, to be employed in each case. Therefore, the TPSM does not present a ready-made formula for transfer pricing issues, but rather introduces basic parameters for a selection by taxpayers and tax administration of relevant allocation keys that are as objective as possible, reflecting the relevant facts and circumstances of the case.

Nevertheless, special attention should be paid to this method, since the way to carry out the allocation of profits between these companies within the same group is the key point on the reason to use the transactional profit split, since it would allow in the specific case of the licensing of intangibles to assess the extent to which the payment of royalties was made according to the arm's length principle. This means that it is assessed, in the first place, whether the payment was made in the *adequate* amount based on the relative contribution of the parties, as measured by their functions, assets used and risks assumed,[277] which enables the determination of whether the allocation of profits was made properly. It is nonetheless essential to note that this does *not* solve the problem of profit shifting indicated in the previous chapter entirely, since once one of the parties residing in a low-tax country is responsible for performing functions and assuming risks – *i.e.* having relevant economic activity – the payments made to it can be considered perfectly in accordance with transfer pricing standards regardless of the level of taxation to which this payment will be submitted in the licensor's country.[278]

The correct use of transfer pricing methods, ensuring compliance with the arm's length principle, nevertheless allows to prevent IP-Intensive firms to shift profits via transfer pricing manipulation in the absence of other anti-avoidance regulations.[279] This means that TP actually works as a general backstop for profit allocation manipulations, unfortunately not dealing satisfactorily with the issue of royalty payments and profit shifting despite recent reforms in its

[276] This key can take many forms, such as based on the costs incurred by each party in the development of the essential components of the intangible; or on the contribution of each party in assets, finished or not, to the preparation of the final product. See OECD (2018): Revised Guidance on the Application of the Transactional Profit Split Method. Inclusive Framework on BEPS: Action 10. P. 24ff.
[277] *Ibid*., P. 23f.
[278] See, for instance, the recent decision on *Luxembourg* v *Commission* (T-816/17).
[279] As indicated by the study in Nicolay, Katharina; Nusser, Hannah; Pfeiffer, Olena (2017): On the Interdependency of Profit Shifting Channels and the Effectiveness of Anti-Avoidance Legislation (Discussion Paper 17-066), P. 29f.

methodology.[280] This implies that any interested jurisdiction should apply as strictly and objectively as possible the arm's length principle to avoid base erosion; however in the specific case of intra-group royalties even this strict enforcement of transfer pricing standards does not ensure a reliable valuation of transfer prices.[281] Still, the existence of strong transfer pricing rules leads to a consequent reduction in the amount of bilateral royalty flows,[282] thereby disrupting the crassest BEPS cases and possibly allowing for a more targeted application of specific rules in a second instance.[283]

In addition, a practice that is gaining momentum in applying transfer pricing rules to transactions involving royalty payments may ensure a fairer and more satisfactory response for all parties involved. These are the retroactive price adjustment clauses, whereby it is permitted, as the name implies, the realization of a retrospective adjustment of the transfer price *after* the profits earned by one of the parties with base on that intangible has been determined. Given their specificity and relatively variable nature, these clauses will be analyzed in the following separate subsection.

2.1.1.3 Retroactive price adjustment clauses as an alternative solution to (hard-to-value) intangibles

As noted previously, despite the proposed reforms in transfer pricing methods concerning royalty payments, difficulties in applying the arm's length principle satisfactorily in transactions involving intangibles still persist. This, coupled with an increasingly frequent emergence of assets with the characteristics of hard-to-value intangibles,[284] leads tax administrations wishing to audit the taxpayer's claims on transfer pricing to be largely dependent on the information provided by the taxpayer itself. From a tax authority perspective, the fear is that taxpayers may make

[280] Transfer pricing documentation requirements show little to no effects on multinational affiliates with high intangible endowments. See Beer, Sebastian; Loeprick, Jan (2015): Profit shifting: drivers of transfer (mis)pricing and the potential of countermeasures. In *International Tax and Public Finance* 22 (3), P. 426–451. DOI: 10.1007/s10797-014-9323-2.
[281] See the insight of Fuest, Clemens; Spengel, Christoph; Finke, Katarina; Heckermeyer, Jost; Nusser, Hannah (2013): Profit shifting and "aggressive" tax planning by multinational firms. Issues and Options for Reform (Discussion Paper 13-044), P. 15f.
[282] For more information, read Dudar, Olena; Spengel, Christoph; Voget, Johannes (2015): The Impact of Taxes on Bilateral Royalty Flows (Discussion Paper 15-052), P. 25ff.
[283] See Chapter 5.3. for more information on this conclusion.
[284] Refer to Chapter 1.2.3 for more information.

inappropriate assumptions to yield the most tax-favorable results when valuing intangibles.[285] In response, there is the possibility of applying the so-called retroactive price adjustment clauses, which would work in parallel with the use of transfer pricing methods to assess *ex post* how well its *ex ante* utilization was performed, much like a “rule of thumb” such as the 25% Goldscheider rule or the Knoppe formula,[286] secondary to the results of using a primary method.

Basically, these clauses established either in national legislation or even through mutual agreement procedures would allow, by retroactively comparing the *ex ante* projections and the *ex post* results of a transfer pricing analysis – whose results are not tainted by unforeseeable events or developments – the conclusion to be drawn that the TP arrangements agreed upon between related parties may not have been accurate enough in their assessment of the value attributed to the intangible.[287] This is not to say that there will be, *prima facie*, a presumption that transfer pricing has been manipulated by the parties involved, but it will serve as an indication that the use of the arm's length principle may not have been done correctly and could lead to a readjustment of the transfer price *after* inserting the intangible into the market and obtaining profits. Therefore, there will be a greater abundance of empirical information non-manipulable by the taxpayer, since it is directly linked to the production of economic value through the commercialization of an intangible asset.

It is noticeable that the objective of this type of norm – already existing in some form in the legal system a few countries, such as Germany and Japan,[288] for example – is precisely to compensate for the disadvantage that the tax administration has in relation to the taxpayer in terms

[285] As stated in Webber, Simon; Ptashne, David; Schneider, Judd (2020): Intangible Asset Valuation Considerations In Times of Uncertainty. In *Tax Notes International* 99 (1), P. 43f.

[286] The OECD notes, however, that such secondary methods do not do justice to the primary ones. As in Goldscheider, Robert (2011): The Classic 25% Rule and the Art of Intellectual Property Licensing. In *Duke Law & Technology Review* 6, P. 2ff; and Rödl & Partner (2019): Bewertung immaterieller Wirtschaftsgüter aus Verrechnungspreissicht. Available online at https://www.roedl.de/themen/geistiges-eigentum-ip/beps-verrechnungspreise-bewertung-immaterielle-wirtschaftsgueter, checked on 09.06.2020.

[287] See OECD (2015): Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, P. 109ff.

[288] As in §1 para. 3 sentence 11f. AStG for Germany, and see Finley, Ryan (2019): Japan Proposes Stricter Rules on Intangible Transfers, Interest. In *Tax Notes International* 93 (6), P. 658. The United States also has a similar rule allowing periodic adjustments by the tax administration or taxpayer, but the OECD proposal seems more targeted and appropriate. Refer to Webber, Simon; Ptashne, David; Schneider, Judd (2020): Intangible Asset Valuation Considerations In Times of Uncertainty. In *Tax Notes International* 99 (1), P. 44ff. Furthermore, the OECD and even other countries argue that the US rule might violate the arm’s length principle for involving hindsight, refer to Brauner, Yariv (2010): Cost Sharing and the Acrobatics of Arm's Length Taxation. In *Intertax* 38 (11), P. 565ff.

of obtaining relevant information for assessing the correct transfer price.[289] It is therefore expected from the taxpayers to proactively include a price adjustment clause in the acquisition or licensing contract by themselves, in order to allow for later transfer pricing adjustment and, thus, avoid corrections made by the tax administration itself.[290]

Neither domestic law or even European law prohibits tax administrations from adjusting the terms of related party payments that were not carried out on arm's length, according to Germany's federal tax court.[291] Furthermore, when dealing with the concept of proportionality, the ECJ recognized in the case *Hornbach-Baumarkt* [292] that economic reasons can justify the conclusion of transactions under non arm's length conditions, as long as the taxpayer has the opportunity to present evidence of the economic reasons for a given transaction. Thus, if there is a discrepancy considered substantial[293] by the tax authorities between the *ex ante* payments and *ex post* results of the transaction, it will generally be up to the taxpayer to prove how and why this divergence occurred, in order to demonstrate whether the transfer price was determined in accordance with the arm's length principle.

By establishing a rule that allows the tax authorities the opportunity to levy additional taxes if the earnings prove to be substantially beyond what was or should have been expected from an intangible assets license, it can assist in controlling any tax advantages that might arise from aggressive tax planning involving intellectual property.[294] The applicability of this type of rule to schemes involving royalty payments presented above[295] would be, in particular, to correctly determine the value of the royalties, which may, depending on the nature of the scheme, be

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[289] See Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern, P. 40f.
[290] Konings, Bart; Morren, Driek (2021): Hard-to-Value Intangibles: How Hard Can It Be? In *International Transfer Pricing Journal* 28 (1), P. 17ff.
[291] Refer to Finley, Ryan (2020): Non-Arm's-Length Transfer May Be Disregarded, German Court Says. In *Tax Notes International* 97 (2), P. 204.
[292] C-382/16.
[293] One should be aware to the fact that such discrepancies are common and even expected in this type of transaction, since it can often be difficult even for the taxpayer, who has most of the information, to determine the actual final value of an intangible. However, what will be considered a “substantial divergence” will be in the hands of the public administration or, alternatively, the competent national legislator. Special attention should be given to unexpected and unusual cases, such as the COVID-19 pandemic, directly impacting transfer pricing assessments. See Subramanian, Pita; Shah, Milind (2020): Intangible Property Transfer Pricing in an Economic Downturn. In *Tax Notes International* 98 (6), P. 631ff.
[294] Fuest, Clemens; Spengel, Christoph; Finke, Katarina; Heckermeyer, Jost; Nusser, Hannah (2013): Profit shifting and "aggressive" tax planning by multinational firms. Issues and Options for Reform (Discussion Paper 13-044), P. 15f.
[295] Refer to Chapter 1.4.

established at a much higher value than is due. This would allow the employment of a retroactive adjustment to *e.g.* reduce the transfer price of the royalties and therefore the amount of the payment that can commonly be deducted as business expenses.

This would basically result in a recharacterization of the amount paid in excess of the market value of the agreed royalty effectively paid between licensee and licensor in a controlled transaction. Strictly speaking, this occurs because if the market value of the intangible is actually lower than the agreed royalty payment between the related parties, part of these royalties have no economic justification to arise, and this retroactive readjustment of transfer prices is necessary to ensure the application of the arm's length as well as to avoid the transfer of tax base in favor of non-resident persons, commonly based in low-tax jurisdictions.[296] The possibility of making these secondary adjustments to the TPs has already been recognized since the beginning of the last decade by the final report of the European Union's Joint Transfer Pricing Forum,[297] which states that, despite the risks of double taxation[298] in the event of a retroactive adjustment, these should in principle be allowed, provided that there is prior permission regulated by the relevant national legislation.

In order to give tax administrations the opportunity to assess whether the estimates were made in a reasonable way by comparing those and their assumptions with actual results,[299] many countries have begun introducing or reforming such price adjustment clauses. In some cases, important features are unfortunately left out, such as in Greece;[300] while in others the OECD

[296] See the insightful contribution by Manca, Mauro (2019): Royalties Exceeding an Arm's Length Value: Deemed (In)applicability of "Secondary Adjustments" in Italy. In *European Taxation* 59 (9), P. 441ff.
[297] European Commission (2014): Mitteilung der Komission an das Europäische Parlament, den Rat und den europäischen wirtschafts- und sozialausschuss über die Tätigkeit des Gemeinsamen EU-Verrechnungspreisforums im Zeitraum Juli 2012 bis Januar 2014. European Commission. Available online at https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/com(2014)315_de.pdf, checked on 09.09.2019, P. 6f.
[298] If the residence country of the counterpart to the transaction does not accept the adjustment, for instance. Refer to the observations of Evers (2015): Intellectual property (IP) box regimes., P. 235ff.
[299] See the report by Dziwinski, Karol (2019): Transfer Pricing and Intangibles: Report on the WU Transfer Pricing Symposium. In *International Transfer Pricing Journal* 26 (3), P. 190ff.
[300] In its national legislation, Greece allows retroactive price adjustments through Article 50 of the income tax code, in which the competent authorities are permitted to unilaterally proceed to an *upward* adjustment of the price, but *not* a downward one. Even if this possibility has not been used so far by the Greek tax administration, mostly by fear of double taxation, the restriction on this rule is substantial. See Savvaidou, Aikaterini; Athanasaki, Vasiliki (2019): General and Specific Anti-Tax Avoidance Measures Under Recent Tax Reform in Greece. In *Intertax* 47 (4), P. 405f.

general guidelines are followed, but there are notable differences in the sense of seeking the drafting of stricter standards, such as in Japan.[301]

It is however a general consensus, as the valuation of those intangibles is largely based on presumptive developments from both foreseeable and unforeseeable events in the future, that tax administrations should nevertheless accept a certain threshold for fluctuations.[302] This means that it is not every divergence between *ex ante* and *ex post* results that will lead to the application of a retroactive price adjustment clause,[303] but simply that these should be used as presumptive evidence for the appropriateness of the factors employed. This valuation technique seems to be one of the most consistent available today for transfer pricing issues involving intangibles, given that, when evaluating practical cases, it is perceived that the royalty rates are commonly based on a projected profit margin, and that possible variations in this projection would allow for a more exact later assessment of the allocation of profits in multinational corporations.[304]

In this sense, one can consider that the jurisprudence of the European Court of Justice is relatively positive towards such adjustments, since there are cases such as *Societé de Gestion Industrielle*[305] and *Thin Cap*[306] in which the ECJ recognizes the possibility for the tax authorities

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[301] This applies in particular to the transfer pricing and CFC rules in the most recent reform in Japan, which uses Discounted Cash Flows to apply retroactive price adjustment clauses. See Hagelin, Johan; Muto, Shunichi (2019): The OECD/G20 Base Erosion and Profit Shifting Initiative and the 2019 Tax Reform in Japan: Revisions to the Earnings Stripping Rules and the Introduction of Hard-to-Value Intangibles into Transfer Pricing. In *Bulletin for International Taxation* 73 (5), P. 231ff. For more information on the usage of the Discounted Cash Flow method to determine future projected revenue, see Deloitte Japan (2019): OECD's hard-to-value intangibles approach to apply. Available online at https://www.taxathand.com/article/11502/Japan/2019/OECDs-hard-to-value-intangibles-approach-to-apply, checked on 18.06.2020.

[302] As discussed by Hughes, Andrew (2020): Addressing Challenges in the Hard-to-Value Intangibles Guidelines. In *Tax Notes International* 97 (13), P. 1399ff.

[303] For instance, an average maximum variation that can be tolerated, *e.g.* establishing a 15% upwards or downwards threshold, diluted over a period of 5 to 10 years. This would partially reduce the effectiveness of the retroactive price adjustment clauses, but would allow a substantial reduction in compliance costs in the form of this *de minimis* rule. The OECD mentions a 20% threshold, up or down, even though no technical explanation is given on why and how this number was reached. See Hoffman, Simon (2020): Hard-to-Value Intangibles and the Pricing of Uncertainty. In *International Transfer Pricing Journal* 27 (3), P. 164. Other exceptions could be included as in the case of force majeure events, such as disasters like the COVID-19 pandemic, that affect directly transfer pricing matters. See Hart, Robert (2020): Practical Transfer Pricing in Uncertain Economic Conditions. In: *Tax Notes International* 96 (4), P. 439ff.

[304] See the case of Coca-Cola, which describes in detail how royalty rates are calculated and projected. It is true that, depending on the industry sector, the techniques employed by the business may be different. However, ex-post results will always be an important comparative parameter in this type of transaction. McClure, J. Harold (2020): Coca Cola's Intercompany Royalty Rate. An Intermediate View. In *Journal of International Taxation* (1), P.37ff.

[305] C-311/08.

[306] C-524/04.

to adjust cross-border intra-group transactions not compliant with arm's length, as long as they have not occurred for “good commercial reasons”.[307] Therefore, the retroactive price adjustment clauses can smoothly be used as an additional resource to obtain reliable information for the application of the arm's length principle, at least from a national – if implemented – and European law point of view.

A different result, however, could possibly be obtained when considering the compatibility of these clauses with treaty law, since it is not certain whether these clauses would be incompatible or not with double taxation agreements. The discussion revolves in particular around the rules set out in Article 9 of the OECD-MC, which establishes in general terms how the allocation of profits and their evaluation among associated enterprises should be handled, which does not expressly provide for the possibility of using retroactive adjustments, making reference to the other rules of the treaties and even a need for mutual consultation among the tax administrations of the contracting states for an adjustment to be made.[308] Thus, specifically for treaty law, it would be necessary for the tax authorities wishing to make such an adjustment to consult with the other tax administration or for the double taxation agreement to be renegotiated and readjusted to provide general rules for the unhindered use of this feature. Of course, there is always the possibility of unilateral implementation at the national level, which, if considered to constitute an incompatibility between national rules and the double taxation agreement, would lead to the occurrence of a treaty override, generally allowed by national law but frowned upon from an international perspective.[309]

2.1.1.4 Final remarks on the relation between transfer pricing rules and royalty payments

As it can be inferred from the difficulties of using transfer pricing rules and the arm's length principle to determine the correct profit allocation in transactions involving intangible assets, it can be seen that the usefulness of this type of rule is relatively restricted to avoid BEPS that abuse royalty payments. Despite the (rare) cases in which methods such as the transactional profit split

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[307] See the insight by Schön, Wolfgang (2019): The Concept of Abuse of Law in European Taxation: A Methodological and Constitutional Perspective. In *Working Paper of the Max-Planck Institute for Tax Law and Public Finance* 18. Available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3490489, checked on 25.11.2019.
[308] See on this opinion Engelen, Christian (2016): Ex post-Informationen und Preisanpassungsklauseln. Kritische Würdigung der OECD-Ausführungen zu schwer bewertbaren immateriellen Werten. In: *IStR*, P. 151ff.
[309] For further information on treaty overriding, see Chapter 4.3.1.2.3.

– which can be rather effectively allied to retroactive price adjustment clauses – are successfully applied, it is possible to comply more precisely with the arm's length, although this “correct” allocation of profits does not prevent aggressive tax planning structures from occurring and allowing them to take advantage of asymmetries between tax systems in different countries. This means that even if a transaction is carried out perfectly in accordance with TP rules, profit shifting structures are still perfectly viable if there is no other, specific rule, to further aid in combating BEPS.

This does not mean, of course, that one should not make an effort to improve and apply the arm's length principle consistently to this type of transaction; however, it is important to realize that this is *only one* of the multifaceted problems that BEPS and royalty payments have. This is a strong indicator that better results will be achieved by coordinating transfer pricing rules with other anti-avoidance standards,[310] which can, for example, reduce the pressure on the arm's length by reducing the overall incentives for profit shifting.[311] This is confirmed as multinational companies react to the tightening of anti-avoidance rules in a specific field through a shift to some extent to other profit shifting strategies.[312] As a consequence, the less comprehensive the reach of transfer pricing and other anti-avoidance rules, the wider is the scope for profit shifting for IP-intensive firms, while they shift between channels according to which rules are the most stringent.

Although not expressly admitting it, the OECD has been slowly diverging from the arm's length principle through more recent projects such as the pillar 2 of the GloBE proposal and a minimum tax.[313] This position reinforces the need to present new systems and solutions to the

[310] As TP rules end up being an allocation tool that deal with substance, not an anti-avoidance rule, as mentioned previously. This was reiterated in a way in the *Coca-Cola* U.S. case, see Avi-Yonah, Reuven; Mazzoni, Gianluca (2020): Coca-Cola: A Decisive IRS Transfer Pricing Victory, at Last. In *Tax Notes International* 100 (11), P. 1423f. Its main goal is and remains to prevent economic double taxation, as indicated by Pankiv, Marta (2016): Post-BEPS Application of the Arm's Length Principle to Intangible Structures. In *International Transfer Pricing Journal* 23 (6), P. 474f.

[311] See Finley, Ryan (2019): Harter Says Tax System Will Not Abandon Arm's-Length Principle. In *Tax Notes International* 95 (4), P. 354f. However, if a given tax authority finds a transaction to be abusive, it will have to resort to a general or specific anti-avoidance rule instead of TP standards, as is with the Canadian case. See Athanasiou, Amanda (2021): Transfer Pricing Law Isn't for Antiavoidance, Cameco Lawyer Says. In *Tax Notes International* 102 (8), P. 1107f.

[312] As stated by Nicolay, Katharina; Nusser, Hannah; Pfeiffer, Olena (2017): On the Interdependency of Profit Shifting Channels and the Effectiveness of Anti-Avoidance Legislation (Discussion Paper 17-066), P. 30 and 36.

[313] For more information, see Chapter 3.4. On the future of the arm’s length principle within the context of the Pillars, refer to Andrus, Joseph L.; Collier, Richard S. (2022): Transfer Pricing and the Arm's-Length Principle After the Pillars. In *Tax Notes International* 105 (5), P. 543ff.; and Hagelin/Duvauchelle (2021): Pillar Two and Transfer Pricing. In: Perdelwitz/Turina (Eds.) - Global minimum taxation?, P. 263ff.

problems of BEPS,[314] which can therefore be used, at least initially, in parallel with the arm's length principle. This was especially intensified with the introduction of the Tax Cuts and Jobs Act, implemented in 2017, in the United States, which dealt a major blow to the once quasi-universal support for allocating international taxing rights through the use of the arm's length principle, due to the residual profit allocation of the GILTI.[315] It should not be overlooked, however, that companies have recently nevertheless had to deal with stricter transfer pricing rules and documentation obligations, as well as with case law favorable to the attributions of tax administrations,[316] which may exponentially increase compliance costs. Therefore, the anti-avoidance rules should be evaluated not only individually, but in their overall gestalt, since the obligations arising from them accumulate for the taxpayer.

Of course, there are also decisions in favor of the taxpayer in particular within the European Union to restrict the scope of transfer pricing rules and anti-abuse rules in the name of (EU) market freedoms, where it is correctly stated that taxpayers should always be given the opportunity to provide commercial justifications as to why a transaction was conducted or not under arm's length standards.[317] Also according to the ECJ, a possible restriction on the fundamental freedoms caused by adjustments under the arm's length principle may be justified insofar as they pursue legitimate objectives *e.g.* related to maintaining the balanced allocation of taxing rights between Member States with different interests in relation to the prevention of aggressive tax planning and tax

[314] Stated by Brauner, Yariv (2014): What the BEPS. In *UF Law Faculty Publications*. Available online at https://scholarship.law.ufl.edu/facultypub/642, P. 98; and Codorniz Leite Pereira (2016): O Controle de Preços de. In: Gomes/Schoueri (Eds.), A Tributação Internacional na era., P. 154.

[315] This will be briefly discussed in Section 3.2.2.3. See also Finley, Ryan (2020): TCJA Marked a Big Step in The Arm's-Length Principle's Demise. In *Tax Notes International* 97 (10), P. 1123.

[316] As in Fedi, Alissa (2019): Transfer Pricing Aspects of Transactions with Marketing Intangibles in a Post-BEPS World. In *International Transfer Pricing Journal* 26 (6), P. 419. Some decisions, however, establish a greater hurdle for documents to be considered unusable, such as the recent *Adecco* (BS-42036/2019-HJR) Danish decision. See Heidecke, Björn; Christen, Anna-Katharina; Martynkiewitz, Niklas (2020): Fremdüblichkeit von Lizenzzahlungen. In *IWB* 23 (19), P. 802ff.

[317] For more information on case law, see Kuzniacki, Blazej (2019): The ECJ as a Protector of Tax Optimization via Holding Companies. In *Intertax* 47 (3), P. 319ff; and Petruzzi, Raffaele; Myzithra, Argyro (2021): Transfer Pricing Rules Under EU Law And the CJEU's Decision in Impresa Pizzarotti. In *Tax Notes International* 101 (5), P. 597.

avoidance.[318] This has recently been confirmed in decisions across Europe that prevent,[319] for example, the deductibility of intra-group royalties due to transfer pricing problems, which actually has the power to solve, on its own, more extreme cases of aggressive tax planning involving TP standards.

Furthermore, the fact that there has been a settlement between tax administration and taxpayer – for example through a mutual agreement procedure – does not necessarily mean that a certain transaction was carried out according to arm's length parameters, but only that there was a *convergence of interest* between them. This is evident from the stance considered as harmful tax practice of some countries, commonly seeking to attract investments from IP-intensive firms, which allows for the unchecked existence of aggressive tax planning structures.[320] The ECJ also expressed itself in this sense, considering that tax rulings that endorse unjustified transfer pricing methods to calculate the taxable profit of a multinational company, inflating royalty payments as to not reflect economic reality, might be considered state aid violating European law.[321] Such cases have been seen in countries looking for an indirect way to encourage multinational companies with intangible assets, as in Luxembourg and the Netherlands.[322] Furthermore, even if there is an agreement that reflects the will of the tax administration and taxpayer to correctly address transfer pricing issues, it should not be indefinitely binding, as seen for instance in the more recent *Coca-Cola* TP case in the U.S.[323]

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[318] *Hornbach-Baumarkt*, C-382/16 and, more recently, *Impresa Pizzarotti*, C-558/19. For an analysis of the latter, refer to Blumers, Wolfgang (2021): EuGH: Niederlassungsfreiheit vor Fiskalinteresse. Zugleich Anmerkung zu EuGH, Urteil vom 8.10.2020 - C-558/19, Impresa Pizzarotti. In *BB* (16), P. 919ff; Petruzzi, Raffaele; Myzithra, Argyro (2021): Transfer Pricing Rules Under EU Law And the CJEU's Decision in Impresa Pizzarotti. In *Tax Notes International* 101 (5), P. 591ff.; and Böhmer, Julian (2021): Regelungen zur Einkünftekorrektur bei Betriebsstätten sind mit Unionsrecht vereinbar. In *ISR* (1), P. 4f.

[319] See, for instance, a Danish case on Finley, Ryan (2019): Court Denies Royalty Deduction In Danish Transfer Pricing Case. In *Tax Notes International* 96 (5), P. 448f.

[320] Refer to Chapter 1.4.

[321] See Dourado, Ana Paula (2019): Aggressive Tax Planning and Harmful Tax Competition. Discussions on the GREIT 11th Summer Course Lisbon. In *Research Handbook on EU Tax Law*. P. 14ff.

[322] The selective advantage granted by the tax administration in favour of a royalty payment with a value detached from economic reality was considered to constitute state-aid violation. See Finley, Ryan (2019): EU Commission Says Nike IP Companies Earned Excessive Profit. In *Tax Notes International* 95 (2), P. 142.

[323] Refer to Armitage, Clark; Schafroth, Heather; Stevens, Elizabeth; Rosenbloom, H. David (2021): Coke Concentrate: A Recipe for Understanding the IRS's Biggest Win in 40 Years. In *International Transfer Pricing Journal* 28 (2), P. 87ff; and Radziewicz, Justin (2021): Coca-Cola Tax Ruling Offers 5 Lessons for Multinationals. Duff & Phelps. Available online at https://www.duffandphelps.com/insights/publications/transfer-pricing/coca-cola-tax-ruling-offers-5-lessons-for-multinationals, checked on 15.04.21.

Outside the European Union, several countries have also shown difficulty in combating profit shifting through the deductibility of royalty payments by making use of transfer pricing rules only. In cases such as in China and Russia,[324] these have been challenged in the court of law not based on traditional TP rules or methods, but rather on the grounds of such business expenditures with licensing fees not being economically rational or justifiable. This highlights that there is also a difficulty for countries beyond the EU – which are as a rule not subject to any supranational legislation – in using transfer pricing rules in a satisfactory manner to combat BEPS.

The shortcomings that transfer pricing rules have were highlighted in this chapter, but this does not mean that they can easily be corrected, given the ever more complex reality in which the arm's length is applied.[325] As long as the interests of tax administrations of different countries and taxpayers conflict and a balance cannot be found, alternative solutions are either restricted to the elaboration of an entirely new system – and all the difficulties of implementation that this encompasses – or to the drafting of rules complementary to each other, thus integrating the international tax system in a way that the arm's length principle alone may no longer be able to fulfill. One of the rules commonly used to counter base erosion and profit shifting alongside transfer pricing rules is the well-known controlled foreign company (CFC) rule, which operates in such a way as to complement the arm's length principle. This means that one does not exclude the need for the other, as will be highlighted in the following section.

2.1.2 Controlled Foreign Company rules acting as outbound anti-avoidance measures

The so-called CFC rules are employed by many countries as a broad anti-avoidance measure against an extensive use of low-tax jurisdictions by multinational companies. This is because even companies that make up a single business group are generally taxed separately, as each constitutes its own legal entity. This means that when a parent company owns a subsidiary abroad, the profits of the latter are taxable only at the parent's level once (and if) distributed.[326] Therefore, if a foreign subsidiary has residency in a low-tax jurisdiction, the taxation of its profits

[324] See, for instance, Hansen/Dyomina (2008): Russia - how transfer pricing applies. In: Adams (Ed.) - Transfer Pricing Aspects of IP., P. 42f.
[325] See the review in Monsenego, Jérôme (2018): Literature Review. Aitor Navarro, Transactional Adjustments in Transfer Pricing, IBDF, 2018. In *Intertax* 46 (12), P. 1031f.
[326] See Hoor, Oliver R. (2019): Luxembourg's New CFC Rules. In *Tax Notes International* 94 (5), P. 419f.

will be dependent on the timing and occurrence of a distribution, which is directly counteracted by CFC-rules.

At first glance, this type of rule fits exactly into the type of rule we are aiming for to combat profit shifting opportunities through international intra-group royalty payments, and although it certainly has relevance in solving the problem at stake, it is essential to make it clear from the outset that, given the nature of this type of rule, as will be seen below, only the so-called *outbound* cases are covered by this norm. This means that the country that introduces a certain CFC-rule may in general only affect subsidiaries resident abroad, but not those cases in which the national subsidiary in your country is controlled by a foreign company and makes royalty payments to it – constituting the so-called *inbound* cases.

It is readily discernible that this rule alone will not be able to comprehensively solve the problem of aggressive tax planning schemes with IP-intensive firms. However, the applications of this regulation are broad and of direct relevance to intra-group transactions such as those due to licensing of intangible assets, and understanding their use, structure, and shortcomings will certainly assist in the development of a comprehensive solution to the current issue.

2.1.2.1 Concept and general operating principles of CFC-rules regarding royalties

Through the application of a controlled foreign company rule, the profits made by a foreign subsidiary will be taxed at the parent's home country level, which will in general have a higher tax rate than the subsidiary's place of residence. That is to say that, when this regulation takes hold, the “shielding” effect of having a foreign affiliate as a separate legal entity is broken, so that income is allocated at the level of the controlling company.[327] This would mean that a royalty payment made – and deducted – by a controlling company would have the income received by the controlled company once more included in the overall revenue of the payor. One of the first and most common requirements for the applicability of a CFC rule is – as the name implies – that the parent company has *control* of its subsidiary, which can be determined in many different ways. As

[327] As made clear in Hemmerich, Aaron (2019): Abzugsbeschränkungen im internationalen Steuerrecht. Analyse und Wirkungsvergleich der deutschen und österreichischen Lizenzschranke. In *IStR* (8), P. 295.

a common rule, owning 50% or more of the capital of the subsidiary is used as the base parameter,[328] but other criteria such as economic or de facto control can be employed.[329]

In addition, CFCs distinguish themselves commonly in two other dimensions,[330] namely (1) the type of income that is subject to the standard, where an *entity approach* can be adopted that will affect the entirety of the income generated by the foreign subsidiary; or a *transactional approach*, restricting the applicability of the CFC-rule to one or more specific types of income and their respective transactions – as a rule those considered passive, such as intangibles. And (2) the definition of low-tax jurisdiction adopted (or not) by the country concerned, in which a *threshold approach* may be adopted, requiring a minimum effective or nominal level of taxation defined by the legislation of the home country; or a *jurisdictional approach*, which is usually adopted via blacklists and/or whitelists with a grouping of countries that will be affected or excluded by the CFC rules.[331]

Furthermore, there are some other variations in the design of controlled foreign company rules, for example through a *de minimis* threshold, in which only those business groups that achieve a minimum profit in a given period of time will be affected. These and other specific rules are usually aimed at reducing the negative economic impacts that may arise from the use of a CFC-rule, since there is not only an imminent risk of double taxation – where taxation occurs simultaneously at the level of the residence country of the parent company and of the subsidiary, especially if no tax credits are granted – but also of reducing the competitiveness of domestic companies abroad, whose subsidiaries will incur a higher tax rate than other companies resident in the same country.

This means that the effectiveness in applying a CFC rule is directly linked to its scope: the broader the scope of the rule, the more it protects its tax base; while at the same time the chances of double taxation will be greater, as well as the emergence of hurdles in the competitiveness of a

[328] Refer to Bräutigam, Rainer; Spengel, Christoph; Streif, Frank (2015): Decline of CFC Rules and Rise of IP Boxes: How the ECJ affects Tax Competition and Economic Distortions in Europe (Discussion Paper 15-055), P. 5f.
[329] For example like the Dutch rule, in de Groot, I. M. (2019): Implementation of the Controlled Foreign Company Rules in the Netherlands. In *Intertax* 47 (8&9), P. 774f.
[330] Bräutigam/Spengel/Streif, *op. cit.*, Fn. 328.
[331] See the insight of Johansson, Åsa; Bieltvedt Skeie, Øystein; Sorbe, Stéphane (2017): Anti-avoidance rules against international tax planning (OECD Economics Department Working Papers, 1356). Available online at https://www.oecd-ilibrary.org/economics/anti-avoidance-rules-against-international-tax-planning_1a16e9a4-en, checked on 30.08.2018, P. 8.

company and the onerousness of its compliance costs.[332] Therefore, every country that has such a rule seeks to find a balance between these two aspects, which even leads some countries to have no interest in the implementation and/or effective application of CFCs, since the international competitiveness of domestic multinationals can be considered more important than an effective fight against aggressive tax planning schemes.

Such is the case *e.g.* of the United States, which despite having been one of the pioneers in the introduction of CFC-rules in 1962,[333] decides in many cases not to apply them in the manner initially envisaged, in order to ensure the international competitiveness of its own companies.[334] Nonetheless, for those countries that do have an interest in using this anti-avoidance resource, the OECD has prepared general guidelines for its implementation through its BEPS Action Plan.

2.1.2.2 OECD/G20 design and objectives for CFC-rules seen in coordination with TP and GloBE in the context of royalties

With the initial objective of presenting general guidelines for countries wishing to introduce or reform their existing CFC-rules that had design features that did not combat BEPS efficiently, the OECD presented overall recommendations in the form of "building blocks" through Action Plan nº 3.[335] With the existence of diametrically opposed interests with regards to the implementation of this type of standard in mind, these recommendations did not at any time constitute minimum standards, but merely a general outline of how a CFC should be structured with respect to its definition, *de minimis* thresholds and affected income, as well as measures to avoid the occurrence of double taxation. Unlike the work on transfer pricing standards and methods, the relative success of the OECD's proposals for CFCs was low,[336] which however does not reduce their importance in the overall design of this type of standard.

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[332] Arnold, Brian J. (2019): The Evolution of Controlled Foreign Corporation Rules and Beyond. In *Bulletin for International Taxation* 73 (12), P. 635

[333] *Ibid*, P. 631.

[334] See Brauner, Yariv; Herzfeld, Mindy (2013): Country Report: United States. The taxation of foreign passive income for groups of companies. International Fiscal Association, P. 783ff.

[335] Available as OECD (2015): Designing effective controlled foreign company rules. Action 3: 2015 final report. Paris (OECD/G20 Base Erosion and Profit Shifting Project). Available online at https://read.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report_9789264241152-en#page1, checked on 10.08.2018.

[336] As seen in Figueiredo (2016): A Transparência Fiscal Brasileira e. In: Gomes/Schoueri (Eds.), A Tributação Internacional na era., P. 256f.

The OECD makes it clear that the primary purpose of CFC-rules is not to raise revenue, but to ensure that the profits of a business group remain within the tax base of the parent company,[337] thereby complementing the use of TP standards.[338] That is to say that transfer pricing rules do not eliminate tax avoidance resulting from passive income accumulation in a CFC generated by a licensing agreement at arm's length to a CFC, *i.e.* in themselves, TP rules do not eliminate the need for CFC rules. The latter should target the income that was possibly obtained at arm's length, but nevertheless assigned to an entity in a low-tax jurisdiction,[339] which highlights the importance of coordination between rules in order to tackle the issue with royalty payments. The balance between taxing foreign income and maintaining market competitiveness is also highlighted in an attempt to attract wider adoption of this type of measure by individual countries.

When it comes to determining the specific structure of a CFC rule, however, the OECD's work does leave much to be desired. Instead of clearly indicating best practices by setting out legal minimum design standards for a CFC – even if only as a recommendation – the BEPS Action Plan nº 3 is restricted to the abstract indication of distinct draft possibilities. This occurs presumably once again with the purpose of ensuring that more countries will adhere to the implementation of this type of rule, which however hinders a standardization of responses to the BEPS problem and makes the choice of design by national legislators difficult, while also increasing asymmetries and the risk of double taxation.[340] A similar issue occurs with the Income Inclusion Rule within the context of the OECD GloBE proposal, that has a very similar structure to a CFC rule.[341] The different possibilities of defining "control" of one company by another are furthermore only briefly discussed on the OECD work on CFCs;[342] as well as the exemptions and threshold requirements for such rules,[343] besides the pro and cons of a transactional or entity approach.[344]

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[337] OECD (2015): Designing effective controlled foreign company rules. Action 3: 2015 final report. Paris (OECD/G20 Base Erosion and Profit Shifting Project), P. 13f.

[338] CFCs and TP rules are sometimes described as a "particular pair of bedfellows", as in Kane, Mitchell (2013): Milking versus Parking: Transfer Pricing and CFC Rules under the Code. In *NYU Tax Law Review* 66, P. 487.

[339] As indicated by Kofler, Georg; Verlinden, Isabel (2020): Unlimited Adjustments: Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the "Saving Clause". In *Bulletin for International Taxation* 74 (4), P. 272ff.

[340] This will lead, as will be seen in the following section, to institutions of a supranational character, such as the European Union, to establish harmonized rules in this area.

[341] Refer to Chapter 3.4.

[342] See OECD (2015): Designing effective controlled foreign company rules. Action 3: 2015 final report. Paris (OECD/G20 Base Erosion and Profit Shifting Project), P. 24ff.

[343] *Ibid*., P. 33ff.

[344] *Ibid*., P. 50ff.

This makes clear the descriptive and explanatory nature of the OECD's work in this regard, and despite devoting a session to identifying the existence of difficulties with royalty payments and intangible assets,[345] does little to address the problems arising from their use and abuse. The same occurs with the issue of double taxation, which is acknowledged by the OECD, but presents materially few practical answers to the problem, which will largely depend on the willingness of the countries involved to protect the interests of their multinational groups.

Some argue even that the OECD itself has decided to put foreign company rules aside, especially since the recent work on the GloBE proposal, in particular pillar 2 and the creation of a minimum tax, which would reduce the situations of use or even completely eliminate the need to implement CFCs.[346] Others, however, consider CFCs an overall better response than a minimum tax, since the latter would not combat profit shifting in a holistic way, but would implicitly legitimize base erosion to the extent of the difference between a country's corporate tax rate and the minimum rate agreed upon.[347] This means that CFC-rules will most likely remain relevant even for the OECD in the near future, although it is important to understand the dynamics of anti-avoidance rules with each other and possible practical changes in their future perspectives and use.

The most recent systematic use of CFC-rules has taken place, in particular, in the European Union, which collecting the OECD's observations and the member countries' own experience,[348] as well as the interactions of the norm with the internal market and the CJEU, has developed a directive in order to harmonize – to a certain extent – the use of controlled foreign company rules. While the OECD's work unfortunately brings little light to the problem of intangible assets, implementation in a more coordinated manner within the European Union might provide for better answers when it comes to the use of this anti-avoidance rule in the topic of royalty payments.

2.1.2.3 EU law requirements for CFC-rules and limits to their application regarding licensing agreements

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[345] *Ibid*., P. 45f.

[346] As observed in Junge, Aaron; Russo, Karl Edward; Merrill, Peter (2019): Design Choices for Unilateral and Multilateral Foreign Minimum Tax. In *Tax Notes International* 95 (10), P. 967 and 968.

[347] See Arnold, Brian J. (2019): The Evolution of Controlled Foreign Corporation Rules and Beyond. In *Bulletin for International Taxation* 73 (12), P. 645f.

[348] The OECD and the European Union have collaborated largely on measures to fight tax avoidance, in a way that many European legal instruments have the endorsement of BEPS. For a synopsis on those, refer to Kofler/Tumpel (2017): Recent EU Initiatives in Direct. In: Haslehner/Kofler/Rust - EU tax law and policy.

Long before the implementation of the Anti-Tax Avoidance Directive[349] within the European Union took place, CFC-rules were already common in many – though not all – member countries, which does not mean that there was no influence from the European legal system on this type of regulation. Initially seen as an exclusive component of the national law of each country, but subject to the supranational restrictions of European law due to the cross-border operation of the standard, the application of CFCs was subject to limitations relating to secondary European law, especially in the form of the parent-subsidiary directive[350], in order to avoid the occurrence of double taxation if both provisions were applied simultaneously.[351]

However, the greatest restriction that CFC rules were directly subject to was in relation to primary European law with the fundamental freedoms, where the difference in treatment between controlled companies of the same business group would be different on the basis of the jurisdiction of residence of the latter – which could consequently discourage investment or the creation of a subsidiary abroad. This could be considered a discriminatory form of treatment and configure possible violation in particular of the freedom of establishment and free movement of capital, depending on the exact formulation of the CFC-rule.[352]

As is known but will be further discussed ahead,[353] possible restrictions to fundamental freedoms can be justified[354] on the basis of combating tax avoidance,[355] evasion and tax fraud;[356] based on the principle of territoriality;[357] in the name of an effective fiscal supervision;[358] the

[349] Council Directive (EU) 2016/1164, available online at https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32016L1164&from=EN.
[350] Council Directive (EU) 2011/96, available online at https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32011L0096&from=en.
[351] See Quilitzsch (2013): Die Hinzurechnungsbesteuerung, P. 144ff.
[352] *Ibid*., P. 156ff. See also Benítez (2019): Chapter 2: The European Union. In: Almudí Cid, Gutierrez et al. (Eds.) - Combating Tax Avoidance., P. 44ff.
[353] Refer to Chapter 4.2.2.
[354] Here, a distinction must be made between justifications provided for in the Treaties and those developed by European case law. In recent years, several developments have taken place in the field of tax law. See for example Kokott, Juliane; Ost, Hartmut (2011): Europäische Grundfreiheiten und nationales Steuerrecht. In *Europäische Zeitschrift für Wirtschaftsrecht*, P. 500f.
[355] Case law of the ECJ, C-72/09, on 28.10.2010.
[356] Case law of the ECJ, C-287/10, on 22.12.2010.
[357] Case law of the ECJ, C-250/95, on 15.05.1997.
[358] Case law of the ECJ, C-233/09, on 01.07.2010.

balanced distribution of taxation rights;[359] to prevent a double recognition of losses;[360] and/or the coherence of the tax system.[361]

Of particular interest to CFC rules is the possibility of justifying such discrimination on the basis of the need to combat tax avoidance, which nevertheless remains restricted to purely artificial arrangements without economic reality, according to the famous *Cadbury-Schweppes*[362] decision of the European Court of Justice. This decision was instrumental in several aspects in establishing minimum basic parameters for the implementation of CFC-rules within the European market, immensely restricting the cases in which such a norm as an anti-avoidance rule could apply. Furthermore, the view that taxpayers should always be given the opportunity to provide evidence of their economic activity was firmly held, in addition to being allowed to provide justification for the use of a certain corporate structure so that it is not considered to be purely artificial.

It is noticeable that there is a very delicate balance between the autonomy of Member States to determine their rules to combat tax avoidance and the promotion of the European single market, which constantly led to a need for the European court to analyze the application of these rules in a concrete case. This not only makes it more difficult and slower to tackle BEPS, but also restricts the leeway of action of each state in a different way, depending on the specific formulation that the implemented CFC has. Going deeper into the problems and requirements of European law surrounding pre-ATAD CFC rules, whether on intellectual property or not, is, however, unnecessary and falls outside of the methodological scope of this work. Not only because these issues have been the subject of various scientific studies and explorations,[363] but also because the attempt to present a solution to the problem of profit shifting with royalty payments must take into consideration the *status quo* of the law.

[359] Case law of the ECJ, C-436/08, on 28.10.2010.
[360] Case law of the ECJ, C-414/06, on 15.05.2008.
[361] (For the first time in) case law of the ECJ, C-204/90, on 28.01.1992.
[362] C-196/04, decision of September 2006. For more on the decision, see Kahlenberg, Christian (2019): Cadbury-Test auch für Drittstaaten - Folgerungen aus der EuGH-Entscheidung in der Rs. X-GmbH für die anstehende AStG-Reform. In *Der Betrieb* 29, P. 1591ff.
[363] For more information on the topic, see for example Brähler (2006): Controlled Foreign Companies-Rules; Groß/Strunk (2015): Lizenzgebühren; Cordewener (2002): Europäische Grundfreiheiten und nationales Steuerrecht;

Therefore, precisely because of the aforementioned issues and considering that greater harmonization[364] in the fight against tax avoidance within the EU would be beneficial not only from the point of view of the struggle against profit shifting, but also from the point of view of the safeguarding of the internal market, the Anti-Tax Avoidance Directive was drafted taking into account the ECJ case law and the European supranational system as a whole.

Specifically with regard to CFC measures, the ATAD brought with itself harmonization based on a tripod with well-known cumulative proxies[365]: a) the presence of a CFC; b) effective low taxation; and c) the presence of "artificial" or "tainted" income.[366] These requirements, which are largely based on the minimum requirements of the OECD work seen above, as well as on the jurisprudence and legal system of the European Union, are however in some cases substantially more moderate than what is internally implemented by the member states.[367] This relative freedom of implementation was intended – besides facilitating the negotiations for the enactment of the directive – to allow these countries to have the opportunity to safeguard their various interests in relation to CFC-rules: on the one hand, the fight against BEPS; and, on the other, the attractiveness and tax competitiveness of their internal market.

The most striking feature of this discretion is the option ATAD gives Member States to decide between a full-fledged entity approach or a "softer" version that follows the transactional approach. This in itself can already lead to immensely different results between the countries involved, and to this extent, the aim of the directive to avoid fragmentation within the internal market has certainly not been achieved. Another point of great relevance to this issue is, for example, the value of the low tax threshold for the activation of a CFC. While in Germany this value is and remains at 25%,[368] having been subject to constant criticism for some time now

[364] Refer to the importance of harmonization and CFC rules in Almudí Cid (2019): Chapter 8: Harmonization of Controlled. In: Almudí Cid/Gutierrez et al. (Eds.) - Combating Tax Avoidance., P. 159ff.
[365] Specifically in Art. 7 para. 1 and 2 ATAD. Refer to Smit (2018): The Anti-Tax-Avoidance Directive (ATAD). In: Terra/Wattel - European Tax Law., P. 259.
[366] Of which royalties or IP-related income are a part of.
[367] See, for example, the case of the German implementation in Bundesministerium für Finanzen (2019): Entwurf eines Gesetzes zur Umsetzung der Anti-Steuervermeidungsrichtlinie.
[368] Even after the implementation of the ATAD. See Böhmer, Julian; Oppel, Florian (2020): Die neue Hinzurechnungsbesteuerung für Beteiligungen an ausländischen Zwischengesellschaften. Eine erste Analyse des BMF-Entwurfs v. 10.12.2019. In *IWB* (1), P. 13f; and Böhmer, Julian; Gebhardt, Ronald; Krüger, Sebastian (2021): Die Änderungen der Hinzurechnungsbesteuerung durch das ATAD-Umsetzungsgesetz. Tatsächlich eine 1:1-Umsetzung der ATAD? In *IWB* (12), P. 479ff.

because it is considered too high;[369] in other countries a common rule is that the current tax paid should be at least as high as a pre-established percentage of what would be paid in the country of the parent company, as is *e.g.* currently done in Luxembourg.[370] Another possibility is to simply set a minimum rate, preferably below the domestic tax rate, for the CFC-rule to be activated,[371] which may or may not be combined with the use of blacklists/whitelists. Those are all outline options interesting for rules that aim at combatting aggressive tax planning structures with royalty payments.

Strategically speaking from a legislative design point of view, and especially when dealing with intellectual property – although the list system has by itself many flaws – the adoption of a whitelist would be preferable insofar as the circumvention of blacklists through the interposition of an intermediate country is relatively simple, whilst the use of a whitelist with a catalog of countries that have rules with a minimum level of protection against profit shifting is more direct and efficient. The use of a percentage linked to the national tax rate also seems to be a more appropriate decision, since any changes in the national tax rate will immediately lead to a proportional modification of the CFC-rule activation range. A potential drawback of this approach would be a rise in the complexity of the rate's calculation, followed by a fragmentation in the activation of the norm. This means that, for the same CFC, it is possible that the low taxation threshold of one country is reached while in another, it is not, which makes it difficult to respond in unison to the problem of BEPS.

An additional interesting ATAD design decision regarding CFCs is to consider as related party not only those companies linked on the basis of their control of each other, but also the possibility of acting through a coordinated behavior. Normally, some form of majority is required for a CFC to be considered a subsidiary, whether in relation to ownership, voting rights, *de facto* control etc., which can in the meantime be freely toughened by Member States by reducing this

[369] Allegedly, a new low tax threshold was not set in order to not harm the ongoing negotiations on the GloBE proposal at OECD-Level. See Bundesministerium für Finanzen (2019): Entwurf eines Gesetzes zur Umsetzung der Anti-Steuervermeidungsrichtlinie, P. 78. This percentage is also used to determine the criteria for low taxation when applying the German royalty deduction barrier, see more on this structure on Chapter 3.2.
[370] Established as 50% of the tax originally due, following ATAD recommendations as seen in Hoor, Oliver R. (2019): Luxembourg's New CFC Rules. In *Tax Notes International* 94 (5), P. 420.
[371] Currently 9% for the Netherlands, as this is the current lowest corporate tax rate within the EU (Hungary). See de Groot, I. M. (2019): Implementation of the Controlled Foreign Company Rules in the Netherlands. In *Intertax* 47 (8&9), P. 774f.

threshold control.[372] However, the so-called “acting in concert” extends even further the scope of CFCs by including companies that coordinate their actions[373] – something that can also be transposed to any rules that are directed at related parties. It should nonetheless be kept in mind that the concept of coordinated behavior is relatively subjective and stands in a grey zone, possibly reducing legal certainty and making it difficult to determine *prima facie* when there will be the activation of such a rule based on this criterion.

Furthermore, as expected from *Cadbury-Schweppes*, there is an obligation to provide for a refraining from the application of CFC-rules in the event that the company passes a substance test, whose central point is the presence of a substantive economic activity. This carve-out, that applies compulsorily for intra-EU/EEA situations and optionally for third country relations,[374] must be coupled with an effective establishment of the company concerned in the host Member State, which can be proved, among others, by factual evidence such as the presence of business facilities, (qualified) staff, equipment etc.[375] However, the requirement of a substantive economic activity can be seen as textually more strict than the wholly artificial arrangement defined by the ECJ case law.[376] This creates an interesting parallel with other rules of European law, since the CFC provision in the ATAD has as general principle the idea to “tax, unless there is a substantive economic activity”, while *e.g.* the parent subsidiary directive has an “exemption, unless there is abuse” logic, even though it is not clarified exactly how a substance test should be conducted.[377]

Other than a carve-out rule, the ATAD also provides for the possibility of adopting a *de minimis* threshold, in cases where a CFC has low accounting profits[378] and/or only a low percentage (approx. 33%) of the assets of a permanent establishment are considered “tainted”[379] – applied on a net basis, *i.e.*, after making deductions. This would reduce the cases of activation of

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372 Refer to paragraph 12 of the introduction to the directive.

373 Böhmer, Julian; Oppel, Florian (2020): Die neue Hinzurechnungsbesteuerung für Beteiligungen an ausländischen Zwischengesellschaften. Eine erste Analyse des BMF-Entwurfs v. 10.12.2019. In *IWB* (1), P. 8.

374 Since the restrictions are based upon EU law. See Smit (2018): The Anti-Tax-Avoidance Directive (ATAD). In: Terra/Wattel - European Tax Law., P. 262f.

375 See in particular Art. 7 para. 2 *lit*. “a” ATAD.

376 For more information, see the other work of de Groot, I. M. (2019): The Switch-Over Provision in the Proposal for an Anti-tax Avoidance Directive and Its Compatibility with the EU Treaty Freedoms. In *EC Tax Review* 25 (3), P. 162ff.

377 Of particular relevance to the jurisprudence of the parent-subsidiary directive is the Deister and Juhler Holding case, C-504/16 and C-613/16. For more on this opinion, see de Groot, I. M. (2019): Implementation of the Controlled Foreign Company Rules in the Netherlands. In *Intertax* 47 (8&9), P.779f.

378 Art. 7 para. 4 ATAD.

379 If an entity approach is adopted, as in Art. 7 para. 3 ATAD.

the CFC-rule to only more "serious" cases, facilitating a little the compliance and administrative aspect of the norm. Unfortunately, however, ATAD's responses to the double taxation issue are relatively limited. Despite the fact that Article 8 para. 7 ATAD provides for an answer in the form of a crediting of taxes paid by the controlled entity itself – but not of its own subsidiaries – in addition to other circumstances in which double taxation could occur in Article 8 para. 5 and 6, one of the major problems is not solved: the application of CFC measures by multiple states simultaneously. As ATAD does not provide for a specific hierarchy for the application of different CFCs between member states or even with third parties, it is inevitable that the use of this rule will lead to cases of double taxation. This may also occur through a subsequent application, *i.e.* at different times, of CFC rules by distinct countries, since these lack coordination or a priority order with each other, double or even multiple taxation might occur.

As has been seen, despite being a step forward in harmonizing European tax legislation to combat BEPS, there are many open questions or issues that are too flexible to represent truly effective measures to achieve their purpose. Thus, it is questionable how efficient the controlled foreign company rules really can be for the issue of profit shifting with royalty payments, and whether in fact the structure presented by ATAD can – with or without reforms – prevent aggressive tax planning structures that abuse IP, at least from an outbound perspective.

2.1.2.4 Efficiency of CFC-rules on royalties and coordination with other anti-avoidance measures

It remains clear that CFC-rules have become widely recognized internationally as a legitimate mechanism to realize tax policy and address base erosion and profit shifting, which is consistent with the provisions and intents behind double taxation agreements.[380] However, many countries have incentives not to implement such rules properly or not apply them in practice, since it will lower their multinational companies' competitiveness in the international market.[381] It has

[380] Opinions on this issue vary slightly, but the general idea is that since CFC rules are used to tax a country's own resident taxpayers, there would be no interference with double taxation agreements. See extensively on Broe (2008): International tax planning and prevention., P. 575ff; and Lang (2004): CFC legislation, domestic provisions, tax.
[381] Refer, for example, to the work of Kane, Mitchell (2014): OECD - The Role of Controlled Foreign Company Legislation in the OECD Base Erosion and Profit Shifting Project. In *Bulletin for International Taxation* 68 (6/7), 322ff.

been empirically proven[382] that the mere presence of CFC-rules in a legal system can reduce bilateral royalty flows, indicating greater resistance by companies to make cross-border royalty payments in the presence of CFC regulations. This has led to a natural process of restricting the applicability of these standards only to very specific cases, where a number of requirements for control, low taxation and type of income must be met in order to activate the rule.

Consequently, despite their partial effectiveness as an anti-avoidance measure against the extensive use of low tax jurisdictions by parent companies of multinational groups, it is not possible for CFC rules to prevent any and every type of base erosion.[383] This is further aggravated by the fact that it is a rule that only covers outbound cases, requiring the foreign company to be controlled by a domestic one. In most cases involving profit shifting with licensing fees, the subsidiaries are those that have residence in high-tax countries that might wish to avoid profit shifting, making cross-border deductible payments in high amounts to their parent companies, which are those that hold control.

This demonstrates that the effectiveness of a CFC-rule is relatively restricted, not only because of the current acceptable scope of the norm within the EU to combat wholly artificial arrangements, but because of the very nature of the regulation to deal with only one side of the BEPS problem, *i.e.*, with multinationals that have a parent company with control residing in a high-tax country *with* an active CFC-rule. This brings us to another problem, which is how relevant the implementation of CFC rules for developing countries is, since they are not, in general, countries with large amounts of outbound investments.[384] The relevance of these rules for the most vulnerable countries is therefore even more limited, which distances us even further from solving holistically the problem of profit shifting with intangible assets. Therefore, although the usefulness of this anti-avoidance measure cannot be completely ruled out, the problem of profit shifting with

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[382] As in the study by Dudar/Spengel/Voget (2015): The Impact of Taxes on., P. 23ff; data used is on a par with the study on patents and CFCs by Karkinsky, Tom; Riedel, Nadine (2012): Corporate taxation and the choice of patent location within multinational firms. In *Journal of International Economics* 88 (1), P. 176ff.

[383] This is recognized by some countries insofar as it is used as a strategy to attract investment when competing with other countries that have stricter systems. Refer to Radmanesh, Sandy (2015): Empfehlungen für eine effektive Hinzurechnungsbesteuerung (sog CFC-Regelungen) - Aktionspunkt 3 des OECD/G20 Base Erosion and Profit Shifting (BEPS)-Aktionsplan. In *IStR* 23, P. 896ff.; and Riedl (2017): Purpose and Policy Considerations for. In: Pinetz/Schaffer (Ed.) – Limiting base erosion., P. 187ff.

[384] As in the case of Colombia, which accounts for about 1% of the total outbound investment made by the US. The total costs to a developing country's public administration of effectively applying a CFC-rule can be much higher than the revenue earned. See the insight by Dueñas, Sebastian (2019): Comparing CFC Rules Around the World. In *Tax Notes International* 95 (6), P. 526f.

royalty payments would depend, at the very least, on an interaction of CFC-rules with other measures of a similar nature.

However, this is another recurring problem of CFC-rules. The interaction with other anti-avoidance systems can be difficult, since despite having a relative complementary character with transfer pricing standards, CFC income and its taxation is evaluated on a current basis, while possible adjustments in transfer pricing often take place in the subsequent financial year(s),[385] since these are extremely complex and tax audits spanning several fiscal years may be necessary. This could in itself lead to double taxation concerns, where a subsequent application of these measures could lead to readjustments *after* the taxation of the income in question takes place through a CFC.

The same problem could occur, for instance, if the country of residence of the subsidiary applies a royalty deduction barrier for intra-group cross-border royalty payments,[386] a very similar issue seen between the income inclusion rule and the undertaxed payments rule within the OECD GloBE proposal.[387] If in one country a non-deduction is activated, this means that these amounts will be taxed normally in the source country; in the meanwhile, if a CFC is activated in the country of the parent company of this subsidiary, these amounts would again be taxed at their level.

Another rule that could eventually lead to enormous conflicts – and even possibly to the extinction of CFCs – is the proposal for a global minimum tax and specifically the income inclusion rule, such as that currently being discussed by the OECD.[388] In the event of implementation, it would be necessary for all countries that have CFC rules to make sure that there is no overlap between the application of these two regulations, and it is even possible that, if the minimum taxation is high enough, that the application of CFCs will become obsolete. This would happen because, if a forthcoming global minimum tax is above the low-taxation threshold that is required for the activation of a CFC, the activation of the latter would never occur. In addition, it must be taken into account that the activation of a CFC is much more onerous than that of a

[385] See the insight by Hoor, Oliver R. (2019): Luxembourg's New CFC Rules. In *Tax Notes International* 94 (5), P. 428f.

[386] More details on this interaction in Chapter 3.2.2. In some cases this interaction is regulated by the lawmaker, as it is in Germany and more recently been done in Austria, see Kofler, Georg; Marschner, Ernst (2014): Änderung im Außensteuerrecht. Verwertung und Nachversteuerung ausländischer Verluste, Abzugsfähigkeit von Zinsen- und Lizenzgebührenzahlungen, beschränkte Steuerpflicht für Zinsen. In *SWK* (9), P. 463ff.

[387] More details on this interaction in Chapter 3.4.

[388] *Ibid*.

minimum tax,[389] since the taxation of the CFC will always be at the same level of the parent company – effectively nullifying the effects of a lower tax rate in the subsidiary's country of residence – while the minimum tax will be defined in advance, and naturally with a lower (or equal) value than the baseline corporate tax rate.

The mere lack of coordination and priority order between CFC rules, as could be seen, is already a problem in itself. If a CFC is activated at different levels, the risk of double taxation is extremely high, as with many other cases assessed here, especially if the CFC does not have disburdening tools such as tax credits, carve-out rules and/or *de minimis* approaches.

Once again it is clear how difficult it is to find a proper balance between a rule that achieves the purpose for which it is designed without overloading tax administrations and the taxpayer with compliance issues and double taxation. In addition, a coordinated response is difficult to adopt considering the different interests of each country, and the ultimate result ends up being a watered down version of what was initially proposed, as perceived by the developments of the ATAD leading up to its implementation and BEPS discussions. One of the biggest problems that the development of a rule with as many different design possibilities as a CFC faces is much more a question of reaching a political consensus than of reaching an appropriate technical response. That is to say that the implementation of new systems and responses is less a question of technical matter than a question of political consensus. Considering all the problems that CFC-rules have, in addition to their action being restricted to outbound cases, a (more) adequate response is still sought in other measures.

2.1.3 General anti-avoidance rules as the last security net against profit shifting using royalty payments

It now remains to examine, finally, whether the flaws of the previous rules regarding license fees (royalty payments) can be overcome by the broad-based regulation par excellence: the general anti-avoidance rules. Despite being norms already existing in the late 19th century,[390] the so-called general anti-avoidance rules (GAARs) are a recent addition in the legal system of several

[389] As discussed by Junge, Aaron; Russo, Karl Edward; Merrill, Peter (2019): Design Choices for Unilateral and Multilateral Foreign Minimum Tax. In *Tax Notes International* 95 (10), P. 965ff.

[390] For almost 150 years, New Zealand has had a GAAR rule in its legal system. See Tretola, John (2017): Comparing the New Zealand and Australian GAAR. In *Revenue Law Journal* 25 (1), Article 3, P. 2ff.

countries, being even one of the many objects of the recent internal reform to the anti-avoidance rules of the European Union in the form of the previously discussed ATAD.

As their very name already suggests, these rules seek to serve as an umbrella, covering cases of anti-avoidance which are not dealt with by other more specific rules of similar purpose. However, one of the greatest difficulties in the study of these norms is the lack of uniformity in their legislative design, since there is no universal consensus on what would definitely constitute a general anti-avoidance rule and, in truth, not even in what would constitute tax avoidance, the primary object of this type of norm.

In an attempt to gain a broader understanding of what they are and how GAARs work in relation to intellectual property and tax avoidance schemes, they will take the center stage in the following subsections.

2.1.3.1 Concept and application of GAARs in the context of IP

When dealing with GAARs, one immediately realizes the importance of their distinct design possibilities, as it is a broad rule that aims to be applied to all unforeseen and unforeseeable circumstances of tax avoidance at the time of its implementation. Therefore, its effectiveness is directly linked to the form and content of its legal provision and, on the other hand, its effective activation by tax administrations and courts of law.[391]

2.1.3.1.1 Analysis of commonalities between GAARs throughout the years

In many cases, GAARs are elaborated precisely on the basis of national jurisprudence and the treatment given to anti-avoidance cases that were considered abusive, even if formally legal at first sight. Some countries even seek to deal with the tax avoidance problem through general anti-avoidance rules only, rather than relying on specific or targeted anti-avoidance measures.[392] This is an indicator that despite having different forms, the GAARs have a common purpose, which is

[391] See Rosenblatt (2015): General anti-avoidance rules for major. P. 27f.

[392] Also known as SAARs and TAARs, respectively. This is, for example, the case for the United Kingdom and New Zealand. See Cassidy, Julie (2019): GAAR anti-avoidance vs GAAR anti-abuse. In *Journal of International Taxation* 30 (9), P. 51. Many other countries also rely only on general anti-avoidance and transfer pricing rules. Refer to Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 384; and Seve, Anthony; Austin, Peter; Wright, Ruth (2020): Australian Taxation Office Audit Focus on Arrangements Involving Intangibles. In *International Transfer Pricing Journal* 27 (3), P. 193ff, as Australia relies exclusively on the coordination between GAAR and TP rules.

to function as a principled backstop[393] against conduct considered undesirable because it would constitute an abuse of a country's tax legislation that leads to tax avoidance.

It is important to emphasize that it is impossible for the legislator to entirely prevent the creation of tax avoidance opportunities through national legislation, as even in a “perfect” tax system, there will always be different treatments based on different tax rules.[394] While an adequate design can reduce the possibilities and its margins of advantage, the tax avoidance problem is in the very nature of tax rules contained within the systems used in the present day. Since specific anti-avoidance rules (SAARs) are, by themselves, insufficient because they are unable to regulate new schemes that could not be anticipated in advance, GAARs have developed these common and broad application features to meet these needs.

This means that, while it is recognized that there are many differences among the GAARs, there are points in common between all of them, since the desired goal by each different form is still the same, invariably leading to the formation of some shared characteristics. Among them, the following can be highlighted: (a) the attempt to characterize a tax avoidance scheme or transaction(s); (b) the attainment of a tax advantage or benefit resulting from this scheme or transaction; and (c) the aspect of the taxpayer's intent or purpose in organizing this scheme or transaction.[395] Of course, one cannot forget the differences that exist between the GAARs of different countries, which may still include, among others, misuse or abuse provisions, as well as provisions linked to the tainting of elements,[396] being difficult to determine straightaway what relative strength a GAAR has.

The main distinction between older general anti-avoidance rules and those being modernly implemented is typically linked to the specificity of its scope. The old rules ended up being very broad, which guarantees a greater margin of discretion for the tax administration at the time of their application and, consequently, less legal certainty and predictability for the taxpayer as to

[393] Some authors even call this an anti-avoidance general principle, enabling a general principle within which rules can be applied accordingly. On this opinion see Freedman, Judith (2004): Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle. In *British Tax Review*, P. 332ff.
[394] See Zimmer, Frederik (2019): In Defence of General Anti-Avoidance Rules. In *Bulletin for International Taxation* 73 (4), P. 219.
[395] For more information, refer to Bowler, Tracey (2009): Countering Tax Avoidance in the UK: which way forward? Edited by IFS. Tax Law Review Committee (TLRC Discussion Paper nº 7). P. 103ff.
[396] See the contribution by Johansson, Åsa; Bieltvedt Skeie, Øystein; Sorbe, Stéphane (2017): Anti-avoidance rules against international tax planning (OECD Economics Department Working Papers, 1356), P. 8f.

when such rule would be applied to the concrete case. Nowadays, the purpose is to elaborate more precise rules, with a list of characteristics or (more) objective criteria that allow identifying, for example, when there is a transaction or arrangement with the purpose of tax avoidance. A GAAR's strength is measured not (only) by the revenue it collects, but also on the efficiency it brings to the system as a whole.[397] Legal certainty for tax administration and taxpayers alike is of the utmost importance.

The tax advantage, on its turn, is defined in a circular manner in relation to the concept of tax avoidance arrangement, which would be a tax saving that otherwise would not be available to the taxpayer were it not for the existence of such a transaction or arrangement that allows for its occurrence.[398] The purpose or intent of the taxpayer would serve, ultimately, to represent the absence of an economically rational action, which would have as its main – or only, depending on the specific choice of wording – purpose to obtain a tax advantage. This means that GAARs always represent a subjective test, because the mere occurrence of higher taxation if another means were employed is not sufficient justification for the application of the norm.[399]

Although they must be inherently indefinite in order to maintain their character of broadness, these characteristics make up the core of a GAAR and will be present, to a greater or lesser extent, in all its variations. The key question, therefore, is how to organize these terms and requirements in order to find a balance between striking the royalty transactions that in fact compose an aggressive tax planning structure and those that are simply transactions that would occur regardless of tax factors and incentives, so that the latter are not hindered by the legal insecurity intrinsic to wide-ranging rules.

Some argue that these insecurities inherent to GAARs are not only natural, but temporary in that their application is distinct from that of a substantive tax rule. General anti-avoidance rules have applicability only directly in the specific case, from which point on administrative and judicial precedents are created over time, thus producing greater availability of information to the taxpayer on whether or not cases will be covered by the regulation. This would be a necessary evil

[397] See the opinion of Grageda, Eugenio (2021): Mexico's GAAR: Will the Bullied Become the Bully? In *Tax Notes International* 101 (5), P. 602ff.
[398] Rosenblatt (2015): General anti-avoidance rules for major., P. 29.
[399] Krever (2016): Chapter 1: General Report: GAARs. In: Lang/Rust/Schuch et al. (Eds.) - GAARs - a key element of., P. 7.

to protect a country's tax base,[400] and its application would become smoother over time – with the advantage of being adaptable to the emergence of new cases, precisely due to its broader scope.

2.1.3.1.2 Practical usage within an intangible asset framework

The application of a GAAR to a transaction involving the payment of licensing fees for the use of an intangible asset could be useful to the extent that the interposition of a company that owns the intangible asset in a low-tax jurisdiction could possibly be serving only the purpose of turning what would be normal, taxable revenue, from the use of IP into deductible business expenses in the form of royalty payments. This is relatively common insofar as it naturally exists within tax law alternative tax outcomes depending on the form or structure of a transaction. In this particular case, the business group has modified its structure so that an income becomes non-taxable at the level of the company that actually uses the intangible in a high-tax jurisdiction, in favor of its parent with ownership over the asset.

Practical examples involving the use of GAARs linked to corporate structures concerning intellectual property, although scarce, exist especially in countries that have not only a legal but also a judicial tradition of using these general rules to solve tax matters, as is the case in Australia. However, their use is usually restricted to situations that prove a lack of commercial rationale and substance, in which both transfer pricing rules as well as GAARs may be of relevance.[401]

One such case can be described as a company A resident in country A that makes royalty payments for the use of legally owned intangibles to company B, from its same corporate group, resident in country B. Even if the arrangement between these companies indicates that the DEMPE functions[402] are performed solely by company B, if company A actually assumes risks associated with its activities on behalf of company B, the payment of royalty payments may be considered not to be rational or consistent enough from an economic point of view. This would justify – as in the comments of the Australian Taxation Office (ATO) in similar hypotheses – that not only

[400] *Ibid*., P. 2.
[401] Refer to Seve, Anthony; Austin, Peter; Wright, Ruth (2020): Australian Taxation Office Audit Focus on Arrangements Involving Intangibles. In *International Transfer Pricing Journal* 27 (3), P. 193f. For more on the relation between this GAAR and TP rules, see Pereira, Neil (2022): Intangibles: The New Frontier. In *Tax Notes International* 105 (1), P. 52f.
[402] See Section 2.1.1.1 for more information on DEMPE.

transfer pricing rules, but also a general anti-avoidance rule might be applicable.[403] This would ensure that in cases relating to transactions involving intangibles, that a holistic view of the issue is taken, with distinct possible tax consequences.

The problem with the application of a general anti-avoidance rule within the framework of aggressive tax planning schemes involving IP presented in Chapter 1 is,[404] however, also similar to the limitations that were dealt with when handling transfer pricing rules. As a result of being a broad-scope norm, GAARs are commonly limited to borderline cases not covered by specific national legislation – if existing at all – in which an abuse of a right is configured through a tax avoidance arrangement whose primary or sole purpose is to obtain a tax advantage. However, there are aggressive tax planning schemes that have, *prima facie*, not only a plausible commercial justification – since the taxpayer is given the freedom to structure its company in whatever legal way it sees fit – but that might be occurring in accordance to arm's length principles while nevertheless eroding a country's tax base. If one seeks to combat this type of aggressive tax planning, one should be skeptical about the effectiveness of a GAAR.

The danger of using a broad rule to solve a highly technical and specific problem involving intangible assets is precisely that of applying the rule to practical cases either too widely or too narrowly, since the vagueness inherent to the wording of a general anti-avoidance rule necessarily entails a (variable) burden of legal uncertainty for the taxpayer. If a GAAR is used indiscriminately both for cases in which there is no economic substance and for schemes that take advantage of asymmetries in the tax systems of different countries, but in an economically justifiable manner, there is a risk of generating a very broad margin of discretion for the public administration in deciding whether to apply the rule or not, in contrast to the current trend of more specific delimitation towards determining the outline of a GAAR.

Even in cases in which a country has a real interest in extensively curbing the shifting of profits and the erosion of its tax base, the ideal response does not seem to lie in such a broad spectrum rule, at the risk of relegating the role of defining the contours of GAARs to the judiciary

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[403] As in the examples of Australian Taxation Office (2020): Taxpayer Alert. Non-arm's length arrangements and schemes connected with the development, enhancement, maintenance, protection and exploitation of intangible assets (TA 2020/1). Available online at https://www.ato.gov.au/law/view/document?docid=TPA/TA20201/NAT/ATO/00001, checked on 27.02.22.

[404] Refer to Subsection 1.4.

and public administration, to the detriment of the taxpayer's possibilities of defense and predictability. This further reduces a country's attractiveness from an economic point of view, since a strict and unclear tax regime can be a determent for businesses.[405] As much as there are systems that give preference to a judicial formation of the GAAR concept, this is not to be mistaken with the idea of endowing this anti-avoidance rule with a wide-ranging use to basically any case in which there is a tax advantage arising from a transaction or tax arrangement. It is precisely for this reason that the main focus of this type of rule must be on the determination of the taxpayer's *purpose* or *intent* when elaborating a certain scheme or carrying out a transaction, which results in a more moderate rule that would ensure that conscientious forms of tax structuring with IP are not placed in the same boat as aggressive tax planning schemes.

Some authors are critical of the use of a principle purpose test in the application of a GAAR, since this supposedly would not have an independent legal meaning, and would merely be a reaffirmation of the need to interpret a rule of law based on the object and purpose of its existence.[406] This means that the reference to the purpose of the taxpayer would, according to this line of reasoning, be totally expendable. In addition, if a situation were to occur in which the same tax arrangement or transaction and the same tax advantage were to be obtained from these, that is, situations at first sight objectively equal, different results could possibly be achieved. However, we do believe that taking the taxpayer's intention is simply an *extra* requirement for the application of a GAAR, needed insofar as its purpose is not to make a moral judgment of the taxpayer's position, but to determine its intentions based on the objective criteria of the case.[407] The purpose criterion further serves the aim of allowing the difficult distinction between cases of tax planning considered as having a justifiable economic reason and those undesirable, classified as aggressive tax planning.

It is certain that the mere existence of a GAAR in a legal system can affect rational decision making by a company for fear of a structure or transaction being affected by the provision. This is certainly aggravated by the – necessary – reference to the taxpayer's intent, as well as the lack of

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[405] As recognized by Cassidy, Julie (2019): GAAR anti-avoidance vs GAAR anti-abuse. In *Journal of International Taxation* 30 (9), P. 55.
[406] As defended by Lang, Michael (2014): BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties. In *Tax Notes International* 74 (7), P. 660f.
[407] On a similar opinion, see Zimmer, Frederik (2019): In Defence of General Anti-Avoidance Rules. In *Bulletin for International Taxation* 73 (4), P.224f.

clarity in what the consequences of activating a general anti-avoidance rule will be. As it can be used in the solving of different tax avoidance cases, the legal result is, in general terms, the disregard or withdrawal of the benefit obtained through the non-avoidance means, usually through the substitution of the "abusive" or inadequate transaction by another, which will determine the taxes due.[408] No more information is, howbeit, available, and in the specific case of a royalty payment used for the shifting of profits from a high-tax jurisdiction to a parent company in a low-tax one, a result to be considered would be a restriction in the possibility of deducting the amounts paid as business expenses.[409] This is because, overall, the concept of tax benefit should be interpreted broadly,[410] which includes possible deductions for licensing fees.

Indeed, specifically when it comes to the use of GAARs in the face of the problem of royalty payments, it can be an extremely useful general rule, albeit by no means a *panacea* that would solve every single tax issue with the transfer of IP and licensing fees.[411] Considering the restrictions in their application – to ensure greater legal certainty and predictability for the taxpayer – to cases where there is a clear intent to obtain a tax advantage through cross-border transactions, the general anti-avoidance rules are rather a (powerful) tool to combat the more egregious tax avoidance schemes.

This means that, for a country that does not seek to thoroughly combat the erosion of the tax base and profit shifting opportunities obtained through transactions with intangible assets, the presence of a GAAR might suffice to simultaneously prevent or remedy the most critical cases of aggressive tax planning, while preserving the economic attractiveness and competitiveness of a given location.[412] However, to rely solely on GAARs may end up reinforcing the aforementioned concerns related to legal security and impacts on corporate decision-making, relegating much

[408] See Krever (2016): Chapter 1: General Report: GAARs. In: Lang/Rust/Schuch et al. (Eds.) - GAARs - a key element of., P. 11 and 12.
[409] This possibility is expressly recognized by Fuest/Spengel/Finke/Heckermeyer/Nusser (2013): Profit shifting and "aggressive" tax., P. 14.
[410] As can be inferred by the wide scope of application of some GAARs. See Mitroyanni (2016): Chapter 2: European Union. In: Lang/Rust/Schuch et al. (Eds.) - GAARs - a key element of., P. 27ff.
[411] As defended by Cassidy, Julie (2019): GAAR anti-avoidance vs GAAR anti-abuse. In *Journal of International Taxation* 30 (9), P. 52.
[412] For a more in-depth discussion regarding the option between a sole and exclusive use of GAARs or their coordination with specific standards, refer to Chapter 5.3.

freedom and power to the judiciary and tax administration to the detriment of the legislative. And, of course, such great power comes with great responsibility.

In order to better determine the applicability of this provision – either autonomously or coordinated with specific measures – it is necessary to evaluate its relationship with higher-ranking law, which may eventually restrict or direct its form of use, modifying all or part of its effectiveness in achieving its purpose.

2.1.3.2 Relation to tax treaties and the article on royalties

By denying benefits due to the activation of a GAAR – for example the incidence of withholding taxes or the non-deductibility of business expenses – questions immediately arise about the dynamics between the anti-avoidance rule and potential existing international treaties to avoid double taxation signed by the countries involved. This question is, in principle, resolved by the respective national (constitutional) rules for the resolution of conflicts between domestic law and international treaties, in which the possibility of a treaty override is also discussed,[413] should the existence of a conflict be confirmed.

In the specific example of WHT, Art. 12 OECD-MC could be violated to the extent that normally exclusive taxation rights are granted to the State where the owner of the intangible asset is located, to which licensing fees are due for its use. However, it could be argued that GAARs would actually have to be applied in this case in the *background* of domestic law, determining first of all to which type of income the double taxation agreement will be applied.[414] This occurs to the extent that tax treaties do not generate a tax obligation,[415] but are responsible for the allocation of taxing rights between two different countries, with the ultimate purpose of avoiding double taxation – as well as double non-taxation – based on the concepts and classification of national law, if they are not provided for in the treaties themselves.

This means that, if a transaction is re-characterized or bypassed for tax purposes, there might be no more income for the treaty to apply to, or else it will simply be applied to the new characterization conferred by the general anti-avoidance rule, without having to address a conflict

[413] A thorough investigation of tax treaty overrides is available in Chapter 4.3.1.2.3.
[414] Also on this opinion, see Krever (2016): Chapter 1: General Report: GAARs. In: Lang/Rust/Schuch et al. (Eds.) - GAARs - a key element of., P. 15.
[415] For more information, refer to Chapter 1.4.1.2.

or treaty override between domestic legislation and a double taxation agreement. The only exception would be in the event that the treaty explicitly defines a term and it is not possible for a GAAR to modify this definition without incurring in conflict.[416] This interpretation seems consistent with the OECD position on the matter,[417] ensuring a GAAR operation compatible with international tax law.

Admittedly, depending on the wording chosen for a particular GAAR, there may still be conflict with international tax treaties. This occurs because, although prima facie there is no direct conflict of rules between this type of anti-avoidance rule and treaty law, each GAAR should have its activation and legal consequences analyzed according to the provisions and hierarchy that the double taxation agreement has in the respective national legal system. However, even in those – probably rare – cases where there is in fact a conflict between the two, the precedence of the GAAR over the tax treaty may be argued on the basis of the comments to Art. 1 of the OECD-MC,[418] which allow the use of anti-abuse rules in a manner compatible with the treaties.

In addition, it must be examined whether there is some form of treaty entitlement with regard to general anti-abuse rules. This occurs since especially after the advent of Action 6 of the OECD initiative, the rules known as the Limitation on Benefits (LoB – more objective) and Principle Purpose Test (PPT – of a rather subjective character) have gained more prominence in the fight against profit shifting, having a very similar nature to the test conducted under GAARs.[419] Therefore, as far as the application of GAARs to transactions involving intangibles, possibly covered by Art. 12 OECD-MC, is concerned, it is unlikely that there will be a conflict with tax treaties, as the recharacterization of the transaction or the denial of benefits will take precedence over the application of the treaty provisions. In the remote event of one occurring, a mutual agreement procedure (MAP) in order to resolve issues arising in the context of an applicable tax treaty and anti-avoidance rules is envisaged as a suitable alternative.

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[416] This could occur, for example, if the tax administration attempts to re-characterize royalties - as defined by the treaty - into some other type of income through a GAAR.

[417] Refer to the commentary of the OECD (2017): Model Tax Convention on Income and on Capital: Condensed version. Available online at https://www.oecd-ilibrary.org/docserver/mtc_cond-2017-en.pdf?expires=1579104442&id=id&accname=ocid57015174&checksum=200E9FF99711033C8A7CF51EE5CC6B95, checked on 15.01.20, P. 286.

[418] *Ibid*., P. 72ff.

[419] Refer to the work of Theophilou, Christos A. (2019): Patent Boxes: The Rise, the Change or the Fall? In *Bulletin for International Taxation* 73 (5), P. 291f.

2.1.3.3 Relation to EU law and possible restrictions on its use

Until the advent of the anti tax-avoidance directive, the European Union was gradually experimenting with the acceptance and format that a GAAR should have in order to fit in properly with the European legal system. The first time the EU even saw a discussion on GAAR was in the proposal for the directive on the notorious Common Consolidated Corporate Tax Base (or CCCTB, for short) in early 2011.[420] At that time, the focus was not specifically against intangible assets, but rather to thoroughly reform the European tax framework and allow the insertion of a general anti-avoidance rule in a harmonious manner. Recognizing the failure of the proposal, the EU Commission issued a recommendation – which is non-legally binding, based on Art. 288 subpara. 5 TFEU – included in its proposal against aggressive tax planning at the end of 2012.[421] Considering its non-binding nature, this instrument employed by the European Commission ended up being a mere soft tax coordination (as opposed to a hard one),[422] which produced an insufficient reaction from European countries towards its implementation. As of 2020, the proposal for a CCCTB has been completely abandoned,[423] and replaced by a newer version adapted to the tax needs arising from the Covid-19 pandemic in the form of the so-called "Business in Europe: Framework for Income Taxation" (BEFIT).

This allows us however to have an insight into what the EU already considered to be a suitable format for a European general anti-avoidance rule, namely of a provision that does not have the function or intent of modifying the scope of already existing special anti-avoidance rules within the Member States. It instead derives its existence from the recognition of the need to block loopholes that allow the occurrence of aggressive tax planning opportunities that the legislator failed or was unable to foresee at the time it legislated in a specific way.[424] There was, of course,

[420] See European Commission (2011): Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) (2011/0058 (CNS)). Available online at https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf, checked on 20.07.20, P. 13 ff.

[421] Refer to European Commission (2012): Commission Recommendation of 6 December 2012 on aggressive tax planning (2012/772/EU). Available online at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012H0772&from=EN, checked on 20.07.20.

[422] As in Pistone (2010): Soft tax law: steering legal. In: Weber (Ed.) - Traditional and Alternative Routes to.

[423] See European Commission (2021): Communication from the Commission to the European Parliament and the Council. Business Taxation for the 21st Century (COM(2021) 251 Final). Available online at https://ec.europa.eu/taxation_customs/system/files/2021-05/communication_on_business_taxation_for_the_21st_century.pdf, checked on 21.04.22, P. 12.

[424] See Mitroyanni (2016): Chapter 2: European Union. In: Lang/Rust/Schuch et al. (Eds.) - GAARs - a key element of., P. 21.

already the desire to harmonize this tax matter within the EU, but there were several barriers to this, such as the competence to legislate on direct taxation being, as a rule, with the Member States; as well as the need for unanimity on tax matters according to Art. 115 TFEU;[425] in addition to the application of the principle of conferral, which would possibly restrict the competence of the EU in particular to those countries that already had some kind of GAAR.

Nonetheless, the coordinated implementation of a mandatory general anti-avoidance rule within the EU for corporate taxation was made possible by the introduction of the 2016 ATAD. This was effectively feasible mainly due to the development of ECJ's case law over the years,[426] which despite ensuring the taxpayer's right to structure their businesses in such a way that they can legally pay as few taxes as possible, should *not* allow for tax mitigation to become tax avoidance within the EU.[427] This means that tax law in Europe does not have to and should not tolerate any and every form of opportunistic behavior just because it is covered by the strict formality of the law and the Member State concerned has not expressly taken legal measures to combat this type of aggressive tax planning stance.[428]

Precisely in order to implement an extra backstop for the other specific anti-avoidance provisions foreseen in the ATAD,[429] this GAAR of mandatory implementation for the MS was included, which would ensure not only the compatibility, but the complete integration of this rule into the European legal system.[430] There are some who question whether the rule contained in Art. 6 ATAD would deviate from the ECJ case law with respect to the issue of abuse in tax law,[431] however, the rule seems simply to reflect the general anti-abuse principle present in European

[425] The EU Commission manifested its worries on this requirement on several occasions. See, for instance, European Commission (2019): Commission launches debate on a gradual transition to more efficient and democratic decision-making in EU tax policy (IP/19/225). Available online at https://ec.europa.eu/commission/presscorner/detail/en/IP_19_225, checked on 20.07.20.
[426] See, for example, Baez Moreno/Pérez (2019): Chapter 6: The ATAD General. In: Almudí Cid/Gutierrez et al. (Eds.) - Combating Tax Avoidance., P. 120ff.
[427] As was decided for example in *Halifax*, C-255/02, para. 72ff.
[428] This was the opinion expressed by Advocate General Maduro, also in Halifax, para. 77.
[429] For instance with CFCs, as seen above.
[430] For a comparison on the different means of implementation of this rule between Member States, refer to Lauratet, Séverine (2020): La clause anti-abus générale de la directive ATAD: comparaison des transpositions dans 5 États membres (France, Allemagne, Irlande, Luxembourg et Pays-Bas). In *Fiscalité Internationale* (2), P. 12ff.
[431] See Smit (2018): The Anti-Tax-Avoidance Directive (ATAD). In: Terra/Wattel - European Tax Law. P. 270f. Some even go further as to express their concerns on the finalistic and legal perspective of the implementation of an EU-GAAR, refer to Almudí Cid/Gutierrez/González-Barreda (2019): Combating Tax Avoidance in the., Chapter 5; and Smit, Daniël (2019): Literature Review. In *Intertax* 47 (4), P. 418f.

community law.[432] Moreover, it is to be expected that in interpreting the rule contained in the directive, the European Court will carry it out in a manner compatible with the doctrine of abuse of law developed so far.

Following the standard common to GAARs, the European rule stipulates that an arrangement or a series thereof will be ignored to the extent that its use has as its main purpose or one of its main purposes the obtaining of a tax advantage that circumvents the intent of a certain tax rule.[433] In addition to the criteria of artificiality of the structure and bypassing the object and/or purpose of corporate tax law, the motivation for the elaboration of the structure must also be taken into consideration.[434] It is understandable that the requirement of motivation is put in a broader manner, since it is not strictly necessary that the *only* reason is the obtaining of a tax advantage in order to trigger the GAAR. This enables this rule, specifically directed at corporate taxation, to be also used in cases involving the payment of royalties, whose structuring for aggressive tax planning can, as seen previously, also be done based on several reasons other than tax savings,[435] such as the centralization of the administration of intangibles, search for local qualified labor, etc.

However, it should be emphasized that, despite its possible applicability to the specific case of licensing fees, even the European GAAR should not be treated as a *panacea* against tax abuse,[436] especially in relation to intangible assets, which are already by their very nature covered with uncertainties and grey areas.[437] From the point of view of the European Union's position prior to

[432] This was expressly confirmed in decisions such as *Kofoed*, C-321/05, but also more recently through the declaration of the existence of a general anti-abuse principle in European law in joined cases C-116/16 and C-117/16. For further information on this principle and its relation to the interpretation of the directives, see Schön, Wolfgang (2019): The Concept of Abuse of Law in European Taxation: A Methodological and Constitutional Perspective. In *Working Paper of the Max-Planck Institute for Tax Law and Public Finance* 18. Available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3490489, checked on 25.11.19, P. 10ff.
[433] This rule has as its core premise the concept of abuse associated with the taxpayers intentions, as stated by Kuzniacki, Blazej (2020): The GAAR in the ATAD. 12th GREIT Lisbon Summer Course Presentation, July 2020.
[434] Refer to Art. 6 para. 1 ATAD, very clear in its requirements.
[435] It is important to remember that the ECJ has expressly confirmed that it is legitimate to take tax issues into consideration in the decision-making process on whether and where to establish a subsidiary in Cadbury Schweppes, and insofar as taxpayers are not using a structure that leads to abusive tax practice, one cannot restrict fundamental market freedoms simply because of lower level of taxation in another Member State. Refer to the *Eurowings Luftverkehr* decision, C-294/97.
[436] For a comparison between the ATAD GAAR, the Multilateral Instrument GAAR and the German one, refer to Haarmann, Wilhelm (2018): Die Missbrauchsverwirrung. In *IStR*, P. 571ff.
[437] Some authors even point out the possible dangers in the current implementation of general anti-avoidance rules in Europe, which have partly mirrored the UK GAAR as a model, without however adopting the safeguards and reasonableness tests present in the national law of the united kingdom. See Freedman, Judith (2019): The UK General Anti-Avoidance Rule: Transplants and Lessons. In *Bulletin for International Taxation* 73 (6/7), P. 337ff.

the OECD BEPS-project, where harmonization in the field of corporate taxation was seen as an impossible mission due to the different opinions and interests of the member states – regarding not only intellectual property –, the adoption of a GAAR through the ATAD represents a huge step forward. However, while the ATAD adopts GAAR as the minimum standard for Member States, creating an incentive for them to charge against tax avoidance, the Court of Justice of the European Union is demanding with its case law caution and that they be contained. And even worse: if the Member State (MS) is too lenient in applying a general anti-avoidance rule, it may eventually be considered a selective advantage for the taxpayer, triggering a state aid violation.[438] ATAD's GAAR, although *prima facie* well drafted, does *not* enhance legal certainty due to its case-by-case application,[439] and it still needs to wait many years of practical application to prove its *de facto* utility.

2.1.3.4 Relation to the specific anti-avoidance rules on royalty payments

The last aspect of relevance to be analyzed is the relationship of GAARs with SAARs or targeted anti-avoidance rules (TAARs). This coordination is essential because, as has been seen, GAARs have a backstop function with respect to the latter, and although there are (many) countries[440] that use only or mainly general anti-avoidance rules to combat profit shifting involving royalty payments instead of SAARs or TAARs – given the innovative and ever-changing nature of this form of aggressive tax planning – specific rules can and should be employed by countries that have the intention of more efficiently curbing this type of erosion of their tax base.

There are no reported conflicts between general and specific rules in what concerns the anti-avoidance measures in comparative law,[441] It is clear that it is preferable to apply the specific rule to solve a given profit shifting issue with precedence over a general rule, if one exists,

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[438] See the contribution by Goulder, Robert (2018): Does the EU's Anti-Tax-Avoidance Directive Have a GAAR Problem? In *Tax Notes International* 91 (12), P. 1275f.

[439] The tax administration is not confined only to the application of predetermined general criteria, but can subject each specific case to a general assessment, and to the taxpayer is guaranteed the right to provide evidence of commercial justification for its structures and/or transactions. See Mitroyanni (2016): Chapter 2: European Union. In: Lang/Rust/Schuch et al. (Eds.) - GAARs - a key element of., P. 42f.

[440] Most countries have at least some sort of GAAR and transfer pricing rules, but not necessarily specific anti-avoidance rules, especially when it comes to intangible assets. See the study by Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 384f.

[441] See Krever (2016): Chapter 1: General Report: GAARs. In: Lang/Rust/Schuch et al. (Eds.) - GAARs - a key element of., P. 13.

according to the principle of *lex specialis derogat legi generali*. A GAAR would therefore be used in cases where there is a devised structure by the taxpayer that is able to circumvent the SAAR or TAAR, either through the elaboration of an unforeseen aggressive tax planning structure or transaction or from the abuse of issues/faults in the design of the specific anti-avoidance measure.[442]

This does not, however, prevent both rules from being applied simultaneously, which would occur, for instance, in the event that it is necessary to recharacterize a transaction through a GAAR so that the appropriate SAAR is then applied to it.[443] In this sense, there is a complementarity relation between these norms, rather than conflicts, since their objectives are different: while GAARs seek the relabeling of a transaction or structure used in order to obtain a tax advantage, the SAAR will, as a rule, directly target the tax benefit that would eventually be obtained from this transaction or structure. This is the case, for example, with royalty deduction barriers, which if activated will not directly affect the transaction, but only the possibility of deducting the amounts transferred as licensing fees in the form of business expenses.[444]

However, GAARs maintain their importance and function to the extent that they have positive behavioral impacts in combating tax avoidance.[445] By definition, TAARs and SAARs may in some cases suggest that certain types of aggressive tax planning are acceptable insofar as they are beyond the parameters specifically provided against them. Thus, the development of specific rules without a general and comprehensive counterpart such as a GAAR may indirectly encourage or legitimize tax avoidance, having an effect contrary to what was originally intended. Moreover, the proportional existence and coordination of SAARs with GAARs has been confirmed at the European level for example through the decision on *X Holding*,[446] where the most important criterion for their proportional application is to grant the taxpayer the opportunity to present,

[442] Refer to the recent reforms in Greece, involving both GAARs and SAARs, on Savvaidou, Aikaterini; Athanasaki, Vasiliki (2019): General and Specific Anti-Tax Avoidance Measures Under Recent Tax Reform in Greece. In *Intertax* 47 (4), P. 402ff.
[443] *Ibid.*, P. 14.
[444] For more on royalty deduction barriers, see Chapter 3.2.
[445] See Cassidy, Julie (2019): GAAR anti-avoidance vs GAAR anti-abuse. In *Journal of International Taxation* 30 (9), P. 53f.
[446] Case law nº C-337/08.

without being subject to undue administrative constraints, evidence of commercial justifications that they may have had for a given arrangement.[447]

Where there are safeguards against arbitrariness inherent in the application of a GAAR, for example through an exclusion system for protected transactions, *de minimis* rules and/or carve-outs,[448] there is no argument against the use of a general rule in conjunction with specific rules for a more efficient fighting against tax avoidance. While foreseeability in tax law is of extreme importance, this is not a definitive argument to preclude GAARs vis-à-vis SAARs, [449] especially if these general rules manage to not make life more complicated for *compliant* taxpayers, as all regulatory sources should be concentrated on the noncompliant.

2.2 Excursus: the OECD Nexus-approach on IP-Boxes

In carrying out the work on BEPS Action Plans 1 to 15, the OECD and the G20 States had a general concern with the use of preferential tax regimes for intellectual property – widely known as IP-, Patent- or License Boxes – on (artificial) profit shifting schemes without there being any rational or substantial economic activity. As a result of this concern and of these discussions, Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, presented as a "solution" the consensus found in the form of the so-called *nexus-approach*, which has as its general purpose the (re)assessment of preferential regimes based on the realignment of the taxation of profits derived from intellectual property with the substantial activities that generate them.[450]

This means that its primary intent is to put pressure on countries to design or restructure their preferential IP regimes[451] to allow a taxpayer to be granted access to such favorable tax regime if and only if it has incurred in qualifying research and development activities *in loco*. This

[447] For more information on European case law requirements, see Öner, Cihat (2018): Is Tax Avoidance the Theory of Everything in Tax Law? A Terminological Analysis of EU Legislation and Case Law. In *EC Tax Review* 2, P. 111f.
[448] For other examples, see Rosenblatt (2015): General anti-avoidance rules for major., P. 171ff.
[449] Zimmer, Frederik (2019): In Defence of General Anti-Avoidance Rules. In *Bulletin for International Taxation* 73 (4), P. 221.
[450] Refer to OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report. Available online at https://doi.org/10.1787/9789264241190-en, checked on 01.10.19, P. 9.
[451] Which have, as of the year 2000, had a 50% increase in the number of countries offering some sort of R&D tax relief to businesses. Refer to Mason, Peter (2021): IP: An Indecent Proposal? In *Tax Notes International* 102 (6), P. 788f.

part will be treated merely as a small *excursus* to the extent that, although the OECD has generally achieved its objectives with the nexus-approach,[452] it does not solve the problem of profit shifting with intangible assets seen previously.[453] The reason lies in the fact that, in addition to the problem of the erosion of the tax base with royalty payments not only occurring in countries that have a preferential regime for IP – this being only part of the problem, where tax havens and countries already with lower tax rates are also used and abused – profit shifting may still occur even if the requirements generated by the nexus-approach are met. Therefore, the solution presented by the OECD has had insurmountable problems since its inception, which invariably will not allow an effective resolution of the problem of profit shifting with licensing fees. It will, however, be treated briefly as it applies directly to a specific part of the problem at hand.

2.2.1 Preferential regimes on IP and a substantial activity requirement

As the objective of encouraging research and development, particularly in the area of intellectual property and intangible assets, is viewed internationally not only as acceptable, but also desirable,[454] the states participating in the OECD discussions decided on framework conditions for obtaining tax benefits from preferential IP regimes without allowing them to become what would be considered harmful tax practices.[455] The nexus-approach would theoretically provide, to this end, for the tax advantage to be linked to the expenditures on research and development activities actually incurred in the same State where a tax benefit is aimed for.[456] This means that the idea behind this approach is that taxes are to be paid proportionally to where there

[452] The progress made in 2019 was already substantial, the final deadline of which being the year of 2021. See the final report so far from January 2022 on OECD/G20 Base Erosion and Profit Shifting Project (2022): Harmful Tax Practices - 2018 Progress Report on Preferential Regimes. Inclusive Framework on BEPS: Action 5. Update (as of January 2022). Available online at https://www.oecd.org/tax/beps/harmful-tax-practices-peer-review-results-on-preferential-regimes.pdf, checked on 21.04.22.

[453] Although it is commonly presented as a “solution” to the strategic location of IP as a tax-avoiding strategy, as indicated in Asen, Elke (2021): What We Know: Reviewing the Academic Literature On Profit Shifting. In *Tax Notes International* 102 (8), P. 1043.

[454] Like the European Commission's Horizon 2020 project, which sees research and development activities as one of the cornerstones of sustainable development. Refer to European Commission (2014): Horizon 2020. Available online at https://ec.europa.eu/programmes/horizon2020/sites/horizon2020/files/H2020_inBrief_EN_FinalBAT.pdf, checked on 28.07.19.

[455] For more information on state incentives for R&D activities, see Martinez (2017): IP Box Regime im europäischen., P. 27ff.

[456] See Adrian, Gerrit; Tigges, Corinna (2017): Die geplante Lizenzschranke nach §4j EStG-E. In *StuB* (6), P. 228.

is creation of value,[457] and not based on the criterion of which State is offering the highest tax discounts.

Interestingly, the OECD works on this field, Action nº 5 of the BEPS project, even though *prima facie* entity based, is actually jurisdiction based,[458] targeting its measures only towards harmful tax practices, and not directly to the aggressive tax planning developed by multinational companies. This means that the OECD addresses its nexus-approach not to the taxpayers involved on tax saving schemes, but individually to its Member States.[459] The idea is to establish a framework with the outer limits of a preferential regime for intellectual property, so that countries are free to design tax incentives in the way they wish – while preserving their national sovereignty – without at the same time having harmful effects on other countries.[460] The focus would therefore be on creating and implementing minimum requirements for substantial activity based on the *proportion* of expenditures made in developing the intangible asset, so that a preferential tax rate can then be applied to the income arising from the use of the product of the R&D activity.

This means that a comparison between the qualifying expenditures incurred to develop the asset in relation to the overall expenditures – also called a "nexus ratio"[461] –, be it within the business group or not, will be employed in determining the amount of income that may receive the tax benefits arising from the preferential regime.[462] As we can see, this nexus-approach system uses the principle – not mentioned so often today by the OECD, especially within the GloBE – of taxation where value is created, in which it would allow the applicability of an IP-Box to income

[457] Refer to Staccioli (2017): §4j. In: Frotscher (Ed.) - Kommentar zum Einkommensteuergesetz., P. 6.
[458] As perceived by the commentary of Smit, Daniël (2019): Literature Review. Combating Tax Avoidance in the EU: Harmonization and Cooperation in Direct Taxation, J. Manuel Almudí Cid, J.A. Ferreras Gutiérrez & P.A. Hernández González-Barreda (editors), Eucotax Series on European Taxation, Kluwer law International, 2018. In *Intertax* 47 (4), P. 419.
[459] As stated by Link, Mathias; Süßmann, Britta (2017): Die deutsche "Lizenzschranke". Entwicklung, gesetzliche Umsetzung, weitere offene Fragen. In *SAM* 4, P. 149.
[460] OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report., P. 24f. Some authors question how far these goals have actually been achieved, since there would be a lack of clarity on exactly how these requirements need to be met, which can lead – especially in developing countries with reduced administrative capacity – to implementing mistakes. This increase in uncertainty and compliance burden for developing countries would prevent them from enacting legitimate tax incentives in order to compensate for specific structural disadvantages. Refer to Valderrama, Irma Johanna Mosquera (2020): Regulatory Framework for Tax Incentives in Developing Countries After BEPS Action 5. In *Intertax* 48 (4), P. 446ff.
[461] See Theophilou, Christos A. (2019): Patent Boxes: The Rise, the Change or the Fall? In *Bulletin for International Taxation* 73 (5), P. 289.
[462] *Ibid*., P. 25.

arising from intellectual property, naturally including royalty payments, only in the proportion in which there was investment in the creation of the asset in the territory of the benefit. This means that, in cases of outsourcing or subsequent acquisition of intellectual property, it would not be possible to apply a preferential regime according to the dictates of the nexus-approach.

There would also be the possibility of carrying out an *uplift* in the amount of qualifying expenditures of up to 30%, to provide the taxpayer with greater ease in attesting to the amounts spent on the creation of the intellectual property. However, the nexus-approach guidelines do not contain a precise definition with firm outlines of what *e.g.* qualifying expenditures and overall expenditures would be, leaving to the participating states a certain leeway regarding this design.[463] Needless to say, this in itself can already lead to very different results in terms of the analysis of whether or not a preferential regime fits into the nexus.[464] And while there are in some cases jurisdictions, such as Spain, that even defend an extended application of the nexus-approach to preferential regimes other than patent boxes,[465] there are others that do not exclude the possibility that some countries, within and outside the OECD, will in the future elaborate preferential regimes that do not correspond to the nexus due to tax competition purposes.[466] This was one of the reasons for the development of unilateral measures by several countries after the nexus-approach project, as was the case in Germany.

Therefore, it is necessary to analyze the advances made regarding the design of prominent IP-Boxes after obtaining a consensus in the nexus-approach at OECD level. One must bear in mind the existence of the grace period for the revising of preferential regimes that ran until the middle of 2021, allowing for the maintenance of benefits derived from non-nexus patent boxes that were conferred until 2016. This does not mean, as we shall see below, that all countries have satisfactorily and definitively implemented substance requirements in their preferential regimes under the nexus-approach.

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463 Refer to Schneider, Norbert; Junior, Björn (2017): Die Lizenzschranke - Überblick über den Regierungsentwurf zu §4j EStG. In *DStR* 55 (8), P. 422. For the analysis of some concrete cases, see the work of Martinez (2017): IP Box Regime im europäischen., P. 223ff.
464 Discussed by Heil, Svetlana; Pupeter, Alexander (2017): Lizenzschranke - Gesetzesentwurf eines neuen §4j EStG. In *BB* (14), P. 797f.
465 As suggested by Corell (2017): Los "Patent Boxes" y otros. In: Cíd/Gutiérrez/González-Bareda (Eds.) - El plan de acción sobre., P. 370ff.
466 See Kraft (2022): §4j EStG. In: Kanzler/Kraft - Einkommensteuergesetz., P. 582f.

2.2.2 Review of preferential regimes

As a way of monitoring the implementation of the nexus-approach and its substance requirements to combat harmful tax practices through preferential IP regimes, the OECD mandated the Forum on Harmful Tax Practices (FHTP) to report regularly on each country's state of progress. Currently, one of the last releases on the topic took place in early 2019, where substantial changes in the design of license boxes have been made worldwide,[467] often reducing those regimes considered to be instruments of internationally harmful tax competition. This assessment has not been restricted only to OECD member countries, but also more broadly to those participating in the Inclusive Framework and the so-called jurisdictions of relevance, even if initially outside the scope of the project,[468] which represents a much more comprehensive result than can traditionally be expected of work by the OECD.

The results indicate that most of the regimes previously considered harmful have either been abolished or reformed to meet the minimum requirements set by the OECD, which represents a major victory for the BEPS project in this respect. One of the most notable exceptions was, for some time, France, which had a broad system of incentives for research & development, which has however more recently been thoroughly reformed and adjusted to the nexus-approach.[469] In fact, not only due to the nexus, but also because of the prominence intellectual property has gained in a globalized economic scenario in recent decades, there has been a tremendous upswing in the adoption of such preferential regimes, which in many cases are either more recent than the OECD's work on the subject or have recently been modified, as was the French case.[470]

Specifically in the field of OECD member countries, some of these rules date from as early as the 1970s,[471] but with growing frequency as of the turn of the century, such as Hungary – with

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[467] Refer to OECD/G20 Base Erosion and Profit Shifting Project (2019): Harmful Tax Practices - 2018 Progress Report on Preferential Regimes. Inclusive Framework on BEPS: Action 5, P. 9.
[468] *Ibid*., P. 11.
[469] For more details on the French reform and new opportunities arising from it, see Bogaert, Jérôme (2019): Le nouveau régime d'imposition des produits de la propriété intellectuelle: principaux changements et opportunités. In *Bulletin Fiscal* (12), P. 665
[470] An in-depth study on modern IP-Boxes was commented on by Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 382.
[471] See this on the justifications of the decision of Quebec to introduce its own IP preferential regime in Boidman, Nathan; Kandev, Michael N. (2020): Quebec Proposes North America's First IP Box. In *Tax Notes International* 98 (13), P. 1499f.

a preferential IP regime since 2003 –, as well as Belgium and the Netherlands – both with IP-Boxes since 2007. Despite the fact that, today, these rules have substance requirements for the granting of benefits, it should be noted that these regimes continue to have as their most prominent feature their very low tax rates, varying, in the European context, from 0% in some cases in San Marino and Hungary, to up to 13.95% in Italy, all of which are much lower than the statutory corporate income tax rate in these countries.[472] *How* to arrive at this derived tax rate differs from country to country and is based on the design chosen by the national legislator, commonly either exempting part of the income or allowing for a notional deduction of (part of) the IP revenue, which despite being two technically distinct means, achieves basically identical practical results.[473]

This means that while there has been some development in the reforms made to the patent boxes with regard to their substance, many countries remain – rightfully so – unconvinced that the implementation of the nexus-approach will be far-reaching enough especially in relation to non-OECD countries, and will be effective enough to prevent aggressive tax planning opportunities and a consequent erosion of their tax base with such low rates.[474] This highlights why the nexus-approach may not be an effective answer to the problem of royalty payments: by coating a preferential regime with minimum parameters proposed by the OECD and accepted by member countries, besides legitimizing IP-Boxes with any tax rate,[475] which may, despite meeting substance criteria, continue to be used for the shifting of profits between high- and low-tax countries, there is a shift on the focus of looking for more practical solutions. This while it is perfectly possible that, in the future, both OECD and non-OECD countries unilaterally implement preferential regimes that are considered harmful.

2.2.3 Effectiveness assessment and perspectives for the future

Indeed, when assessing the economic impacts of implementing the nexus-approach, one initially perceives a decrease in royalty inflows in particular due to the fact that acquired IP no longer benefits from preferential regimes implemented or reformed in a way that follows the

[472] As of 2020. Refer to Asen, Elke (2019): Patent Box Regimes in Europe. Tax Foundation. Available online at https://taxfoundation.org/patent-box-regimes-europe-2019/, checked on 20.11.19.
[473] See Evers/Miller/Spengel (2013): Intellectual Property Box Regimes: Effective. P. 6ff.
[474] Refer to the insight of Kaul (2018): Der Nexus-Ansatz. P. 60.
[475] These tax rates can, whether linked to license boxes or simply to a country's nominal corporate tax rate, in themselves be considered "harmful" in a scenario of international tax competition.

OECD guidelines.[476] This, however, in addition to being normalized over time after a period of adaptation of companies to the new regimes, may also be due to the inherent design problem of the nexus as it is a norm developed to directly affect *countries*, and not companies.[477] Thus, those companies resident in nations that do not reform their preferential regimes may be internationally considered as practitioners of aggressive tax planning – triggering some particular responses, as is the case of the German one[478] – regardless of whether they meet the criteria of substance or not, since the regulation of their country of residence is considered harmful on account of their specific design.[479]

Worse still, the fact that this approach had such a long grace period until the middle of 2021, in order to allow a gradual and less drastic change for countries and companies alike, prompted countries to adopt unilateral measures in the form of a quasi BEPS-override,[480] due to the slow response proposed by the OECD. This time lag alone undermined the effectiveness of the regulation, as many authors had already pointed to the possibility of non-implementation by several countries, either within or outside this timeframe,[481] driving responses beyond this international standard. This fear is in part confirmed by the fact that, in line with the tax incentives found in Europe, preferential regimes for intellectual property are gaining a foothold in North America, at the federal level in the USA through the foreign derived intangible income (FDII); and at the provincial level in Canada, *e.g.* in Quebec.[482] Surprisingly enough, neither of the two regimes seems to be fully aligned with the modified nexus approach. While there are those who believed that the end of this grace period would also end the need for unilateral rules,[483] it should

[476] See Dudar/Spengel/Voget (2015): The Impact of Taxes on., P. 27.
[477] Schnitger, Arne (2017): Weitere Maßnahmen zur BEPS-Gesetzgebung in Deutschland. In *IStR* (6), P. 224.
[478] For more information, see Chapter 3.2.2.2. There is a threat of a restriction on the deduction of license payments at the level of the company in Germany without there being an actual infringement against the nexus-approach. See Jochimsen, Claus; Zinowsky, Tim; Schraud, Angélique (2017): Die Lizenzschranke nach §4j EStG - Ein Gesellenstück des deutschen Gesetzgebers. In *IStR* (15), P. 597ff.
[479] Refer to Holle, Florian; Weiss, Martin (2017): Einschränkung des Abzugs für Aufwendungen aus einer Rechteüberlassung. In *FR Finanz-Rundschau Ertragssteuerrecht* (5), P. 220.
[480] See Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), available online at https://www.wiso-net.de/document/MCDB__DBDBDB1227655, checked on 12.10.18, P. 206f.
[481] See Max, Marcel; Thiede, Jesko (2017): Der Gesetzesentwurf zur Einführung einer Abzugsbeschränkung für Lizenzaufwendungen - "Lizenzschranke". In *StB* (6), P. 175ff.
[482] See the analysis by Boidman, Nathan; Kandev, Michael N. (2020): Quebec Proposes North America's First IP Box. In *Tax Notes International* 98 (13), P. 1504.
[483] As is the case with Loose, Thomas (2019): Status Quo und Zukunft der Lizenzschranke. Was folgt noch aus Aktionspunkt 5 des BEPS-Projekts? In *IWB* 17, P. 689f.

be remembered that after the legislative implementation of an anti-avoidance rule, it will hardly be removed from the legal system of a country, in most cases being necessary an active stance of the legislator in this sense.

Nevertheless, it is not acceptable to deprive the nexus-approach of its merit in some aspects. In the specific German case, for example, the OECD work had a clear function of unifying concepts.[484] This prevented, due to the direct reference of the German legislation to the OECD report, the development of a German definition of what a preferential regime considered harmful would be,[485] being ideal for an international harmonization, desired in this context of fighting BEPS. Excluding the cases not belonging to OECD members – since it is easy for them not to follow the guidelines of the organization[486] – the nexus-approach has significantly reduced the deficiencies present in preferential global schemes, creating greater incentives for research and development activities rather than the mere acquisition of IP that would receive benefits, even if they were developed prior to the introduction of the regime.

However, this effectiveness is put in check as IP regimes that were already compliant with OECD substance standards now require greater control and consequently a reduction in the simplicity of procedures for taxpayers and tax administrations alike. While the former are now responsible for calculating qualifying income and providing documentary evidence to justify the granting of the benefit on an annual basis, the latter have become responsible for monitoring and reviewing these calculations also annually, ascertaining the link between the R&D expenditures and the income benefited by the preferential tax rate.[487] Therefore, in order to be economically efficient, the positive spillovers from carrying out local research & development activities, as well as a possible increase in tax revenue, must be greater than the (new) administrative costs and a

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[484] See the insight by Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) - 100 Jahre Steuerrechtsprechung in Deutschland., P. 940f.
[485] And therefore reducing conflicts between taxpayer and tax administrations. See Geurts, Matthias; Staccioli, Guido (2017): §4j EStG-E - das neue Abzugsverbot für Lizenzaufwendungen. In *IStR* (13), P. 518. This has received, however, a major setback with the more recent letter from the German Ministry of Finance, establishing its own criteria for determining whether a preferential tax regime is in accordance with the modified nexus approach. Refer to Bundesfinanzministerium (2020): Anwendungsregelung zu §4j EStG. In *IStR* 6, P. 240.
[486] As stated by Kaul (2018): Der Nexus-Ansatz., P. 60.
[487] An increase in administrative costs – as well as possible sanctions for countries that fail to comply with the OECD guidelines – are briefly discussed in McLoughlin, Jennifer (2019): Tax Havens May Need Resources To Satisfy OECD Substance Standard. In *Tax Notes International* 93 (11), P. 1206f.

possible loss in tax revenue due to the latest restrictions for preferential arrangements combined.[488] Further than that, the new OECD GloBE proposal, by implementing a minimum tax, would make the OECD BEPS Plan Action 5 lose most of its meaning, as even preferential regimes within the parameters of the nexus-approach would trigger the minimum taxation at 15%.[489]

Notably, the purpose of some anti-avoidance rules is not necessarily to increase tax revenue, but to ensure fair international tax competition, which allows an allocation of taxing rights according to criteria of value creation and substance,[490] as is the case with transfer pricing rules. However, the nexus-approach remains in a limbo, in which at the same time as it has aligned the vast majority of preferential regimes to criteria of substance, it has legitimized the use of IP-Boxes that meet certain requirements as an instrument for the shifting of profits with intellectual property, in addition to leaving out entirely the problem of countries with naturally low corporate tax rates, which do not fall into the category of a preferential regime. This increase in complexity, combined with an inability to avoid less than single taxation, also leads to a destabilization of the transfer pricing system, not promoting fairness.

Ideally, IP-Boxes would have to turn into more input incentives – tax relief for the costs of developing research – than output incentives – tax relief for the profits generated from IP –, as it would at least make sure that R&D activity happens in the low tax country.[491] The idea behind BEPS Action 5 and its link with value creation ends up putting in check its acceptance as a robust technical concept, being seen rather as a mere politically driven design.[492] Projects that tackle the problem in a non-holistic way end up possibly causing more damage than benefits, and even after

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[488] Refer to Theophilou, Christos A. (2019): Patent Boxes: The Rise, the Change or the Fall? In *Bulletin for International Taxation* 73 (5), P. 290.
[489] See Chapter 3.4 for more information.
[490] It is worth mentioning that, especially when it comes to developing countries, there is a lot of criticism regarding the concept of value creation and substance, which would ultimately benefit only those countries already developed and industrialized. If mainly used to deny taxing rights to tax havens due to a *lack* of "real" economic activity, the concept of value creation has its uses as a negative definition, however in the realm of taxation rights in general, has the potential to lock the low-income countries out of the international tax stream. In theory, value creation will always allot less to "hands" and more to "brains". See the opinions of Das, Rasmi Ranjan (2020): The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights? In *Bulletin for International Taxation* 74 (3), P. 134ff.; and Codorniz Leite Pereira (2016): O Controle de Preços de. In: Gomes/Schoueri (Eds.), A Tributação Internacional na era., P. 151ff.
[491] Refer to Chapter 1.4.1.1.
[492] See Kofler, Georg; Verlinden, Isabel (2020): Unlimited Adjustments: Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the "Saving Clause". In *Bulletin for International Taxation* 74 (4), P. 271f.

Action 5 of the BEPS project, the problem of erosion of the tax base with licensing fees remains greater than ever, and the need for a thorough answer in the near future is dire.

2.3 Interim results

In chapter 2 we saw the first measures, with a broad-specter, commonly adopted by countries to address base erosion and profit shifting, as well as to ensure an adequate allocation of taxing rights, in light of the problem of aggressive tax planning schemes using royalty payments. As is readily apparent, the broad nature of these rules invariably leaves several gaps and loopholes tied to legal insecurity that can possibly be used by multinational companies to generate or maintain an artificial shifting of profits from high- to low-tax jurisdictions. To aggravate this problem, the tendency of some countries to opt for (harmful) tax competition puts in check the effectiveness of these general norms, which work much more as a backstop for crass deviations from the expected tax outcome with intangibles than as a means of really effective counteracting of BEPS.

It is certainly true that the correct implementation of transfer pricing standards and/or CFC rules, for example, reduces the volume of royalty flows between countries,[493] which however does not mean that the problem is automatically solved when such rules are put in use. While CFC rules are restricted to outbound cases and have very strict requirements within the European Union, transfer pricing standards are by their very nature very unlikely to deal with intangible assets due to their uniqueness. The implementation of this type of rule, as is the case with GAARs and even Action 5 of the BEPS project, presenting the nexus-approach as a minimum standard, must not be allowed to create a false sense of security and of solving this issue definitely, since profit shifting with royalty payments is a constant reality in the international taxation scenario and must necessarily be fought in a coordinated manner with specific rules in order to ensure a minimum of effectiveness against this type of scheme, if it is of interest of a given country.

However, this is a challenge that has been faced directly – and with very varying degrees of success – by only a handful of countries, since most of them stick to implementing general rules,

[493] Refer to Dudar, Olena; Spengel, Christoph; Voget, Johannes (2015): The Impact of Taxes on Bilateral Royalty Flows (Discussion Paper 15-052), P. 25f.

given their adaptability, and few or no specific rules aimed at the problem with licensing fees.[494] Even in such cases, however, coordination between general rules by themselves is often lacking, in situations where, for example, transfer pricing adjustments and CFC rules are applied to the same profits, even at different points in time. Precisely due to their broadness, these rules can end up bringing about one of the main problems that international taxation has always aspired to solve: the double taxation of income. As a result of these failures and conflicts, the OECD itself has distanced itself from some of its more traditional standards, such as TP, through projects like the GloBE proposal.

From a European perspective, recent decisions of the European Court of Justice, as well as directives with broad-spectrum rules such as the ATAD, indicate the existence of a general principle and obligation of Member States to combat aggressive tax planning schemes that lead to tax abuse and avoidance. This should occur, according to the Court of Justice, regardless of whether there is a legal provision in national law or not, since there is an obligation of Member States of the EU to prevent the use of European law, be it primary or secondary, by abusive structures.[495] In order to ensure greater predictability in this fight against tax avoidance, the wide-ranging rules available to date are insufficient and should be supplemented by further, specific ones. There is thus a general thirst for new systems and solutions, able to keep up with the latest trends in trade and technology in a practical and effective manner.

It remains clear, therefore, that there are inherent flaws in the network of general rules commonly adopted by countries and employed in the fight against the problem object of this thesis, which ranges from its scope as legal rules, to shortcomings in its legal certainty and effectiveness to deal with intangible assets. These flaws have to be recognized as characteristics that demonstrate the insufficiency of current general standards to deal with profit shifting and royalty payments schemes, and it is not acceptable for those who really seek to address BEPS to content themselves with the results that these standards have achieved so far on their own. And while it is important

[494] See Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 384ff.
[495] For more on this opinion and on the recent case-law, see Lampert, Steffen (2019): Zur Vereinbarkeit der Quellenbesteuerung von Zinsen und Dividenden mit dem Unionsrecht in den "Dänemark"-Urteilen des EuGH (Rs. C-115/16 bis C-119/16 und C-299/16). In: *ISR* 19, P. 261ff.

to acknowledge their value and use, their employment alone is insufficient and harmful for a healthy and legitimate international tax competition scene.

Chapter 3: Developing specific anti-tax avoidance rules targeting profit shifting through royalty payments

As previously shown, the concerns raised by aggressive tax planning using intangible assets have increasingly gained in importance throughout the years.[496] This leads countries interested in dealing with said fiscal maneuvers to adopt the most varied measures, ranging from broad general anti-avoidance and transfer pricing rules to very specific ones – targeted specifically at royalty payments and intellectual property – such as royalty barriers or an inverted tax credit system.

Such rules have not only varied ranges of effectiveness and application framework, but also distinct implementation issues – be it through unilateral handling or international coordination with other States and actors. This prompts for multiple conflicts regarding their implementation and higher-ranking law, in which the legal and political feasibility of the measure stands as a hurdle to the desire to oppose base erosion and profit shifting that uses intangible assets.

This Chapter will therefore carry out an analysis on the intricacies of the characteristics, application and framework of *specific* rules targeting profit shifting through royalty payments –

[496] See, for instance, the Harmful Tax Competition (1998): OECD report, and Grubert, Harry (2003): Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location. In *National Tax Journal LVI (1)*, P. 221ff., as well as more recent works and reports such as Skeiei, Øystein Bieltvedt; Johansson, Åsa; Menon, Carlo; Sorbe, Stéphane (2017): Innovation, patent location and tax planning by multinationals (OECD Economics Department Working Papers, nº 1360), P. 18ff. and Finley, Ryan (2018): Intangibles, Low-Tax Affiliates Are Key Risk Factors for Sweden. In *Tax Notes International*, P. 751.

whilst generally not yet discussing its relation to higher-raking law.[497] These rules are, as seen in the previous chapter, directly targeted, to a greater or lesser degree, to solving the issue with licensing agreements, having a parallel but joint action with the broad-scope anti-avoidance rules already discussed. It quickly becomes evident how differing approaches to the problem of profit shifting through intangibles can lead to contrasting methods who aim at the same goal, with varying degrees of success and practicability. The first technique to be considered is rather old-fashioned: withholding tax at source.

3.1 Withholding tax on royalty payments as a possible simplistic answer to the issue

3.1.1 General characteristics

Most countries in the world tax, at least to a minimum amount[498], income originated at the hand of non-residents within their territory[499] over which they – as a consequence of a “genuine link”[500] – exert sovereignty. This is usually achieved through withholding taxes, commonly targeted at the so-called *passive*[501] income, being *e.g.* compensation for the use of external financing (such as licences and credits) paid in the form of licence fees to licensors or interests to creditors.[502] Those taxes, whose logic is consistent with its historical development in the League of Nations,[503] will therefore be levied together with the payment of the income in a cross-border context, and by that dismissing the need for enforcement and high administrative costs.

All things considered, withholding at source may be seen as a primitive and unsophisticated manner of taxation, but nevertheless noticeably effective and straightforward, so far as to be considered as one of the two “prominent pivots” of the international tax system – in addition to the permanent establishment doctrine.[504] This is clearly noticeable insofar this policy dates back

[497] For a deeper insight into this topic, see Chapter 4.
[498] The effective tax rate varies greatly, but is usually around 10 to 15%.
[499] For a comprehensive list, see Deloitte: Withholding Taxes 2018. International Tax. Available online at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-withholding-tax-rates.pdf, checked on 04.02.19.
[500] For more on this definition, see Gadžo, Stjepan (2018): The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal. In *Intertax* 46 (3), P. 194ff.
[501] Which royalties are a part of, alongside interests and dividends, for instance.
[502] Obermair, Gustav M.; Jarass, Lorenz J. (2015): Unilateral Withholding Tax To Counteract Base Erosion and Profit Shifting. In *European Taxation*, P. 509.
[503] Wilkie, J. Scott (2018): An Inverted Image Inspires a Question: Comments on Professor Ulrich Schreiber's "Sales-Based Apportionment of Profits". In *Bulletin for International Taxation* (4/5), P. 276.
[504] Lee/Yoon (2018): General Report. In: Rosenblatt/Tron et al. (Eds.) - Withholding tax in the era., P. 9.

to the earliest days of the income tax itself and still is omnipresent in various countries' tax frameworks, even though many deem cross-border withholding as nothing more than a burden and hindrance to global capital flows.[505]

Surely, on a *fiscal utopia*[506] with adequate and effective tax rates in all jurisdictions around the world, equitable cross-border movement of investments and capital among countries, and a full-fledged exchange of information between tax administrations, it would be reasonable to think that cross-border withholding taxes would no longer be required. However, since those taxes not only protect the tax base of the source state, but also allow for the levying of taxes where capital and income would otherwise conceivably escape taxation – given that the earnings recipient is not a resident of the country in which the income is sourced and does not have any significant connection to it –, withholding at source was and is largely used by countries wishing to hamper base erosion and profit shifting.

Some consider that this methodology currently plays a diminished part in international taxation, since multilateral cooperation has increased on various levels[507] – such as with the European Union through primary and secondary law, as well as the vast Double Taxation Treaties network of over 3000[508] treaties, many of which providing for the elimination of withholding at source on specific categories of income flows etc. – leading to a *withering out*[509] of withholding taxes. Furthermore, one of the main issues raised by such taxes is the risk of double taxation, specifically when there are no foreseen compensatory measures on the receiving end of the licence fees, which is what led many of the actors in the international scenario to regard withholding at source sceptically.[510]

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505 On this matter, see Goulder, Robert (2018): Rethinking Withholding: An Analog Tax for the Digital Age? In *Tax Notes International* 91 (1), P. 129.
506 See Maisto, Guglielmo; Arginelli, Paolo; Silvani, Cesare (2018): Curbind Base Erosion via Withholding Taxes: The Case for a "Reverse Controlled Foreign Company" Approach. In *Bulletin for International Taxation* 72 (10), P. 578.
507 *Ibid*.
508 See the most recent numbers in Quak, Evert-Jan; Timmis, Hannah (2018): Double Taxation Agreements and Developing Countries. Institute of Development Studies - K4D Desk. Available online at https://assets.publishing.service.gov.uk/ media/5b3b610040f0b645fd592202/Double-Taxation-Treaties_and_Developing_Countries.pdf, checked on 12.04.20.
509 See Lee/Yoon (2018): General Report. In: Rosenblatt/Tron et al. (Eds.) - Withholding tax in the era., P. 13.
510 As a result of this scepticism, some rules such as the European interest and royalty directive have been created and put into practice alongside DTT in the same fashion. On this matter, see Cordewener (2018): The Interest and Royalty Directive. In: Wattel/Marres et al. (Eds.) - Terra/Wattel European Tax Law., P. 198.

In spite of the criticism – specially economic – directed at this system, fact is that two of the main issues being discussed since the last century in the field of international tax law are closely related to withholding taxes, that is: the phenomenon in which multinational enterprises and international investors do not pay their "fair share" of tax and, to the extent that they are paying those taxes at all, that they are not paying it to the "right" country. Whilst the liberalization of capital markets – and this not only within the EU – has evidently led to substantial benefits for countries, consumers, investors and multinational enterprises alike, it has opened up, particularly for the latter, opportunities for tax avoidance that were not available to this extent previously.[511]

This has ultimately culminated in a pendular movement concerning withholding taxes, in which some countries move somewhat in the opposite direction the OECD/G20 discussions[512] on international taxation have been heading over the past few years. Even some states like the Netherlands, who were – and in some measure still are – part of bigger tax avoidance schemes such as the infamous double Irish with a Dutch sandwich[513], have recently introduced withholding tax at source rules[514] concerning royalties and interests, in an attempt to repair reputational damage caused by its permissive tax rules and curb tax avoidance techniques used by multinational enterprises. According to a research conducted by SEO Amsterdam Economics for the Finance Ministry of the Netherlands, around €22 billion in royalties and interests were transferred by MNE (ab)using Dutch tax law in 2016 alone, promoting tax avoidance.[515]

This does not necessarily mean, however, that all that has been achieved so far in matter of liberalization of capital markets and investment flows should be undone and set aside. It is, as

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[511] As with the latest Apple, Starbucks and Amazon scandals. This has, however, been an issue for a long time. On this matter, see the observations on Chapter 1 and specifically Easson, Alex (1996): Fiscal degradation and the internation allocation of tax jurisdiction. In *EC Tax Review* (3), P. 112.

[512] On this matter, see Art. 12 OECD-MC and commentary, as well as their work on intangibles through the BEPS Action Plan 5, where withholding taxes play no relevant role: OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report, checked on 03.08.18. This approach has been somewhat reversed once more with the OECD GloBE proposal.

[513] For more information on how this tax avoiding structure works, refer to Chapter 1.4. and, for instance, Kramer, Jörg-Dietrich (2017): Germany's New Royalties Barrier Rule: Preventing Tax Evasion By Limiting Deductibility in Specified Cases. In *Tax Notes International* 88, P. 880ff.

[514] That went into effect in 2021. It is worth noting that this WHT can also be triggered if the payments are made for genuine businesses. On this matter see Sprackland, Teri (2018): Netherlands to Introduce Withholding Tax on Royalties, Interest. In *Tax Notes International* 92, P. 748; and Tolman, Charlotte; Molenaars, Michael (2021): The New Dutch Conditional Withholding Tax And Hybrid Entities. In *Tax Notes International* 104 (4), P. 427ff.

[515] *Ibid*.

already seen, in the very nature of intangibles to be easily transferable, as it is desirable to incentive its development and avoid double taxation. Nonetheless, the aim of the OECD Action Plan on BEPS still is, even when consistently setting withholding taxes aside, to not only shun double taxation, but also double *non-taxation*, ensuring that taxes are paid no more but no less than *once*,[516] and also where value is created and the economic activity takes place.[517] In that respect, the following parts of this chapter shall elucidate two rather distinct approaches to withholding taxes on royalty payments, and how they can substantially contribute to the current objectives outlined in this thesis for the international taxation scene.

3.1.2 Two fundamentally different approaches on withholding taxes

Whilst withholding at source is a very widespread practice, it can have several practical particularities when it comes to its implementation in the struggle against profit shifting through intra-group royalty payments. Even though, as aforementioned, being oftentimes utterly ignored as an option or even frowned upon by both the OECD on its action plan on base erosion and profit shifting[518] – at least until the advent of the GloBE proposal – and the European Commission[519], withholding *is* a relevant solution to be analysed by those who truly wish to fend off base erosion and profit shifting.

Essentially, the alternatives available to the States on introducing withholding taxes against base erosion and profit shifting via intra-group royalty payments are (a) a broad-specter withholding tax, affecting *all* intra-group royalty payments; and (b) a withholding tax as a subject-to-tax clause, in which *only* intra-group payments made *e.g.* to low- or zero-tax countries are

[516] For more on the principle of single taxation (*Einmalbesteuerung*), see the insightful contribution of Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) - 100 Jahre Steuerrechtsprechung in Deutschland, P. 931.
[517] OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report. Available online at https://read.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en#page1, checked on 08.03.18.
[518] Being avoided in the base erosion and profit shifting recommendations like "toxic debris", as seen in Goulder, Robert (2019): BEPS and Withholding: Unlikely Bedfellows. In *Tax Notes International* 94 (7), P. 677. This situation has only seen some minor changes in the latest discussions on the GloBE proposal, to be seen on Section 3.4.
[519] See the Report of the European Commission, which merely indicates low withholding rates as one of the means for aggressive tax planning. There have been so far, however, no changes on the Interest and Royalties Directive (2003/49) concerning a minimum effective taxation clause. European Commission (2017): Aggressive tax planning indicators. Final Report. Institut für Höhere Studien und Wissenschaftliche Forschung. Luxembourg (Taxation papers, 71-2017).

affected. The functioning, implementation and practical advantages and disadvantages of these options will be scrutinized in detail hereinafter.

3.1.2.1 Broad-specter withholding tax on royalties

The possibility of a withholding tax that would be levied on every single royalty payment, irrespective of the residence of the payee and the applicable tax rates in its country of residence, is the most basic and direct method to avoid profit shifting. This would not only ensure that the due royalties paid are taxed at least to a minimum amount in its country of origin – which could for example be around a 10% rate, as of the rule proposed by Art. 11 para. 2 OECD-MC, or 15%, as is the current minimum accepted by the inclusive framework within the GloBE proposal – but also that the tax would be paid on the income *where the payer of the royalties* was located. This methodology is comparable to the propositions for the digital economy of the market as a jurisdiction and a destination-based cash flow tax,[520] in which taxation is adjacent to the location of the paying company/consumer, within the territory and sovereignty of the source country, which is of easier control and surveillance.

The indicated withholding royalties at source rule serves, thus, as a minimum threshold for taxing business profits in cases of multinational enterprises that are physically present in a national market through subsidiaries who have taken the right to use a given intangible asset in the form of a licensing agreement, which would usually allow them to assign their activities and shift profits through companies of the same group, using controlled transactions with royalty payments. This one-dimensional answer acts as a quick fix, *prima facie* unilaterally available to any country wishing to implement it, offering a less complex but efficient answer to the BEPS issue.[521]

Albeit the initial appeal of this "simple" solution, other issues are raised immediately by it, such as the risk of double taxation due to the levying of taxes in both the source and residence country. To circumvent this matter, countries would have to ensure that the taxes levied at source are credited against the tax liability in the residence state, as well as a full refund of possible excess

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[520] On this matter, see Jiménez, Adolfo Martin (2018): BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties. In *Intertax* (8-9), P. 632ff.
[521] *Ibid.*, P. 638. Refer also to Chapter 5.3 for more on this discussion.

taxes withheld.[522] This last concept deviates considerably from the prevailing current country practice, which limits the tax credit conceded by a withholding tax to the amount due on royalty income net on expenses. Be that as it may, this other systematic would ensure that the recurrently denounced excess on tax credits – which may arise due to the difference between a withholding tax levied by the source country on a gross basis *versus* the taxes levied in the residence country on a net basis – would be held at bay.[523]

The problematic deriving from this approach is also promptly recognizable: it would lead to substantial restrictions on the taxing rights of residence countries, subverting the traditional logic of the international tax system regarding royalties and redistributing this revenue to source countries. Such a broad reintroduction of withholding taxes, while concurrently fending off double taxation, would undoubtedly require intense cooperation between countries, if possible at all, considering the inevitable shift in tax revenue it would encompass.

If, on the other hand, the problematic of double taxation is ignored – considering it is not forbidden[524], but 'merely' undesired by the international tax framework – and such a withholding system is unilaterally enacted, other complications would emerge. On the one hand, it is to be expected that the insertion of this structure will lead to cases of discrimination between companies of different branches. Given that as long as there is a broad withholding tax for royalties for the licensee and these are also liable to tax for the licensor, companies with varying types of investments and reliance on revenues from intellectual property will be differently impacted, generating competition distortions and asymmetries between them. On the other hand, these cross-border transactions must either be tax-free in the receiving state, offset proportionally or simply take losses from double taxation. In each case, distortions in investments[525] – domestic and foreign – are expected, in addition to creating intergovernmental disputes regarding the distribution of

[522] Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 17.
[523] *Ibid*., P. 17.
[524] See Lehner (2015): Grundlagen. In: Vogel/Lehner (Eds.) – DBA, and Stein, Torsten (2006): Völkerrecht und nationales Steuerrecht im Widerstreit? In *IStR*, P. 505.
[525] Again, with the exception of the granting of a full refund on withholding taxes, as previously mentioned, that is, unlike the common *praxis*, not limiting the tax credit to the amount paid on royalty net income, avoiding the notorious excess tax credits. Then, taxation at source would not be definite and thus irrelevant for investment decision-making. For more on this, see Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 17ff.

taxing rights.[526] Not to mention, as we shall later see,[527] the problem of unilateral measures such as this in relation to treaty and European law.

The issue of withholding taxes is very sensitive to investments in so far as, in deciding on a broad measure seeking to ensure minimum taxation of royalty payments made abroad, there will either be, to a greater or lesser extent, a reallocation of the power to tax between source and residence state; or – which is more likely in the event of a solely unilateral measure – the affected company will suffer double taxation. This means that the introduction of a broad WHT in a country can substantially reduce its attractiveness as a business location, reducing the amount of bilateral royalty flows and possibly even direct investment and spillover generation.

This knowledge naturally affects the decision-making process of every country towards withholding and the broad implementation of tax credits differently, since withholding at source will also mean being simultaneously on the receiving end and granting of tax credits. In some countries, such as Germany, where companies have been evaluated as being net receivers of royalties,[528] there would be no or little interest to implement a similar measure, as it would likely ultimately reduce the country's final tax revenues.[529] The OECD.Stat database also unsurprisingly shows in its statistics on royalty balances from 2012 that countries such as the United States, the Netherlands and Japan are amongst the top net recipients of royalties – being the ones potentially "damaged" by the implementation of a comprehensive withholding tax –, while on the other end countries such as Ireland, Switzerland and South Korea are top net payers, potentially benefited by it.[530] Considering there are substantial economic interests involved that can dramatically change from one country to another, broad acceptance of this indirect reallocation of taxing rights is all the more complicated.

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[526] Fuest, Clemens (2013): Besteuerung multinationaler Unternehmen: keine Alleingänge! In *Wirtschaftsdienst* (3), P. 139.
[527] For higher-ranking law issues, refer to Chapter 4.
[528] For a broader analysis on this matter, see Haselmann/Ismer/Kaul/Ruf (2016): Quellensteuern auf Lizengebühren und Schachteldividenden., P. 364.
[529] A full analysis of the German economic situation in the case of implementation of a broad withholding tax (with a 10% rate) on royalties is made by Jarass/Obermair (2015): Faire und effiziente Unternehmensbesteuerung., P. 169ff. and 82ff. Jarass follows-up on this proposal fort he EU more recently in Jarass, Lorenz J. (2021): A Proposal for a Simpler, Fairer EU Withholding Tax. In *Tax Notes International* 104 (10), P. 1115ff. See also on this topic Ditz, Xaver; Pinkernell, Reimar; Quilitzsch, Carsten (2014): BEPS-Reformvorschläge zu Lizenzgebühren und Verrechnungspreisen bei immateriellen Wirtschaftsgütern aus Sicht der Beratungspraxis. In *IStR* (2), P. 48.
[530] A deeper statistical analysis is provided by Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 28ff., in which it is concluded that, even as a net receiver, Germany might benefit from a general 10% WHT.

However, not everyone considers that a reallocation of the taxing powers is adverse. Dissatisfaction not only with the paradigms of the traditional distribution of resident-source taxation, but also with the results of the BEPS project, has led the United Nations to react with the idea of using withholding taxes as a way to combat profit shifting,[531] irrespective of revenue outcomes. The UN has been expanding in its projects the threshold for the taxation of business profits at source in a broad way, adopting an approach entirely dissenting from that proposed by the OECD and its members.[532] Furthermore, there has been intense debate on broadening the scope of the definition of royalties on Art. 12 of the UN-MC – once again differing from OECD initiatives – to include *e.g.* every payment for the use of software within the concept of royalty, which would extend, by default, the scope of any rules specifically directed to the payment of royalties.[533]

This does not mean, of course, that the UN has given unrestricted support to the implementation of withholding taxes, but at least this solution is seen as such, and is not simply left aside by developed countries as a proposal hindering the economy. Thus, the problematic of base erosion and profit shifting through royalty payments – as well as on other fields of international tax law – has been addressed by the UN with more and broader withholding taxes, which supports the stand of source countries.

The proposal analyzed in this section, as well as the direction taken by the United Nations, even though it is not restricted to royalties, have in sum some clear advantages, namely: (a) the fact that it is directed to any and all transactions involving royalties in an international scenario

[531] Reforms to Art. 12 have been intensely discussed as of 2015. See Committee of Experts on International Cooperation in Tax Matters (2015): Eleventh Session E/C.18/2015/CRP.6. Agenda item 3 (a) (v) Article 12 (Royalties). United Nations. Geneva. P. 27ff. The same goes for the taxation of the digital economy, also taking into consideration the different options for developing countries with different characteristics, as in Johnston, Soong Stephanie (2019): U.N. Digital Economy Tax Report to Consider Withholding Taxes. In *Tax Notes International* 94 (6), P. 560.

[532] For more on this topic, see Jiménez, Adolfo Martin (2018): BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties. In *Intertax* (8-9), P. 632.

[533] Refer to Chapter 1.4.1.2 for more on this definition, and, for an interesting case study on the classification of software payments as royalties in Australia, India and Argentina, see Castro, Daiana (2019): Taxation of Software Payments: Multi-Jurisdictional Case Law Analysis. In *Bulletin for International Taxation* 73 (3), P. 115ff. This approach differs substantially from the classification adopted in Chapter 1. Recently, this topic has been broadly discussed in the UN level, but the UN Tax Committee decided against including software payments in the definition of royalties. See Sarfo, Nana Ama (2021): The Evolution of the U.N. Tax Model - Software Payments as Royalties. In *Tax Notes International* 102 (6), P. 719ff and Johnston, Soong Stephanie (2021): U.N. Tax Committee Notes Support For Revising Royalty Definition. In *Tax Notes International* 102 (5), P. 666.

ensures greater neutrality and consistency to the rule; (b) withholding is an old and common practice, and its imposition in order to avoid BEPS with royalties would have a character of progression, and not an absolute break of paradigms in the international tax system, facilitating its implementation; (c) withholding taxes have a low operational cost for tax authorities, and are also a solution for developing countries, with little or insufficiently advanced tax systems; (d) in the event that there is a provision for granting a tax credit in the country of residence, greater legal security for companies operating in the field is available, which leads arguably to a preferable system than to depend on lengthy litigations and maybe even transfer pricing disputes, which may even prompt retroactive price adjustments.[534]

It is also possible to glimpse in a broad WHT an opportunity to reverse, in spite of eventual revenue losses for some countries, the growing trend of double non-taxation in the international scenario. Thus, the advantages provided by intellectual property tax avoidance would at least decrease, reducing the attractiveness of tax havens. This would also generate benefits for the competitiveness of national companies in relation to the larger multinationals, which to a great extent benefit from dubious tax schemes and unfair competition. Some authors[535] consider that, after the implementation of such a rule by an economically strong and significant country, such as Germany, there would be more incentives for other countries to adopt the measure, whilst exerting pressure for the residence country to offer the royalty payee a tax credit in order to maintain its international competitiveness, in addition to encouraging the negotiation of bilateral tax treaties with appropriate withholding rules.

This being said, it must be acknowledged that the problematic with double taxation, possible investment losses and the redistribution of taxing power make it a mechanism *per se* difficult to be accepted and widely implemented. Moreover, there is no denying that the incentives for profit shifting through royalties would not cease altogether, given that a withholding rate of 10 to 15% still remains far from the world average corporate tax rate, which stands nowadays at around 25%.[536] There is, nevertheless, a more precise and specific alternative that could circumvent – or at least diminish – some of these issues raised by the implementation of a broad

[534] For more on transfer pricing and royalties, as well as retroactive price adjustment clauses, see Chapter 2.1.1.
[535] See, *e.g.*, Obermair, Gustav M.; Jarass, Lorenz J. (2015): Unilateral Withholding Tax To Counteract Base Erosion and Profit Shifting. In *European Taxation*, P. 513f.
[536] See Asen, Elke (2020): Corporate Income Tax Rates around the World, 2020. Tax Foundation (Fiscal Fact, 735).

and unrestricted withholding tax on international intra-group royalty payments, while striving to preserve the advantages of this system, notably a withholding tax as a subject-to-tax clause. This alternative pathway will be the subject of consideration for the next subsection.

3.1.2.2 Withholding tax as a subject-to-tax clause on royalties

Despite the fact that this is *one* alternative path for the implementation of withholding taxes by itself, it is necessary to highlight the multiplicity of forms of implementation and elaboration that a subject-to-tax clause may, by its very nature, present. The general idea behind this system is to maintain withholding at source of royalties as an exception, and not as a rule, being ideally applied only to cases where the transactions carried out have characteristics of aggressive tax planning, that is, for low-tax jurisdictions comprehensively considered. This concept has many similarities with the subject-to-tax rule present in the OECD GloBE proposal, to be further discussed in Chapter 3.4. Thus, the negative economic impacts – both for the tax authorities and for the companies involved – that could result from an unrestricted imposition of a withholding tax would be limited, providing a more meticulous solution for the hypothesis of BEPS.

However, it is evident that the criteria selected to achieve these purposes have varying degrees of success and scope of action, depending on the existence of carve-outs, *de minimis* rules and so on, therefore achieving different outcomes based upon legislative design choices. The framework's goal is to develop an anti-avoidance mechanism that acts fundamentally different from a broad WHT. Hence, the objective is structurally different from that of a mere source taxation: to tackle low-tax jurisdictions and profit shifting.

Since this type of taxation has, as aforementioned, always been seen as a hindrance to the efficient allocation of resources to multinational enterprises,[537] in addition to generating the expectation of offsetting by the State of residence to avoid double taxation, this clear conflict of interest cripples its implementation. It is precisely for this reason that the focus of withholding as an anti-avoidance rule is distinct, *i.e.*, that of combating aggressive tax planning through a *conditionality* in the application of the tax rule.

[537] Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 2.

3.1.2.2.1 The rule's approach

The methodology behind a conditional withholding tax is, typically, as follows. Through national legislation – due to traditional requirements of legality in taxation – a given country implements the possibility of withholding tax collection on intra-group royalty payments made abroad. This, in turn, would be usually reduced on the basis of treaty law[538] and/or European law, in particular Art. 12 of the OECD-MC and the European Interest and Royalties Directive (2003/49/EC). However, the national tax authorities could have the right to deny or proportionally lower the WHT reduction benefit in the event, *e.g.*, that the residence country taxes the income earned by paying royalties below a certain acceptable value.[539]

As previously stated, a 10% minimum rate, as of the rule proposed by Art. 11 para. 2 OECD-MC, or a 15% rate, as accepted by the inclusive framework of the OECD, could be deemed as "acceptable", but there are also other criteria that might be used in order to assert this value. In the context of the 2011 European Commission proposal for a Common Consolidated Corporate Tax Base (CCCTB)[540], there was a provision on Article 81 denying benefits based on low statutory corporate tax rates next to a general anti-avoidance rule, in which the threshold was 40% of the average corporate tax rate applicable to Member States in the European Union.

This proposal is, however, not currently under discussion by the European Commission, since they decided to re-launch the project in October 2016, under two different proposals for a Common Corporate Tax Base[541] and the Consolidation Proposal[542] for the tax rate. Nonetheless, conceivably to facilitate discussion rounds and approval, the proposal for a definite criterion on low taxation is absent in these new projects, despite the existence of other general anti-avoidance rules[543] in line with the Anti-Tax-Avoidance Directive (ATAD). The same can be said about the

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[538] Mainly through double taxation agreements, that might free a given taxpayer of the (national) obligation to withhold taxes, or even establish a different rate at which to do so, such as is the agreement between Germany and Italy; or Germany and Luxembourg. For more information, see Baumhoff, Hubertus; Liebchen, Daniel (2014): Steuerfragen im Zusammenhang mit immateriellen Wirtschaftsgütern. In *IStR* 19, P. 712f.
[539] Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 18.
[540] European Commission (2011): Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB). 2011/0058 (CNS). Brussels.
[541] European Commission (2016): Proposal for a Council Directive on a Common Corporate Tax Base. 2016/0337 (CNS). Brussels.
[542] European Commission (2016): Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB). 2016/0336 (CNS). Brussels.
[543] As discussed previously on Chapter 2.1.3.

latest proposal that came to replace the CCCTB project called BEFIT, mentioned previously, which most likely for reasons of consensus building has not yet decided on specific criteria linked to low-taxation.[544]

On the other hand, there are actual models that can be used to develop or analyze the practical application of a withholding tax as a subject-to-tax clause. The United States has, in its Model Convention of 2016[545], clauses against preferential tax regimes that would deny benefits granted to royalty payments by the treaties in the event that, in the case of a "connected person"[546], a transfer is made that fits into a differentiated taxation regime in the residence country. Clarification is offered in the Preamble to the 2016 US-MC[547], being its ultimate goal not to raise revenue, but to avoid low or non-taxation on highly mobile income such as intellectual property. The threshold for considering a special tax regime granting lower taxation is notwithstanding this intent very generous, since it allows for effective tax rates of up to 15% on the one hand, *or* that represent as far as 60% of the general statutory rate, and those will *not* give rise to a special tax regime.

It should be furthermore noted that one of the recurring problems with the methodology found in some of the present proposals is precisely to restrict or focus the combat of BEPS to special treatment regimes. While, for example, the infamous IP-Boxes are a (fair) share of the problem, it cannot under any circumstances be restricted to those, since tax havens, which by their very own nature have very low or no base taxation, are a relevant and old part of the issue and cannot be left aside.

Thus, the same problem is revealed in another proposal for a preferential tax regime clause in the final report of OECD Action nº 6 of 2015[548], in order to avoid treaty shopping and the abuse

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[544] Refer to European Commission (2021): Future-proof taxation – Commission proposes new, ambitious business tax agenda. Available online at https://ec.europa.eu/commission/presscorner/detail/en/ip_21_2430, checked on 21.04.22. For more information on this project and why tax avoidance projects have not been successful so far in the EU, refer to Krümpelmann, Max (2022): Tax Avoidance and Harmful Tax Competition: A Proposal for an Alternative Solution. In *European Taxation* 62 (7), P. 275ff.

[545] Available online at https://www.treasury.gov/resource-center/tax-policy/treaties/documents/treaty-us%20model-2016.pdf, checked on 26.04.19. For more information on other US anti-avoidance measures, refer to Chapter 3.2.2.3.

[546] Rule of Art. 12, para. 2 "a" of the US-MC, in conjunction with Art. 3, para. 1 "l" and "m" with term clarifications.

[547] Available online at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf, checked on 26.04.19.

[548] OECD (2015): Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. Action 6: 2015 final report. Paris: OECD. P. 96ff.

of treaty benefits. While the proposal resembles the US model, allowing for the inclusion in tax treaties of rules aimed at denying benefits – when the risk of BEPS based on the national legislation of one of the contracting states is seen as likely – there are important differences to be mentioned.

The most striking of these is the fact that the restriction of benefits is not limited to payments made between related parties. This makes the rule proposed by the OECD much broader, encompassing many hypotheses not covered by the US special tax regime clause, as well as creating additional obligations for the payer and the associated withholding, which will have to determine whether a special regime is applicable to its creditor or not.[549] In addition, the definition of special regime used by both differs substantially, particularly as there is no definition whatsoever by the OECD of what a preferential effective rate of taxation would be, beyond the use of vague legal terms. For instance, to define what would *not* be a special tax regime, paragraph 81 indicates it would be the cases in which a regime would not '*disproportionately* benefit [...] royalties'. Even though there is a suggestion for the contracting parties to establish a protocol with its own list determining which tax regimes would be deemed 'special', it is not clear whether this list should be comprehensive, binding etc.

Taking into account the above characteristics, there has been heavy criticism[550] made to the OECD project in this sense, which had lost much prominence to the initiatives of the United States and even discussions within the European Union in the form of a minimum effective tax clause for the Interest and Royalties Directive[551] until the GloBE initiative and especially its pillar 2. The European Commission's justification[552] is that, by means of the directive, it not only wants to ensure that European legislation prevents double taxation, but also that it does not inadvertently causes double non-taxation.

[549] Some authors do, however, support the idea of applying the withholding tax also to payments between unrelated parties, such as Maisto, Guglielmo; Arginelli, Paolo; Silvani, Cesare (2018): Curbind Base Erosion via Withholding Taxes: The Case for a "Reverse Controlled Foreign Company" Approach. In *Bulletin for International Taxation* 72 (10), P. 579.

[550] For more information, see Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 7.

[551] 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. Official Journal of the European Union. L 157/49. The OECD has recently answered, however, with its GloBE proposal discussions, seen further on Chapter 3.4.

[552] European Commission (2015): Communication from the Commission to the European Parliament and the Council. A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action. COM(2015) 302 final. Brussels. P. 8ff.

The idea behind this clause proposed in 2015 is similar to that provided for in the US model: the benefits granted through the directive, preventing the collection of withholding taxes in royalty payments made between Member States, would not be granted in the absence of a minimum effective tax rate in the transaction.[553] This would be set at a 10% rate,[554] corresponding to the lowest general corporate tax rate applied among EU Member States at the time. Today, however, Hungary has a corporate tax rate of 9%, and this minimum value would probably have to be adjusted, although with the same final objective.

This conditionality of the rule is what makes this methodology differentiated and effective, in which transactions allegedly carried out by a valid economic interest will continue to benefit from the exemption from withholding taxes, while those theoretically employed with the sole or main purpose of reducing the final tax burden will have additional mechanisms to ensure a minimum taxation. It has yet to be decided, however, whether an exception would be envisaged when determining whether IP-Boxes that comply with nexus requirements would be carved out of the rule. Hence, special taxation regimes could hypothetically be left out of the scope of the minimum effective taxation (MET) clause if the Member States so wish, albeit consensus on this matter would be hard to achieve.

Ideally, this clause would also be applied to cases in which IP-Boxes have excessively low rates, given that the purpose of the rule – for its greater effectiveness – is to simultaneously combat tax havens *and* the use of 'legal' mechanisms to overly reduce the tax burden by means of BEPS. The implementation of this clause in the Interest and Royalties Directive requires, however, consensus in the Council, *i.e.*, among the governments of all EU Member States, the same issue currently being faced by the OECD GloBE. Despite the current trend of some countries that previously did not have any form of withholding tax in royalties to introduce the rule – as is the case of the Netherlands[555] for 2021 and partially of Cyprus[556] for royalties earned on rights used

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[553] This is also very similar to the current GloBE proposal under discussion by the OECD, discussed in depth on Section 3.4.

[554] Vleggeert, *op. cit.*, Fn. 550. P. 8.

[555] See, for instance, the Dutch subject-to-tax WHT, triggering when a statutory rate of less than 9% *or* a EU blacklisted country is involved. This marks a clear break with past trends, but has limited applicability due to treaty and EU limitations. Refer to Chapter 4.2, 4.3 and Pötgens, Frank; Geerse, Paula (2020): Withholding Tax Act 2021: A Split from Historical Trends! In *European Taxation* 60 (10), P. 451ff.

[556] Deloitte (2018): Withholding Taxes 2018. International Tax. Available online at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-withholding-tax-rates.pdf, checked on 04.02.19.

within the country –, there are still other examples like Luxembourg and Hungary that do not have any form of withholding on royalties. This lack of interest in the introduction of these rules is a harbinger of great difficulty in finding consensus for the implementation of a MET clause, since these are countries with a tax policy of "pass-through", in which they could have much to lose through the aforesaid system and would harm themselves with their consent to it.[557]

3.1.2.2.2 Implementation issues

Nonetheless, even if a conditional withholding tax rule were to be approved, there are evidently other aspects of its implementation and effectiveness that need to be discussed. One of them is related to the carve-out rules, that is, how to determine which will be the cases that will be excluded from the withholding imposed by the tax. There is the possibility of a dual approach[558] for a taxpayer to avoid paying the tax, through (I) a *main* test, in which (a) it would be determined whether the creditor of the payment actually conducts economic activity in his country of residence, having direct ties and responsibility for their intellectual property – similar to the OECD's criteria for value creation; and (b) the country of residence is cooperative and exchanges tax information through international treaties; in addition to (II) a *subsidiary* test, revealing the conditionality character of the tax, in which an effective tax rate (ETR) of at least 10 to 15%, or a percentage of the statutory tax rate of the source country, is required in order for there to be no withholding.

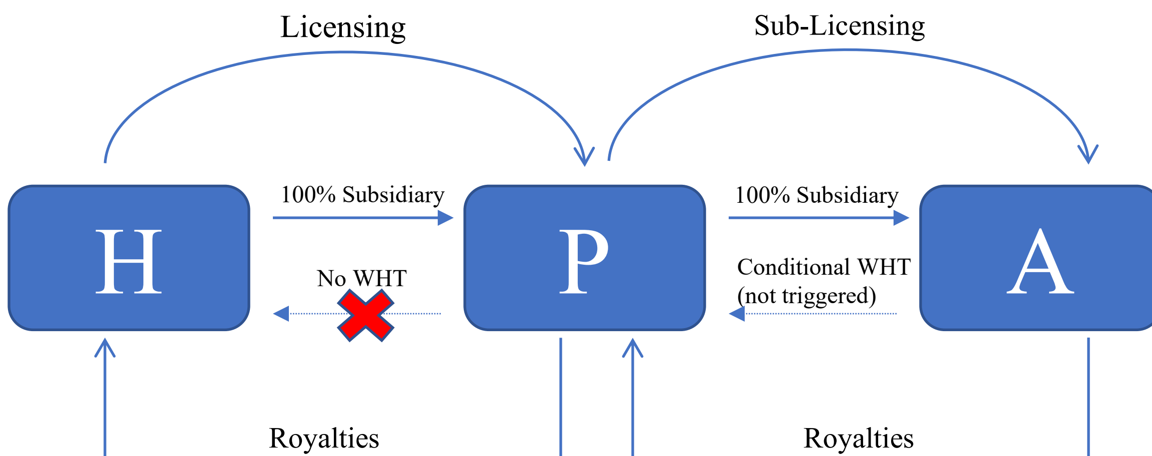
One of the biggest problems provided by this mechanism is, however, the use of countries that do not have a system of withholding taxes on royalty payments as conduits to avoid taxation, in a pass-through system. This problem can be illustrated as follows[559]: a company H, located in a tax haven country H, which has a preferential regime for royalties or simply a very low corporate tax rate in the range of *e.g.* 5%, transfers the use of a license of its intellectual property to related company P, of which it owns 100% of the shares, located in the pass-through country P, which in turn makes a sub-licensing to related company A, its subsidiary also with 100% of the shares,

[557] See Monteith, Christian (2014): Steuergestaltungen mit Lizenzboxen. In *StuB* (23), P. 886.

[558] Proposed, among others, by Maisto, Guglielmo; Arginelli, Paolo; Silvani, Cesare (2018): Curbind Base Erosion via Withholding Taxes: The Case for a "Reverse Controlled Foreign Company" Approach. In *Bulletin for International Taxation* 72 (10), P. 579.

[559] Example adapted from Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 9.

located in country A. Hence, company A will make a royalty payment to company P, which in turn will make another payment of royalties to company H.



Graphic 1. Source: made by the Author.

Considering that country P does not have a rule for withholding taxes, simply taxing the value of the company's net profit – in which deductions for royalties paid are made – at a fixed rate of, say 20%, with no special regime; and that country A has a conditional withholding rule, whose application is restricted by treaty or, in the event of EU Member States, by the Interest and Royalties Directive, to cases in which the ETR is less than 15%, the problem becomes immediately apparent.

There will not be, in this hypothesis, withholding in the royalty payment made between countries A and P, since the tax rate in country P is 20%. This remains true even after the payment of P to H, since the ETR is calculated based on the company's net profit.[560] So, if an arm's length €100 sub-license payment was made from A to P, while €95 for the license was paid from P to H, the net profit of the company in P would be €5. Of these €5, 20% would be paid in corporate tax, *i.e.*, €1. The ETR in P would therefore ultimately be 20% (€1 out of €5). Meanwhile, the remaining €95 would be taxed at a rate of 5% in H, resulting in a mere €4,75. Thus, the final taxation paid by the corporate group in this example is only 5.75% (€1 + €4,75), well below the minimum of 15% established by the rule in A. This rule of conditional withholding of the tax is, therefore, completely

[560] This is confirmed by recent works and discussions within the EU. For more information, see Working Party on Tax Questions (2016): Room Document # 3. Direct Taxation - Interest and Royalties Directive. Effective Taxation in the IRD. Council of the European Union. P. 5f.

bypassed with the simple interposition of an intermediary who does not withhold the tax – in this case, P – between A, which has the conditional rule, and H, the tax haven.

There are basically only two ways to prevent the use of this type of pass-through structure for profit shifting. The first one would consist in the adaptation of the *rules* that condition the withholding tax. If it were to be implemented in a way that the effective tax rate takes into account royalty payments made to third parties, the deductions arising from this payment would not be computed for purposes of determining the tax paid at the end. The broad tax base of royalty inflows, disregarding royalty outflows, would then be used to determine the ETR.

Thus, in the example above, the effective tax rate in P would be of only 1% (€1 tax paid out of €100 income), and even by adding up the amounts paid in H the limit of 15% would not be reached, triggering the conditional WHT on the first step from A to P. As such, however, the implementation of the rule would not only be extremely difficult given the need for an extensive information exchange between the countries involved if one wishes to take into account all taxes ultimately paid, but could also overly expand the scope of the rule and harm companies with double taxation. If a slightly more restrictive interpretation is adopted, and the conditional WHT is always activated taking into account an ETR of the broad tax base, without deductions, regardless of the amount paid in the next links of the chain, there is an even greater risk of double taxation. On the other hand, this would be an international incentive for the implementation of a WHT by countries that do not have one and end up serving as channels for pass-through schemes, which leads us to the second possible solution to the problem.

If *all* countries that do not have a withholding tax (whether conditional or not) were to implement one – in the example above, country P – there would no longer be the possibility of such a scheme. However, the need for international cooperation and consensus is so broad that it is almost utopian, considering many of the incentives that a country has to become or remain a tax haven are the same for a country that wants to maintain its pass-through status without withholding a tax on royalties. Even the current success of the GloBE proposal did not result in minimum standards, but merely a "common approach", in which each country is allowed to decide for the implementation or not of anti-avoidance measures.[561] Bilateral negotiations on double taxation

[561] See Chapter 3.4 for more information.

agreements on this matter is certainly a further measure to be taken into consideration, but would likely be unsuccessful and/or too slow in some cases, especially with the countries where it is needed the most. It would be reasonable, however, to allow the taxpayer in A for instance to prove that sufficient tax has been paid in the third country involved, transferring to it the responsibility of sharing (or not) information with the tax authorities in order to be released from its tax obligations when it comes to withholding.[562] It is also true to say that this withholding system only makes sense and needs to be maintained insofar as there are tax havens. As soon as there is a broad international consensus on minimum taxation and these tax havens do cooperate, the withholding tax will no longer be definite.

Another evident problem in the implementation of a WHT is related to the conditionality of the rule established in the agreements to avoid double taxation. Without going directly into the merit of the relationship between this type of rule and higher-ranking law, which is a matter for Chapter 4, it must be stressed again that conditionality is not, as a rule, established at the national level, but rather bilaterally (or multilaterally) through international and supranational agreements and rules. Thus, the exemption from withholding should only be granted on tax treaties if and only if it is proven that the royalties are effectively taxed at a minimum rate in the country of residence. This possibility is confirmed in paragraph 6 of the OECD's commentary[563] on Art. 12 of the OECD-MC, where it is clearly stated that the possibility is in principle open for introducing a provision regarding the dependence of the withholding tax exemption on the taxation of royalties in the State of residence where the beneficial owner is.[564] This controversy would ultimately have to be settled bilaterally, especially if the residence country is to provide for tax credits in order to avoid double taxation, which is also another objective of the OECD within this measure.

In short, the problems of implementing a conditional WHT are summarized in the ease of bypassing this system with pass-through structures, which either require a tougher tax treatment line, which takes the broad tax base for royalty inflows into consideration to determine the effective tax rate; or the utopian solution that all countries will introduce withholding rules through international consensus. In any case, a minimum of international cooperation is needed in

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[562] Refer to Chapter 5.3 for more on this idea.
[563] OECD (2019): Model Tax Convention on Income and on Capital 2017 (Full Version). OECD Publishing. Available online at http://dx.doi.org/10.1787/g2g972ee-en, checked on 03.05.19. P. C(12)-5.
[564] For more information on this, see Kaul (2018): Der Nexus-Ansatz. P. 61.

particular in order to avoid double taxation and to implement the rule successfully, without the need to enter into conflicts with international agreements or have to carry out the notorious treaty overriding. But even after dealing with the problems of implementing the rule, it has yet to be assessed how effective a conditional withholding tax really is, in order to determine how meaningful its implementation would be.

3.1.2.2.3 Effectiveness assessment

The determining criterion for assessing the effectiveness of a conditional withholding measure is its ability to avoid profit shifting through intangibles. *A contrario sensu*, it has been shown for decades that the absence or abolition of withholding taxes in payments made to intra-group companies generates unique opportunities for tax planning, being seen – even before the introduction of the Interest and Royalties Directive in 2003 – as a "recipe for disaster".[565] The same is confirmed by the OECD in 2013[566], indicating how the absence of or low WHT is one of the necessary common requirements for aggressive tax planning that generates base erosion and profit shifting, alongside with the minimization of taxes paid at the source country level and a low or non-existent taxation at the recipient level in the residence country.

It is clear that the absence of a withholding tax is not, by itself, responsible for the existence and feasibility of profit shifting through intangibles, but rather the coordination made possible by different rules in different countries. Thus, the absence of withholding appears as an important link in the chain of aggressive tax planning, ultimately generating huge losses for the economy.[567] If this link is broken, such tax planning structures become immediately obsolete or, at least, less attractive to multinational companies. The Study on Structures of Aggressive Tax Planning and Indicators[568], in 2016, confirms this theory and indicates seven different models of aggressive tax

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[565] Easson, Alex (1996): Fiscal degradation and the inter-nation allocation of tax jurisdiction. In *EC Tax Review* (3), P. 113.

[566] OECD (2013): Addressing Base Erosion and Profit Shifting. Paris. Available online at https://doi.org/10.1787/9789264192744-en, checked on 07.08.18. P. 44ff.

[567] For more on this topic, see, for instance, Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 13ff.; Karkinsky, Tom; Riedel, Nadine (2012): Corporate taxation and the choice of patent location within multinational firms. In *Journal of International Economics* 88 (1), P. 176ff; and Grubert, Harry (2012): Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, are Being Globalized. In *National Tax Journal* 65, P. 247–281.

[568] Delegated by the European Commission, see Ramboll Management Consulting; Corit Advisory (2016): Study on Structures of Aggressive Tax Planning Indicators. European Commission. Luxembourg (Taxation papers, Working Paper N. 61).

planning used by multinationals, in which the absence of WHT played a major role not only in the BEPS hypothesis through intangible assets and patent boxes, but in *all* studied structures.

It is safe to say nonetheless that a withholding tax would not solve every single BEPS-related problem given the issues mentioned earlier, including hindrances to its implementation, as there still are means of bypassing it. Nevertheless, this is not a mechanism that can simply be ignored as a solution, as has happened in OECD discussions in past years up to the GloBE. It would seem that this is a measure that will have to be coordinated with others – for example the resolution of transfer pricing problems should still be addressed by the arm's length principle or other, newer appropriate mechanisms; and CFC-Rules remain in outbound cases necessary[569] – but it possesses by itself a very effective and impactful applicability against aggressive tax planning involving intangible assets, whether it involves IP-Boxes or not.

To ensure its effectiveness, it is important that (A) its rate is low enough to avoid distortions in the market, especially distinctions between net and gross taxation; but high enough for MNEs to strive to avoid it, ideally so that it is in itself a reasonable taxation (in the event that there is no taxation in the country of residence, for example). Therefore, it seems to us that a 15% tax rate is reasonable[570], even though its exact value is not as relevant, as long as the "a" criterion is met; (B) the tax basis should be the broad amount of the royalties received, without the deductions of the royalties paid to third parties, in order to avoid cases of "pass-through"; and (C) the criteria to apply the tax conditionality should be clear, precise and based on an effective tax rate in order to provide for legal certainty, also allowing the submission of evidence by the taxpayer of the collection of the tax abroad to avoid the withholding of the tax.

Despite withholding taxes – whether conditional or not – often being overlooked as instruments to combat BEPS, its potential effectiveness is more than proven, and it may act in order to ensure minimum taxation in the use of licenses and intellectual property. Even if it is an

[569] For reference on the discussion on these topics, see Chapters 2.1.1 and 2.2.2, respectively, as well as the conclusions on Chapter 5.3.
[570] A rate of 10% would, in our opinion, have the same issue as with the broad WHT and be insufficient since it could still effectively be used for aggressive tax planning. Furthermore, a 15% minimum rate has already been agreed upon by the OECD inclusive framework. Another possibility would be to establish different rates based on cooperative jurisdictions *vs*. tax havens and non-cooperative jurisdictions, that could range from 10% as a base to 15% in case of blacklisting. A similar approach has been suggested in the field of digital taxation by Brauner, Yariv; Baez Moreno, Andres (2015): Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy. In *SSRN Journal*. DOI: 10.2139/ssrn.2586202.

antiquated and simplistic way of ensuring taxation, with its conditionality the aim is to obtain the best possible results in tackling BEPS with the least possible modification of the international tax framework, in an optimized manner, facilitating its implementation. This would guarantee an effective application of the rule without a major paradigm break or redistribution of the power to tax – which is not *per se* unwanted, but certainly guarantees less resistance on the part of some countries regarding the regulation.

This measure has, accordingly, an excellent cost-benefit, for being effective and efficient, with relatively low implementation difficulty, without or with little distortion of the level playing field of competitiveness among companies. Some countries have even implemented similar measures, as is the case seen in the Netherlands, seeking to introduce a WHT; France, with a punitive withholding tax of up to 75%[571] against some specific jurisdictions introduced by law in a blacklist of non-cooperative countries; and even the United Kingdom, who seeks a withholding tax in the event of license payments with suspected treaty shopping, as well as with the introduction of a principal purpose test rule.[572]

Even the OECD has been forced to recognize more recently that this kind of measure can have high value in fighting BEPS, despite the possible limiting consequences for the free market.[573] This occurs mainly as a result of the dissatisfaction of several countries with some of the outcomes presented so far by the BEPS project, and the longer it takes for a joint solution to be found, the more likely it is that countries – or even entire economic blocs – will take unilateral action, indifferent to the risks of double taxation, distortions in the international market and a disproportionately higher compliance cost for companies, all in the name of fighting off base-eroding payments and the artificial shifting of profits.[574]

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[571] For more information, see the KPMG report on the issue, available online at https://home.kpmg/xx/en/home/insights/2018/12/tnf-france-expanded-blacklist-non-cooperative-jurisdictions-broaden-cfc-rules.html, checked on 07.05.19.

[572] For more information, see HM Revenue & Customs (2016): Deduction of income tax at source: Royalties. Updated Technical Note. HM Revenue & Customs. Available online at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/532314/M1070_revised_TN_final.pdf, updated on 6/27/2016, checked on 10.08.18.

[573] Specially on the OECD's project on the taxation of the digital economy and its two-pillar program, in which an undertaxed payment rule as a form of minimum effective taxation may be used with a withholding tax. For more information, see Section 3.4.

[574] For more information, see Goulder, Robert (2019): BEPS and Withholding: Unlikely Bedfellows. In *Tax Notes International* 94 (7), P. 677ff.

As the first measure analyzed for the struggle against base erosion and profit shifting that uses international intra-group royalty payments, withholding taxes, especially the conditional one, seem promising perspectives, even though underused and not widely discussed until now. Even if one cannot overlook eventual problems that this measure may have with higher legislation – to be analyzed in depth and alongside other measures in Chapter 4 – its value and relevance are nevertheless confirmed. As of the next subsection, we will turn our eyes to an entirely different and very specific measure recently implemented by some countries on a unilateral basis: the royalty deduction barriers.

3.2 Restrictions on the deduction of royalty payments as a more targeted approach

Unlike the withholding measure seen so far, royalty deduction barriers are a relatively recent system, employed specifically in combating base erosion and profit shifting through licensing and intellectual property. Its purpose is, as such, to create a targeted anti-avoidance tax measure, in which the traditional logic of net taxation of a company's profits is subverted – that is, the enabling of expense deductions before taxation, such as through royalty payments due to the use of intellectual property – to prevent or restrict the deduction of such expenses if certain prerequisites are met that indicate an aggressive tax planning with IP.

Clearly inspired by thin capitalization rules on interests, rules preventing royalty deductibility are, however, far less popular, to be found in some form only in about 16% of the countries in the world.[575] Nowadays, there are two main models used in designing royalty deductibility barriers. One, older and more rudimentary, sets a ceiling on cross-border royalty deduction based on an arbitrary rate in the form of a percentage usually linked to the taxable income of a company, being actually a general restriction on the deductibility of such payments as business expenses.[576] The other, more recent and main focus of this section, are true anti-avoidance rules that link the possibility of deducting these payments, to a greater or lesser extent, to the occurrence of "sufficient" taxation in the country receiving the payments. The different design options, together with the general features that define this anti-avoidance rule, will be henceforth

[575] A spreadsheet is available in the Appendix I with empirical research linked to all countries with available data that have some sort of deductibility restriction linked to royalty payments. The majority has, however, opted for a more rudimentary option – probably due to administrative restrictions –, which is not truly an (effective) anti-avoidance measure.

[576] Used, in particular, by developing countries. Further discussion can be found in Section 3.2.2.3.

discussed below, as well as in particular the pioneering – but distinct – implementation of such barriers by two EU member countries,[577] namely, Austria and Germany.

3.2.1 General characteristics

As previously mentioned, the main purpose of this rule is to unilaterally allow for the deduction of expenses with royalty payments only in case they are "duly"[578] taxed in the creditor's place of residence. Thus, this is evidently a measure to fight off BEPS and aggressive tax planning systems that allow for the transfer of gains through licensing in a corporate group to countries with a low tax burden or special regimes for intellectual property (IP-Boxes). In this respect, this barrier strives to link taxation to economic substance, ensuring that the profits of a company linked to intellectual property – which, as seen, are easy to transfer and difficult to value – are no longer artificially relocated, due to (aggressive) tax planning, to a country other than the one in which the value was created.[579]

This method also interestingly stands, in some cases, as a reaction to the results of the BEPS project, which paradoxically has the potential to create more opportunities for and facilitate base erosion and profit shifting,[580] especially with reference to the OECD's position on IP-Boxes and the nexus-approach. In addition, its enactment may ultimately lead to a higher tax revenue,[581]

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[577] Firstly, the choice of EU countries is justified in so far as they have an extra layer of complexity in relation to higher-ranking law, having restrictions dictated by European law whilst also being subject to their own double taxation treaties and to WTO rules. This analysis will be essential for the next chapter, where a rule must be able to be implemented in accordance with all the different facets of higher-ranking law in order to be considered effective. Within the European Union, a few countries – such as Belgium, France and Luxembourg – have also recently adopted some sort of deductibility barrier. However, the Austrian and German models laid the groundwork for the others in the first place, being much more restrictive. Occasional comments, where relevant, will be woven over the other models. For further information, refer to the Appendix I.

[578] For more on this general idea, see Zöchling, Hans; Plott, Christoph (2014): AbgÄG 2014: Das neue Abzugsverbot für niedrigbesteuerte Zinsen und Lizenzgebühren. In *RdW* (243), P. 215ff.; Adrian, Gerrit; Tigges, Corinna (2017): Die geplante Lizenzschranke nach §4j EStG-E. In *StuB* (6), P. 228ff.; and Max, Marcel; Thiede, Jesko (2017): Der Gesetzesentwurf zur Einführung einer Abzugsbeschränkung für Lizenzaufwendungen - "Lizenzschranke". In *StB* (6), P. 175ff.

[579] As in Action 5 of the OECD Action Plan. OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report, checked on 03.08.18.

[580] As happens for example with (the absence of) withholding taxes and permissibility with IP-Boxes, as seen in the last section. For more on this opinion, see Jiménez, Adolfo Martin (2018): BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties. In *Intertax* (8-9), P. 621f.

[581] In the case of Austria, the projections were originally at around 100 million Euro per year, and Germany between 10 and 50 Million, depending on the year. For more information, see Bundesfinanzministerium (2014): Vorblatt AbgÄG 2014. Available online at https://www.bmf.gv.at/steuern/Vorblatt_AbgAeG_2014.pdf?67ry2a, checked on

which in many cases would justify the implementation of the measure on its own, nowadays especially considering the need for revenue due to the Covid-19 pandemic.

In the same way that WHTs figure as an essential element in various international tax planning schemes, the introduction of a barrier to the deduction of royalty payments could counter several of these structures by obstructing their functioning methods. By preventing the deduction of expenses on royalty payments in the source country, corporate systems with licenses acquired through tax havens become obsolete, since the value of royalties will be taxed in the country of origin, as these will not be deemed as "expenses", given that they are originally not (sufficiently) taxed in the country of destination. The same would apply to countries that have a patent or IP-Box system, in which license payments have their own, more beneficial tax regime; or those that have a high lump sum deduction of business expenses[582] or even tax refunds, which also ends up generating a particularly low effective tax rate.

As a consequence of the application of a restriction – whether full or not – of the possibility of deducting these expenses with the payment of royalties, there is in fact no direct taxation of the company located in a strategically chosen foreign country, but an indirect taxation performed through the payer, as a result of the increase in its final taxable income.[583] The tax treatment given to a company would then depend directly on the taxation carried out within the framework of another company of the same group.[584] Subsequently, the shifting of profits through licenses paid to companies of the same business group in countries in any of the situations described above would no longer serve any purpose whatsoever.[585]

08.05.19, P. 7; and Bundesregierung (2017): Regierungsentwurf eines Gesetzes gegen schädliche Steuerpraktiken im Zusammenhang mit Rechteüberlassungen. BR-Drucks 59/17. Deutscher Bundestag. Available online at http://dipbt.bundestag.de/extrakt/ba/WP18/795/79562.html, updated on 16.11.2018, checked on 08.01.19, respectively.

[582] These are countries where the nominal rate of taxation is seen as normal, and therefore are not considered tax havens, but through high lump-sum deductions of business expenditures, makes the ETR on royalties very low. For more examples and information, see Zöchling, Hans; Plott, Christoph (2014): AbgÄG 2014: Das neue Abzugsverbot für niedrigbesteuerte Zinsen und Lizenzgebühren. In *RdW* (243), P. 215.

[583] In the end, the national taxpayer is "punished" due to the fact that his payee has relevant tax advantages in another State, hereby increasing the overall tax burden of the group as a whole. See Gosch (2022): §4j. In: Kirchhof/Avvento/Mellinghoff (Eds.) - Einkommensteuergesetz., P. 503.

[584] Dziurdz, Kasper; Marchgraber, Christoph (2014): Überlegungen zum konzerninternen Abzugsverbot für "niedrig Besteuerte" Zinsen und Lizenzgebühren. In *ÖStZ* 599, P. 379.

[585] van Lück, Kolja (2017): Gesetzentwurf zur Einführung einer Lizenzschranke durch §4j EStG. Verfassungsrechtliche und europarechtliche Herausforderungen. In *IStR* (10), P. 388.

One of the major advantages that immediately becomes apparent from this system is that the deduction of business expenses, despite being usually granted, generally relies solely on domestic law. Consequently, the restriction of these deductions under the pretext and requirement to demand fair taxation at the level of the payee can be done in an entirely unilateral manner, not requiring *prima facie* international cooperation or consensus. The specific criteria used to deny this deduction, on the other hand, can vary greatly depending on the scope sought for the standard. While it is safe to assume that it is not in any country's interest to completely prohibit the deduction of companies' business expenses – be it in general or solely on royalty payments – under penalty of reducing competitiveness or even making some businesses unfeasible, the question remains as to how and to what extent a country wishes to use this resource to avoid BEPS. As such, royalty deduction barriers are conditional by nature.[586]

On the other hand, one of the greatest risks in denying expense deductions is an exacerbated increase in the final tax burden paid by royalties, as the tax will be levied at the licensee level in the source country – since it cannot be deducted – and again at the licensor level in the country of residence, if the rate is not equal to 0%. Therefore, there is a highly damaging economic double taxation[587] for the corporate group if this rule is not very well structured as an anti-avoidance measure.

Most certainly will a corporate group that undertakes royalty transactions be affected since, typically, the restriction on the deductibility of licensing expenses is limited to payments made within the same business group, since these are the most likely to be used in tax planning schemes. The criterion to determine whether two or more companies are part of the same economic group, however, is usually regulated by other domestic legislation, and significant deviations between countries are bound to exist. Assuredly, the requirements will generally involve, to a greater or lesser extent, control and participation in the decisions of one company by another.

[586] Even if, in some countries, there are stricter criteria for the activation of the provision and consequent restriction on the deductibility of royalty payments, leading to an almost continuous application of the provision. Some practical examples will be presented in the following section, and for the remaining refer to Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 382f.
[587] For the difference between an *economic* or a *legal* double taxation, see Brähler (2014): Internationales Steuerrecht. P. 16ff.

Another relatively relevant factor is whether this rule is restricted to cross-border cases only, or whether it will also apply to intercompany transactions within the country. Although this in practice does not make much of a difference to the effectiveness of the rule – since the withstand of BEPS within a country does not require this type of conditional rule, which is usually aimed at international taxation – the relevance of this design option gains prominence when linked to supranational law, especially European law,[588] in order to avoid discrimination in the treatment of national and international companies, which would be incompatible with the common market. The fact is that, regardless of the wording of the royalty barrier, it will affect mainly, if not exclusively, cross-border cases, *i.e.*, with connected persons outside the national territory.

However, certainly one of the most important criteria to be determined is the one concerning which level of taxation is acceptable in the country of residence in order not to trigger the limitation on domestic deductions. After all, it is a specific conditional measure to avoid base erosion and profit shifting through royalty payments, and it is essential to determine what would be deemed as "fair" and "sufficient" taxation or not. Certainly, as with the withholding measure, it is easy to say that, when dealing with a tax haven without any taxation of the revenues from royalty payments, that is, with a rate of 0%, the deductions should in some way not be allowed for the payer through this measure. What, though, should be the starting point for discussing a restriction on deductions? Besides, in order to determine an acceptable tax amount, there are other factors in this provision that must be taken into consideration, such as the decision for a *partial*[589] or *full*[590] prohibition of the deduction: if it is fully prohibited, from the moment the threshold is reached (sharp line[591]), there will be an enormous distinction in the treatment of a payee located in a country with a rate slightly below the threshold and a payee located in a country with a rate slightly above this threshold, with a tradeoff of greater legal certainty; in the case of a partial restriction on deductions (sliding scale), it will be lower as the rate approaches the established threshold, but it will have greater complexity in its application.

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[588] For more on this matter, see Chapter 4.2.
[589] As is the case with the German rule, seen in Subsection 3.2.2.2.
[590] As is the case with the Austrian rule, seen in Subsection 3.2.2.1.
[591] A „sharp line" or „sliding scale" system in the taxation of income has been splendidly explained and discussed by Goldin on his visit and "Brownbag Lunch" at the Max-Planck Institute for Tax Law and Public Finances in the 10th of January 2019. For more information on his views, see Fox, Edward G.; Goldin, Jacob (2019): Sharp Lines and Sliding Scales in Tax Law. In *SSRN Journal*. DOI: 10.2139/ssrn.3339656.

Hence, there are some possibilities in determining the threshold rate. If the deductions are denied in their entirety, the most appropriate approach would be to decide on a relatively low threshold tax rate, otherwise there would be too much harm to licensees who have a licensor located in countries with a lower tax burden than the source country. This system is, however, relatively simple to avoid by adapting the local tax rate to the threshold established by other countries.[592] If, on the other hand, the restrictions on deductions are proportional to the residence country rate, the source country may, in theory, coherently implement any value for the threshold up to the amount it charges internally as corporate income tax.[593]

There is also a third possibility or method that may eventually be used concurrently with the others to determine whether or not there will be restrictions on the deductibility of royalty payments, namely, the existence of a special regime for royalties in accordance with the OECD's nexus-approach. When the purpose of the deduction rule is to combat IP-Boxes that are out of the OECD standard of economic substance and value creation,[594] the tax rate in the country of residence stands only in the background, as the specific characteristics and requirements for a company to make use of a differentiated taxation regime with intellectual property are more relevant. Thus, if the IP-Box is in accordance with the OECD nexus requirements, there will be no restriction on deductions because it is a regime that, in theory, does not promote BEPS; while, if this regime does not have requirements linked to the economic substance and value creation, the restriction on deductibility will be triggered independently of the tax rate.

This way of implementing the rule of deduction barriers obviously deals only with countries that have an IP-Box implemented, given that only the requirements for obtaining a differentiated regime of taxation of intellectual property will be analyzed. In this manner, the

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592 As is bound to happen with a minimum tax rate of 15% in the context of the GloBE. Refer to Chapter 3.4.

593 It is important to note that some countries, especially developing countries, have a stricter system of restrictions on the deductibility of royalties that is completely independent of the tax rate to which payments are ultimately submitted. This occurs through a process of administrative simplification, where the costs to the tax authorities are minimal to control and calculate the amounts due. As this is not an anti-avoidance measure per se, but a general rule relating to the deductibility of royalties, setting an invariable cap on their deductibility, these rules are outside the methodological scope of this work. See for example the case of Brazil and Nigeria in Gomes/Kingston/Pinheiro (2016): O Regime de Transparência Fiscal. In: Gomes/Schoueri (Eds.), A Tributação Internacional na era, P. 218ff; and Adegite, Victor; Ogueri-Onyeukwu, Nwakaego (2019): Transfer Pricing and the Right to Use Intangibles in Nigeria: Is the Arm's-Length Principle at Risk? In *Tax Notes International* 95 (2), P. 137ff.

594 As is clear by the BEPS project in OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report. Available online at https://doi.org/10.1787/9789264241190-en, checked on 01.10.19.

countries that naturally have a low tax rate – as is the case of tax havens, which do not necessarily make use of an incentive system such as IP-Boxes – are not covered by this rule, dealing only partially with the profit shifting issue.[595]

In summary, royalty payment deduction barriers may have varying degrees of effectiveness depending on their scope and form of implementation. Since it is a relatively recent mechanism, developed with the purpose of providing a fast, unilateral and efficient response to the issue of aggressive tax planning that uses the mobility and difficulty of valuation of intellectual property, there is still much to learn about it. We will therefore move on to the analysis of this instrument from the perspective of its practical application, with pioneers of its implementation in the European Union, albeit with entirely different forms of operation.

3.2.2 Practical application

To better understand the functioning of this system, this subsection will be dedicated to the analysis of some practical applications of royalty payment deduction barriers, especially from Austria, innovating with the implementation of the rule, followed by Germany,[596] which introduced the rule some years later, adapting the Austrian experience to its needs. The specificities and form of operation of each one will be highlighted, as well as its advantages and disadvantages in combating BEPS. Then, some similar rules implemented or under discussion in other countries will also be briefly presented and discussed.

3.2.2.1 The Austrian example

In February 2014, through the Tax Modification Act of 2014 (AbgÄG 2014[597]), the Austrian National Council decided to restrict the possibility of deducting royalties – and interests – in some cases of low taxation.[598] In the rationale for the implementation of the measure, the intention of curbing advantages in corporate groups that seek, through asymmetries in the tax laws of some countries, to explore the differentiated treatment granted to the expenses of a company

[595] Refer to the *excursus* on Chapter 2.2 for more information.
[596] This was also done by France later in the year 2019, however in a nearly identical way with the German one. Where there are differences or it is relevant to point out specifics of the French experience, these will be highlighted.
[597] Published in the Austrian Federal Law Gazette BGBl. I Nr. 13/2014, on 28.02.2014.
[598] For information on how the earlier taxation of licenses was made on Austrian territory, see Trinks, Matthias (2014): Neue "Lizenzschranke" für konzerninterne Transaktionen in Österreich. In *IWB* (6), P. 212f.

with intellectual property and their corresponding gains, was indicated.[599] The OECD's BEPS project was also mentioned[600] as a relevant factor in the decision to aim at avoiding intra-group profit transfers by means of interest and royalty payments to low-tax countries or special tax regimes. Although the OECD, within the framework of the BEPS project, had been intensively engaged in finding a coordinated and cooperative response between countries, Austria reveals its lack of interest – or patience – with this type of initiative,[601] and opens the way with a more direct and simple path of implementation.

Later on that same year, through the Second Tax Modification Act of 2014 (2. AbgÄG 2014[602]), some linguistic adjustments were made to §12 para. 1 n° 10 KStG (Austrian Corporation Tax Act) – the paragraph responsible for the provision – in addition to expanding the scope of the possibilities for deduction restrictions, which were, however, only specified through the Austrian Annual Tax Act 2018.[603] While part of the literature on the subject is critical[604] with regards to the employment of unilateral measures within the BEPS project – which has a greater focus on cooperation and coordination among countries in the international tax scenario – Austria saw fit to act autonomously when implementing this legislation.

Despite the fact that, in general, reference is made to a *restriction* on the deduction of expenses, in this specific case it is, in fact, a *prohibition*, since the Austrian legislator openly decided to establish a rule with a full constraint of the deduction in royalty payments if the necessary requirements are met. And even though this rule follows the general policy of not distinguishing whether payments are made domestically or internationally, as previously discussed, typically only payments made abroad will be affected, considering the prerequisites for the application of the rule. In addition, the direct reference to the OECD's BEPS plan and to

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[599] Österreichisches Parlament (2014): Erläuterungen 24 der Beilagen XXV. GP - Regierungsvorlage. Available online at https://www.parlament.gv.at/PAKT/VHG/XXV/I/I_00024/fname_337614.pdf, checked on 13.05.19. P. 30.
[600] *Ibid*.
[601] As is the opinion of some authors, such as Kofler, Georg; Marschner, Ernst (2014): Änderung im Außensteuergesetz. Verwertung und Nachversteuerung ausländischer Verluste, Abzugsfähigkeit von Zinsen- und Lizenzgebührenzahlungen, beschränkte Steuerpflicht für Zinsen. In *SWK* (9), P. 461f. The effectiveness of such a measure cannot, however, be understated, as proven by Hemmerich, Aaron; Heckemeyer, Jost H. (2021): Unilaterale Abzugsbeschränkungen als Gegenmaßnahme zur IP Steuerplanung in Europa. In *Steuer und Wirtschaft* (3).
[602] Published in the Austrian Federal Law Gazette BGBl. I Nr. 105/2014, on 29.12.2014.
[603] For more information on this, see Lachmayer (2015): §12 KStG. In: Renner/Strimitzer et al. (Eds.) - Die Körperschaftsteuer. P. 72 and Mayr, Gunter; Schilcher, Michael (2015): 2. AbgÄG 2014: Neuerungen im KStG. In *RdW* (1), P. 55ff.
[604] For more information, see Jerabek, Richard; Neubauer, Nikolaus (2014): Unionsrechtskonformität des §12 Abs. 1 Z 10 KStG? In *SWI*, P. 369.

countries with lower or more favorable taxation for intellectual property makes it more than clear that this norm aims at tax issues on an international context.

However, the application of this payment barrier is relatively broad in respect to royalties,[605] and will apply in any event where royalty payments have been made to a (a) legal person governed by private law; (b) be it national or foreign (c) belonging, directly or indirectly, to the same corporate group or under the control of the same shareholder; (d) with low or no taxation and (e) that is the beneficial owner of the payment relating to the intellectual property. As a legal consequence[606], then, there finally is a complete disallowance of the deduction of expenses for the payment of royalties at the level of the payee. Those criteria and resulting effects shall be discussed ahead in detail.

3.2.2.1.1 Expenses on royalties

Included in the scope of the rule are any and all expenses incurred in connection with royalties, of which the concept is obtained through Austrian national law in §99a para. 1 clause 2 EStG (Austrian Income Tax Act). This paragraph is the result of the implementation of the EU Interest and Royalties Directive, although its application is not restricted to the cases covered by the directive[607] and is therefore used to determine the concept of royalty payments referred to in §12 para. 1 n° 10 KStG.

This definition of royalty is very much oriented and resembles the classification established by Art. 12 OECD-MC,[608] being nonetheless even broader, explicitly covering the concept of software provided there is a copyright transfer, for example. Payments made in connection with leasing business are also included in the concept of license and royalties, even though there is no direct relationship with intellectual property.[609]

3.2.2.1.2 Related party and payee

[605] See Subsection 2.2.2.1.1. below.
[606] See Subsection 2.2.2.1.5. below.
[607] On this topic, see Zöchling, Hans; Plott, Christoph (2014): AbgÄG 2014: Das neue Abzugsverbot für niedrigbesteuerte Zinsen und Lizenzgebühren. In *RdW* (243), P. 216.
[608] Refer to Chapter 1.3 for more on this definition.
[609] Lachmayer (2015): §12 KStG. In: Renner/Strimitzer et al. (Eds.) - Die Körperschaftsteuer. P. 73.

While the object of this barrier on deductions is clearly royalty payments and also interests, on a personal level only the payments made to legal persons governed by private law thus considered by Austrian national law *or* legal persons comparable to these under foreign law will be observed. Hence, not only corporations, but also non-profit associations and even private foundations are covered by the rule, while legal entities under public law and natural persons are automatically excluded from its application. Also excluded from this scope are payments made to legal entities that meet the prerequisites of European law for State Aid to promote risk capital investments.[610]

In the way it is structured, this provision is subject to a number of criticisms,[611] as there is a clear possibility of using a foreign state structure in determining what a legal entity under public law is to circumvent the requirement as a payee or beneficial owner. The exclusion of individuals may also make it difficult to apply the rule or allow bypassing it in the case of business partnerships or other "transparent" structures, in which each partner must be assessed separately and in proportion to its participation to determine whether or not the prohibition will apply to the deduction of expenses.[612] This would, in fact, be the only hypothesis in which one could speak of a partial restriction on deductions of payments in the Austrian rule, since if only part of the partners or shareholders of a transparent entity fulfilled the requirements of the provision, only the proportion of the payment applicable to them would have their deduction prevented – however, in its entirety in their own individual cases.

A second requirement for the application of the standard is that the legal person receiving the payment is to be part, directly or indirectly, of the corporate group of the payer; or, alternatively, is directly or indirectly under the control of the same shareholder as the payer.[613] These concepts are analyzed and determined also according to Austrian national law, in particular within the context of §9 para. 7 KStG and in the legal concept of corporate group of §15 AktG (Stock Corporations Act) and §11 GmbHG (Limited Liability Companies Act).

[610] *Ibid*., P. 74. This last exception makes reference to the Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, OJ C 194, 18.08.2006. These guidelines are, however, as of 30.06.2014 no longer in force.
[611] For some of them, see Staringer (2014): Begrenzung des Betriebsausgabenabzugs bei Niedrigbesteuerung. In: Drüen (Ed.) - Aktuelle steuerrechtliche Beiträge. P. 571ff.
[612] Mayr, Gunter; Schilcher, Michael (2015): 2. AbgÄG 2014: Neuerungen im KStG. In *RdW* (1), P. 56.
[613] For more specific information, see Kaul (2018): Der Nexus-Ansatz. P. 39.

Furthermore, the Austrian legislator was aware of the pass-through problem mentioned in the first part of this Chapter 3 on withholding taxes, by means of interposed structures with the sole and exclusive purpose of circumventing the application of a given rule. Therefore, the determination of who is the true *beneficial owner* of the transaction is decisive in the framework of the prohibition on deductions, *i.e.*, it is not enough that the payee is the receiver of the sums, but also that he receives them on his own behalf, and not as an intermediary, in other words, receiving the payments as agent or trustee for another person. With this system, the so-called back-to-back loans[614] and sublicensing schemes are directly included in the scope of the rule, and the legal definition[615] of beneficial ownership is relegated to §99a para. 3 EStG.

On this matter, one of the relevant linguistic modifications provided by the Second Tax Modification Act of 2014 was the replacement of the term "receiving corporation" by "recipient" in order to make it clear that the determining factor for the application of the deduction barrier is to establish who the beneficial owner of the payment is, irrespective of it being a company or not, if it does not coincide with the recipient. In this fashion, if the person receiving the payment is in any way obliged to pass on the royalty payment received in its entirety to a third party, that person being the one who bears the risk of the transaction, the first "formal" recipient of this transaction will *not* be the beneficial owner, but in fact the one who is behind this initial recipient.

It is clear that the prohibition on the deduction of expenses will only be applied if the other requirements are met by the beneficial owner, nevertheless the primary purpose of this system is to perform the analysis of the incidence – or not – of the rule on the correct party. For example, in the event that the recipient of the payment transferred is an individual or legal entity under public law, the beneficiary will be automatically excluded from the application of the prohibition, even if the first payment was made to an entity that would meet all the necessary requirements. This beneficial owner requirement is therefore only relevant when the civil law recipient of the payment

[614] Specifically targeting interests, see Polivanova-Rosenauer, Tatjana (2014): AbgÄG 2014: Abzugsverbot für Zinsen und Lizenzgebühren. In *taxlex*, P. 106.
[615] The OECD also has discussion drafts on the definition of „beneficial ownership" on Art. 11 and 12 of the model convention, where national definitions are seen as secondary, even though not completely irrelevant. For more information, see OECD (2011): Clarification of the meaning of "beneficial owner" in the OECD Model Tax Convention. (Discussion Draft). Available online at http://www.oecd.org/tax/treaties/47643872.pdf, checked on 15.05.19. P. 8ff.

differs from the economic recipient, with a relationship of interdependence and obligation in the transfer of the payment, acting as a backstop against conduit companies.

3.2.2.1.3 Condition of low taxation

One of the most important criteria for prohibiting the deduction of expenses incurred with the payment of royalties, and which highlights its purpose in combating BEPS, is that of the low taxation condition. Initially, there were three different cases[616] in which the rule would apply to royalty payments, namely (I) full non-taxation of royalties; (II) a nominal rate lower than 10%; and (III) the application of special taxation regimes that would result in an effective tax burden lower than 10%. However, with the Second Tax Modification Act of 2014, a fourth hypothesis was included (IV) in which, due to a full or partial tax refund, the final tax burden also ends up being less than 10%.

During discussions regarding the low taxation criterion in the draft of the 2014 Federal Act, there was initially mention to a 15% minimum threshold for taxation. However, this was reduced to 10% in order to avoid triggering with various models of tax incentives internal to the EU itself, for example in Ireland, as well as in some cantons of Switzerland. The fourth criteria introduced, however, has the explicit purpose of combating systems such as that of Malta, which despite having an apparently high tax burden – initially of 35% – returns a large part of the tax amount,[617] drastically reducing its final tax burden.

Therefore, the prohibition on deductions also takes effect when the payee, despite not being directly benefited with a complete non-taxation or a low nominal or special tax rate, has its taxes being refunded so that the ETR is less than 10%. This requirement covers the cases in which this refund occurs at the level of the company or of its shareholders[618] – as is the case in Malta – in order to avoid bypassing the rule through a refund protracted in time. As the distribution of profits and this refund may occur at a very distant moment from the payment of royalties, this update in the Austrian legislation provided for the possibility of restricting the deduction of payments in the

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[616] For more information, see Kaul (2018): Der Nexus-Ansatz. P. 39.
[617] Currently, Malta returns up to 6/7ths of the relevant tax paid, 5/7ths in case of passive royalties. For more information, see the Deloitte report on Deloitte (2014): Taxation and Investment in Malta 2014. Reach, relevance and reliability. Available online at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-maltaguide-2014.pdf, checked on 15.10.18.
[618] For more information, see Mayr, Gunter; Schilcher, Michael (2015): 2. AbgÄG 2014: Neuerungen im KStG. In *RdW* (1), P. 56f.

fourth and third hypothesis of tax refund or discounts through a preferential system in the mere presence of abstract danger of its subsequent occurrence, according to §12 para. 1 n° 10 *lit*. “c” KStG. If, after nine[619] fiscal years, there is no tax refund or discount through a special regime, the taxpayer may claim the deduction of expenses retroactively pursuant to §295a BAO (Austrian Federal Tax Code).

Regarding the hypothesis of full exemption of the duty to pay corporate tax on the payment of royalties, it is important to emphasize that this may occur either through a personal or objective criterion, that is, it is irrelevant for which reason an exemption is granted in the payment of taxes related to intellectual property – whether due to the person or income involved – if the rate is 0%, the rule prohibiting the deductions of expenses will apply. This will not be the case, however, in the event that a legal entity in a corporate group does not pay the taxes, but that this is done in accordance with national law at another stage of the chain, such as by the lead company; or in a scenario of the triggering of a CFC-rule in which a foreign parent company has its income from royalty payments duly covered and taxed.[620] It should be noted that, with this wording, the rule on personal tax exemption will also apply to cases where Austrian domestic companies are released from full tax liability on corporate taxation in accordance with §5 KStG.[621]

With respect to the second hypothesis of incidence of the prohibition on deductions of royalty payments, in the case of a nominal tax rate lower than 10%, it is important to highlight that this is not restricted to cases in which the *general* tax rate is below this minimum. This occurs because, if there is a differentiated nominal tax rate, below the limit, directed to a specific category of income – in this case, royalties or even interests – the rule will be applied in the prohibition on deductions.[622] Furthermore, for the final value of this rate to be calculated, the taxes paid at the federal, state and local levels must be taken into consideration, as long as they are calculated on the same taxable base; and especially in cases of international taxation with cross-border

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[619] Previously five.

[620] This has been so far the interpretation given to the rule, for more information see Kofler, Georg; Marschner, Ernst (2014): Änderung im Außensteuergesetz. Verwertung und Nachversteuerung ausländischer Verluste, Abzugsfähigkeit von Zinsen- und Lizenzgebührenzahlungen, beschränkte Steuerpflicht für Zinsen. In *SWK* (9), P. 463.

[621] For more information, see Kaul (2018): Der Nexus-Ansatz. P. 39ff.

[622] See Lachmayer (2015): §12 KStG. In: Renner/Strimitzer et al. (Eds.) - Die Körperschaftsteuer. P. 77.

transactions, which are the most affected in the framework of this rule, the taxes withheld at source[623] by Austria itself must also be included.

Excluded from this calculation, meanwhile, is the taxation on the distribution of profits of a company to its shareholders, since it consists in a different taxable basis arising from the taxation of revenues due to royalty payments. Thus, regardless of the rate used for this taxation, there is no direct impact on the application of the prohibition on deductions.[624]

Furthermore, another characteristic of this rule still under discussion by the legal doctrine is the remote hypothesis that a country has a nominal tax rate lower than 10%, but an effective tax rate higher than it, which could occur *e.g.* in case of a restriction on the deduction of royalty payments laid down by foreign law. Through a literal interpretation of the rule, all the necessary prerequisites for the imposition of the prohibition would be fulfilled,[625] and there would be no point in relativizing it given the effective taxation of an amount higher than the minimum limit, since the norm simply makes reference to the requirement of a *nominal* tax rate within a given value. However, when performing a teleological and systematic interpretation of the rule, whose primary purpose is to ensure a minimum taxation on royalty payments and tackle base erosion and profit shifting through aggressive tax planning, it seems reasonable to include an exception in the legislation for this (remote) possibility, in order to avoid further discussions and interpretative dissentions.

For the first analyzed elements that would lead to a prohibition on expense deductions, the full non-taxation of royalties and the nominal tax rate below 10% are straightforward and easy to evaluate and identify. The major issue is posed by the third, in determining whether the *effective* tax burden granted by a special taxation regime is below the indicated range, since there is no national legal definition of what would a special regime that leads to a detrimental reduction for tax purposes be. To facilitate its application, the Second Tax Modification Act of 2014 introduced in the phrase “on the basis of a tax reduction provided *also* for this purpose” the previously non-

[623] For more on this opinion, see Kofler, Georg; Marschner, Ernst (2014): Änderung im Außensteuergesetz. Verwertung und Nachversteuerung ausländischer Verluste, Abzugsfähigkeit von Zinsen- und Lizenzgebührenzahlungen, beschränkte Steuerpflicht für Zinsen. In *SWK* (9), P. 464.
[624] See Lachmayer (2015): §12 KStG. In: Renner/Strimitzer et al. (Eds.) - Die Körperschaftsteuer. P. 78.
[625] Opinions differ widely on this matter, as some have taken the opposite view on this debate, considering that the triggering of the prohibition should not happen on such a case, based on interpretation. For more information, see Peyerl, Hermann (2014): Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern. In *ÖStZ* 314, P. 228.

existent term “also”, to cover any regime that has at least one of its goals to grant tax benefits to intellectual property, either through specific rules for this purpose or through general rules that ultimately benefit multiple tax regimes. Excluded from this rule are, however, regimes that only benefit forms of income other than royalties or interests, as they are outside the scope of the regulation.[626]

Thus, the ultimate purpose of this provision is to cover any preferential treatment that, for example, reduces the tax rate or the tax base and results in an effective tax rate of less than 10% – irrespective of the nominal tax rate.[627] This does not mean that a direct comparison between the amount of tax that would be charged in Austria and the amount actually charged in the country of residence will be made, since not every difference will be considered as preferential treatment, but it will be calculated from the value used as the tax basis, any discounts granted and the tax actually paid. This is naturally questionable on how it will be precisely determined in different cases insofar there is the possibility for issues with non-proportional taxes, especially when other sources of income are involved.[628]

It is important to emphasize nevertheless that §12 para. 1 n° 10 KStG does not strictly require that there be in fact taxation in order for the prohibition on deductions to not be activated. In the event that the ETR is below 10% merely because the payee has suffered losses in a particular tax year or due to a group taxation regime where losses have been attributed to it, the prohibition will not automatically apply.[629]

Another question raised when enforcing the rule is whether, in the event that the royalties are taxed in two or more different countries, each with a rate lower than 10% – which adding up would however result in an amount above the minimum established by Austrian law – there would be the possibility of not applying the prohibition on deducting royalty payments. This could easily occur especially among countries that do not have double taxation agreements among themselves, so that there is no tax relief among them, leading to a final taxation higher than the limit of 10%.

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[626] See Zöchling, Hans; Plott, Christoph (2014): AbgÄG 2014: Das neue Abzugsverbot für niedrigbesteuerte Zinsen und Lizenzgebühren. In *RdW* (243), P. 217 and Lachmayer (2015): §12 KStG. In: Renner/Strimitzer et al. (Eds.) - Die Körperschaftsteuer. P. 78.
[627] *Ibid*.
[628] See Kaul (2018): Der Nexus-Ansatz. P. 40.
[629] Österreichisches Parlament (2014): Erläuterungen 24 der Beilagen XXV. GP - Regierungsvorlage. Available online at https://www.parlament.gv.at/PAKT/VHG/XXV/I/I_00024/fname_337614.pdf, checked on 13.05.19. P. 13.

If in this case the exact wording of the current legislation is followed, it would not be necessary to consider the resulting tax burden of the transaction, but only the tax rate effectively applied by each country, individually.[630] Nonetheless, as with the considerations made above, from a systematic and teleological point of view, however, this result is incoherent, insofar as the purpose of the rule is to ensure a minimum taxation for royalties, thus avoiding BEPS through aggressive tax planning. If due to a tax liability in two or more countries the tax burden exceeds the amount required by the Austrian rule, it should not be applied, observing the tax consequences in all the States involved.

When analyzing the scope of application of each of the hypotheses of this legislation, it can be perceived that the Austrian lawmaker intended to categorically cover the most common and known forms of structuring aggressive tax planning and profit shifting through royalty payments, in order not to let any specific model escape the framework of the rule. However, this exhaustive list may even be considered unnecessary[631] if it is observed that, ultimately, the intention is to ensure a certain minimum taxation, and when complying with the third criterion of a minimal effective tax rate of 10%, all other cases will automatically – and more fairly – be covered. It is certain that, by listing different possibilities of incidence of the rule, its applicability is more easily guaranteed, as it is not necessary to calculate, in each individual case, the ETR. However, this also creates the possibility of inconsistencies and asymmetries in the application of the rule, as shown above, and a simplification or unification of the requirements on the incidence of the prohibition on deductions would ensure a more uniform and fair application to it.

3.2.2.1.4 Preferential treatment

Although preferential treatment is partially considered as one of the criteria for determining the application of the barrier to deductions of expenses for royalty payments based on low taxation, some specific considerations are pertinent. The choice of the Austrian legislator in drafting this rule was to relegate a secondary role to the presence of a preferential treatment, in which the ultimate aim is to combat low taxation, regardless of its origin. Therefore, the struggle against the infamous intellectual property and patent-boxes is carried out primarily in an indirect manner,

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[630] For more on this matter, see Dziurdz, Kasper; Marchgraber, Christoph (2014): Überlegungen zum konzerninternen Abzugsverbot für "niedrig Besteuerte" Zinsen und Lizenzgebühren. In *ÖStZ* 599, P. 381.

[631] On this matter, see Peyerl, Hermann (2014): Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern. In *ÖStZ* 314, P. 228.

since ultimately what will cause the application of the prohibition on deductions is the existence of taxation below an "acceptable" level as defined by the legislator, and not the presence or absence of a preferential system of treatment for intellectual property.

This partly occurs because the implementation of this system was prior to the OECD discussions regarding IP-Boxes and the nexus-approach[632] – which directly influenced the model for the elaboration of other rules, such as the German one[633] – but also seems to be a well-informed choice, since it makes clear that the purpose of the rule is to combat aggressive tax planning and ensure minimum taxation, indirectly recognizing the relevance that policies to encourage research & development may have, provided they do not become mere mechanisms of tax planning.

Certainly, relegating a secondary character to preferential tax regimes in this regulatory framework has the downside of affecting cases where a tax incentive is being granted legitimately – for example in accordance with the OECD's nexus-approach, where there is economic substance and value production in the taxed location – relying solely on a criterion of absolute value in effective taxation. While using low taxation as the determining factor may have been a conscious choice by the legislator, it should not be forgotten that the above-mentioned OECD report in the nexus-approach on the subject, which would possibly allow for a concurrent battle against BEPS and the preservation of adequate tax incentives in the form of IP-Boxes, was not yet available. Nevertheless, it is very questionable whether any form of substantive carve-out would be meaningful in fighting tax-avoidance, as will be discussed later on Chapter 5.

Accordingly, the preferential tax regimes are mentioned by the Austrian prohibition rule as one among several tax models to be countered, not being seen as a possible exception and valid incentive given their intent to foster research & development. Interestingly enough, Austria itself does not have any kind of IP-Box, but recognizes the importance of encouraging the production

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[632] Since the final report is from 2015, as in OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report. Available online at https://read.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en#page1, checked on 03.08.18.

[633] For more information, see Section 3.2.2.2.

of intellectual property with tax bonuses for research, which in its last tax reform[634] increased from 10 to 12%.

3.2.2.1.5 Legal consequences

Once all the necessary legislative requirements have been met, the legal consequences are relatively straightforward, but nevertheless impactful: under Austrian tax law, no deduction of business expenses related to the payment of royalties will be permitted. It is important to emphasize that this prohibition is always applied in an *integral* manner, regardless of which tax rate is actually applied in the residence country, as long as it is below the minimum of 10%. This means that a payee who receives a royalty payment and pays corporate tax in an amount of 9% in his country of residence;[635] and a payee who receives a royalty payment and does not pay any corporate tax in his country of residence will ensure that the payer receives exactly the same treatment by Austrian law, since both are below the limit established by law. On the other hand, a payee who is subject to a rate of 10.5% will not suffer any consequences for this.

This is the result of the legislative decision for a *sharp line*,[636] which leads to acutely different treatment among taxpayers who are not so unlike each other. While this facilitates the applicability of the rule, the outcome deviates significantly from a standard of fairness and proportionality, in particular by linking these drastic legal consequences to a mere numerical rate test to determine whether or not BEPS or aggressive tax planning is intended and whether it should be curbed. Moreover, this structure allows the regulation to be easily circumvented with a change in the tax rate of the country of residence that wishes to continue allowing for structures of aggressive tax planning in order to attract investments, for example.

From the perspective of an international tax competition, the decision to link negative tax repercussions in Austria to the foreign tax collection structure can also be considered questionable, at the very least. It is conceivable that a country may, due to *e.g.* successive economic crises, establish higher transfer taxes, while keeping corporate and income taxes lower, to ensure a

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[634] From the years 2015/16. For more information, see Bundesministerium für Finanzen (2015): Vortrag an den Ministerrat. Steuerreform 2015/2016. With assistance of Bundesminister Schelling. Available online at https://www.bmf.gv.at/steuern/Vortrag_Ministerrat_Steuerreform_20152016.pdf?5b0v3k, checked on 21.05.19.

[635] Such as Hungary nowadays.

[636] Once more, see Fox, Edward G.; Goldin, Jacob (2019): Sharp Lines and Sliding Scales in Tax Law. In *SSRN Journal*. DOI: 10.2139/ssrn.3339656 for more information, as well as Section 3.2.1.

minimum of taxation internally.[637] This would make companies resident in the country with subsidiaries in Austria automatically subject to stricter tax rules under Austrian law if transactions with royalties were not directly and "properly" taxed.

Considering that the prohibition on deductions does not occur in a proportional manner, this rule may in a number of cases be responsible for the occurrence of economic double taxation, since there will be a collection of the tax on royalties at the level of the payer – as they are not deducted as expenses – and at the level of the payee – at a rate below 10% that provides for the triggering of the Austrian rule, but that is different than 0%. This inevitably affects only cross-border transactions, in which two different rates from two different countries will be applied on the same value, which leads to clear conflicts with European legislation.[638]

Recently, through the tax reform act nº I of 2019/20,[639] a slight change was made to the rule to avoid double taxation at least partially, but in another case: that of a concurrent application of the rule restricting deductions and the Austrian controlled foreign company rules. Despite not dealing with the problematic issue arising from the triggering of the prohibition in case taxes are still being paid in the residence country, at least this rule of primacy of the Austrian CFC legislation was added over the prohibition in the deductibility of expenses with royalties. This occurs to avoid double taxation in the event that expenses with royalty payments fall simultaneously within the scope of the prohibition in §12 para. 1 No. 10 KStG and are considered as passive income for purposes of CFC rules.[640] If both were activated at the same time, there would certainly be an economic double taxation, in which on the one hand the payment expenses would not be deductible in Austria, while on the other hand the amounts received by the parent company in the country of residence would be added to the income of the paying entity, and once again taxed.[641] From this

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[637] For more on this example, see Wimpissinger, Christian (2014): Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach §12 KStG unionsrechtswidrig? In *SWI*, P. 227.
[638] More information on Chapter 4.2 and Peyerl, Hermann (2014): Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern. In *ÖStZ* 314, P. 229.
[639] Available online at https://www.bmf.gv.at/steuern/Text_StRefG_2019-20_BegE.pdf?6yqk5u, checked on 13.08.2019.
[640] Refer to the discussion on the cumulation of CFC rules and deductibility barriers within Austrian law in Blum, Daniel W. (2021): Das Zusammenspiel von Zinsschranke, Hinzurechnungsbesteuerung und Abzugsverbot für niedrigbesteuerte Zins-/Lizenzzahlungen. In *RdW* (4), P. 289ff.
[641] On this issue, see Knesl, Pavel (2019): Entwurf des StRefG I 2019/20 - Ausgewählte Änderungen des Körperschaftsteuergesetzes. In *ÖStZ* 12, P. 304f.

moment on, the CFC rules take precedence over the applicability of the prohibition on deductions, as occurs in the German rule, to be seen below.

Moreover, given that the rule on prohibitions has been adopted unilaterally and is possibly harmful to multinational companies through double taxation, there is a serious risk of negative impacts on foreign investments in the country, as well as on those of Austrian companies that wish to obtain licenses from abroad. This arises from the asymmetry provided by this rule, in which in an exclusively Austrian domestic case, where there is a royalty payment between companies of the same corporate group, the income from intellectual property will be taxed at the value of the corporate tax rate of 25%; while on the other hand, in a cross-border transaction, if the taxation in the country of the payee triggers the Austrian prohibition of deductions, but has a taxation that is not zero, a significantly higher taxation will likely occur over the original 25%.

As seen above, there are many problems and nuances of this rule regarding royalty payment deductibility. In spite of this, the merit of the Austrian initiative in solving the problem cannot be overlooked, as it served even as a model for a newer – and perhaps improved – version of the German-developed system that will be dealt with below.

3.2.2.2 The German example

Upon Austria's implementation in 2014 of the system of barriers to deductions on royalty payments seen in the above section, the German government stressed its previously expressed indication through its coalition agreement that it intended to await the results of the OECD international discussions, prior to the possible implementation of similar rules[642] – alongside the already existing regulation to limit deductions on interest payments of §4h EStG in conjunction with §8a KStG. This was so with the publication, in 2015, of the Final Report of Action Plan n° 5

[642] As stated, "We are awaiting the completion of the OECD-BEPS (Base Erosion and Profit Shifting) initiative in the year 2015, a project to counter international tax avoidance, which we actively support. If our goals under the OECD-BEPS initiative cannot be achieved during this period, we will take national measures. [...] We also want to ensure that the tax deduction of licensing expenses is accompanied by an appropriate taxation of royalty income in the recipient country." (autonomous translation). For more information, see CDU Deutschland (2013): Deutschlands Zukunft Gestalten. Koalitionsvertrag zwischen CDU, CSU und SPD. 18th legislative term. Available online at https://www.cdu.de/sites/default/files/media/ dokumente/koalitionsvertrag.pdf, checked on 11.06.19. P. 65.

of the OECD,[643] seeking to combat harmful tax practices more effectively, according to criteria of transparency and economic substance.

However, the results obtained at the international level were apparently insufficient, since in December 2016 the German Federal Ministry of Finance published a draft bill "against harmful tax practices in connection with the transfer of rights",[644] which despite some modifications was approved by the German Federal Council (*Bundesrat*) on the 2nd of June 2017, and published in the Federal Law Gazette[645] with effect as of 27th of June 2017, including the new §4j in the German Income Tax Act (EStG). Initially, following the systematic of barriers in interest deductibility[646] in the already existing §4h EStG, the idea was to simply extend the scope of this article to also cover royalty payments, as the Austrian rule works. However, this would mean that the application of the barrier to the deduction of royalties would take place observing the same requirements for interests, that is, regardless of the related person and the taxation at the level of the payee, which was heavily criticized.[647] Thus, the government opted for the creation of a new article exclusively for royalties.

The strategy behind this German project is however very similar to that employed by Austria in its innovative legislation, which sets a clear counterpoint to the tax practices developed in some countries in relation to fiscal incentives. While there is a clear international policy of promoting intellectual property through IP-boxes given their economic, technological and developmental relevance, Germany, as well as Austria, have decided to position themselves almost on the opposite side, in line with OECD reasoning – which regards these incentives as a harmful tax practice if there is no alignment with rules that require transparency and an adequate economic

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[643] OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report. Available online at https://read.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en#page1, checked on 03.08.18.

[644] Available online at https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_IV/18_Legislaturperiode/Gesetze_Verordnungen/2017-07-04-Gesetz-schaedliche-steuerpraktiken-rechteueberlassung/1- Referentenentwurf.pdf;jsessionid=C8C2806EBB1446E1C8028B17C5683D17?__blob= publicationFile&v=2, checked on 11.06.19.

[645] BGBl. I Nr. 43/2017, on 04.07.2017.

[646] For more information on this topic, refer to Kessler, Wolfgang; Benke, Maximilian (2019): Besteuerung von Aufwand - überschießende Steuerwirkungen der Zinsschranke bei Holding-Gesellschaften? In *Der Betrieb* 43, P. 2367ff.

[647] For more information, see Ritzer, Claus; Stangl, Ingo; Karnath, Susan (2017): Zur geplanten "Lizenzschranke". In *Der Konzern* (02), P. 68.

substance.[648] Therefore, instead of initially implementing its own IP-Box, the decision was to restrict the possibility of deducting royalty payments made in a situation considered harmful for tax purposes.

It is important to note, nevertheless, that despite the existence and early proposition of this rule combating license-boxes that do not meet minimum requirements of economic substance, Germany succumbed to competitive pressure for innovation and presented, for the first time in 2019, a bill of indirect tax incentives – with up to a 25% allowance – on research and development open to all taxpayers.[649]

This reinforces the idea that there are several economic reasons to encourage research & development, specifically in order to ensure the future viability of a country as a business location, given the positive spillovers that the results may eventually bring, correcting prospective market failures along the way.[650] The initial plan was to increase the overall level of spending on research & development from 3% of GDP in 2017 – which was already above average for the major economies competing with Germany, such as the US, France and China – to 3.5% of GDP annually.[651] This would ensure an advantage for Germany as an attractive business location, while at the same time enforcing its own rules against artificial profit shifting. A similar stance can be seen by France, which has always been a country known for granting tax incentives for research and development activities,[652] and yet has been extremely active in combating BEPS through its vanguard stance in the GloBE proposal discussions and the elaboration of a minimum tax,[653] as well as in the introduction, in 2019 through its finance law, of a royalty deduction barrier basically identical to the German one,[654] of partial non-deductibility and directed at harmful tax regimes.

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[648] Refer to Link, Mathias; Süßmann, Britta (2017): Die deutsche "Lizenzschranke". Entwicklung, gesetzliche Umsetzung, weitere offene Fragen. In *SAM* 4, P. 149.

[649] See Finley, Ryan (2019): German Government Submits SME-Focused R&D Allowance Law. In *Tax Notes International* 94 (4), P. 366f. on this topic.

[650] For more on an economical analysis on this topic, see Falck, Oliver; Fichtl, Anita; Lohse, Tobias (2019): Steuerliche Forschungsförderung: Wichtiger Impuls für FuE-Aktivitäten oder zu wenig zielgerichtet? In *ifo Schnelldienst* 72 (9), P. 3ff.

[651] See the analysis on Frey, Johannes; Schmid, Florian (2019): Germany Readies R&D Tax Incentive Program. In *Tax Notes International* 95 (1), P. 51f.

[652] As stated in Bogaert, Jérôme (2019): Le nouveau régime d'imposition des produits de la propriété intellectuelle: principaux changements et opportunités. In *Bulletin Fiscal* (12), P. 665.

[653] See a thorough discussion in Chapter 4.4.

[654] More details can be seen in Fumenier, Patrick; Maignan, Clara (2019): Limitation de la déductibilité des redevances de droits de la propriété intellectuelle : risque d'une première application pratique avec les Etats-Unis. Edited by

Therefore, unlike the Austrian rule, the German (and French) model is addressed solely and exclusively to preferential tax regimes that are considered harmful, *i.e.* that lead to a very low or no tax burden and do not meet the criteria of transparency and economic substance set by the OECD,[655] while being perfectly compatible with its own national IP incentives, that naturally meet the necessary requirements. After some modifications on the project, direct reference is made to the criteria established in Action Plan n° 5 and to the nexus-approach[656], which is a clear and straight course of action against base erosion and profit shifting of intellectual property through royalty payments and the (ab)use of IP-Boxes. The idea behind a direct reference in the German legislation to an OECD "soft law" report is the offspring of a recent genuine internationalization of tax law,[657] in which the lawmaker has ensured in this way that the German administration and judiciary cannot generate an understanding and autonomous interpretation of harmful tax competition that is detached from that drawn up on the basis of a multilateral international consensus.

The rule was therefore implemented with reference to OECD terms – even if unilateral measures were not the intended outcome of this BEPS Action Plan – and seen by many as the German way to promote protectionism[658], its greatest advantage being the possibility of full implementation without any need for international coordination.

Moreover, this rule has proven to be a true *restriction* in the deductions of royalty payments, and not a prohibition. This means that, when a transaction falls within the scope of the rule, there will be no immediate and complete impediment to deductions of expenses related to the payment, but this will be proportional to the tax rate actually levied in the country of residence, according to a specific formula. Thus, the German legislation found a fairer – but more modest – way to combat profit shifting, as will be seen in the specific criteria of the law to follow.

Deloitte. Available online at https://taj-strategie.fr/limitation-de-deductibilite-redevances-de-droits-de-propriete-intellectuelle-risque-dune-premiere-application-pratique-etats-unis, checked on 08.07.19.

[655] See Moritz/Baumgartner (2022): §4j EStG. In: Bordewin/Brandt (Eds.) - Einkommensteuergesetz. Kommentar., P. 6ff.

[656] For more information on this method, see Chapter 2.2.

[657] For more on this idea, see Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) – 100 Jahre Steuerrechtsprechung in Deutschland, P. 923 and 940ff.

[658] Jochimsen, Claus; Zinowsky, Tim; Schraud, Angélique (2017): Die Lizenzschranke nach §4j EStG - Ein Gesellenstück des deutschen Gesetzgebers. In *IStR* (15), P. 593.

3.2.2.2.1 Expenses for the assignment of rights

Firstly, it is important to highlight what is the object of this rule, that is, which types of transactions it encompasses. The "assignment of rights" is directed to the most diverse types of intellectual property, described in detail in paragraph 1 of §4j EStG,[659] however without being limited to them, since it is an explanatory list. These include the granting or right to use copyrights, patents, trademarks, know-how and so on, as well as plans and procedures.[660] It is nonetheless important to note that only those assignments of rights that are limited in time fall within the scope of the rule, as the complete alienation of intellectual property rights are not encompassed by the royalty payments barrier.[661]

One perceives a clear intention of the lawmaker to establish a relatively comprehensive rule, covering basically any and all royalty payments, provided that the other criteria are met. This broad definition is extremely similar to that used in §50a para. 1 No. 3 EStG, and therefore brings with it some of the problems present in the other rule, such as those linked to the rights of use of software.[662] Some of the terms used, on the other hand, have a more concrete legal definition in other provisions, as is the case of copyrights, found in §73a para. 2 EStDV (German Regulation for the Implementation of Income Taxation).

3.2.2.2.2 Related party

The restriction in §4j EStG shall only be effective for the payer in cases where the payee of the royalty payment is a related party within the meaning of §1 para. 2 AStG (German Foreign Tax Act). The criteria used by German law essentially stipulates the need for a minimum control between debtor and creditor, directly or indirectly, through the participation of at least 25% of the shares of one another; or the power to exercise, through third parties or otherwise, influence on the decision-making process of the company.[663]

This directs the scope of the rule to licensing structures for intellectual property carried out in a group of companies, which does not normally affect cases of payments made to third parties.

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[659] See Staccioli (2022): §4j. In: Frotscher (Ed.) - Kommentar zum Einkommensteuergesetz., P. 11ff.
[660] For a comprehensive discussion on those definitions, see Chapter 1.2.
[661] Jochimsen/Zinowsky/Schraud, *op. cit.*, Fn. 658, P. 594ff.
[662] For more information, see Schnitger, Arne (2017): Weitere Maßnahmen zur BEPS-Gesetzgebung in Deutschland. In *IStR* (6), P. 221.
[663] See Loschelder (2022): §4j. In: Schmidt/Heinicke et al. – Einkommensteuergesetz., P. 347f.

A coherent approach, considering the purpose of the regulation is to more accurately combat aggressive tax planning, which occurs as a general rule through internal planning within the corporate group. As a consequence, however, it is possible to imagine that companies belonging to a group that are subject to the application of the restriction on deductions of royalty payments are at a competitive disadvantage in the market in relation to those that make payments to independent third parties, since they will possibly be subjects to a higher tax burden if the restriction is indeed applied.[664] This phenomenon arises as a counterpart to the eventual competitive advantages that a multinational group can obtain through savings in the taxes paid through its international structure, and an equilibrium provided by the other criteria of the deductions restriction is in order.

It is also worth mentioning that, when dealing with a permanent establishment, it will be covered by the rule only in the event of a transaction with a true related party, and not with its head office. Since they are considered as only one taxpayer by the German legal system, it is not appropriate to talk about distinct, related parties between a permanent establishment (PE) and its head office or vice-versa, being it impossible to apply the rule on restriction to royalty payments.[665]

Another peculiarity – or improvement, depending on the point of view – of the German rule in relation to the Austrian one is that there is no mention, in the matter of the subjects involved in the transaction, of the need for them to be a legal entity under private law.[666] Thus, legal entities under public law are also included, and possibly even natural persons in the payee concept of German legislation. This concept seems to be reasonable, considering that not only legal entities under private law are subject to aggressive tax planning, even if they likely are the vast majority. Thus, with a broader rule on a subjective level, this provision enables itself to achieve its purposes more effectively, provided that the other requirements restrict the application of the restriction to cases in which there is, *de facto*, an abuse of tax asymmetries between jurisdictions.

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[664] For more on this matter, see Geurts, Matthias; Staccioli, Guido (2017): §4j EStG-E - das neue Abzugsverbot für Lizenzaufwendungen. In *IStR* (13), P. 516.
[665] For further information, see Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), available online at https://www.wiso-net.de/document/MCDB__DBDBDB1227655, checked on 12.10.18, P. 207; and Schneider, Norbert; Junior, Björn (2017): Die Lizenzschranke - Überblick über den Regierungsentwurf zu §4j EStG. In *DStR* 55 (8), P. 420.
[666] See also Moritz/Baumgartner (2022): §4j EStG. In: Bordewin/Brandt (Eds.) - Einkommensteuergesetz. Kommentar., P. 41f.

Finally, it is worth noting the use of the term "other creditors" in §4j EStG, included with the purpose of combating back-to-back licensing systems, like the logic of beneficial ownership employed in the Austrian rule seen in Section 3.2.2.1. Considering the danger that the rule is circumvented with the simple interposition of a chain structure,[667] *e.g.* in a third jurisdiction, with the sole and exclusive purpose of avoiding the royalty barrier, the German legislator saw fit to allow the rule to be applied in the event of there being *another payee* that is the final recipient of the amounts paid as royalties.[668] Thus, the initial payee becomes simultaneously payer, passing the royalties forward to the next in the chain. In order to avoid the occurrence of a cascade effect, however, it is necessary to provide for the application of the restriction on deductions in only one of the links in the chain, that is, its application must be restricted to only once internally to a corporate group for the same set of royalty payments. As a result, it is ensured that the same business group is not restricted more than once, which could considerably increase its final tax burden.

3.2.2.2.3 Condition of low taxation

From the criterion of the low taxation condition, the major distinctions between the Austrian and German lawmaking strategies emerge: while the Austrian model has opted almost exclusively for a low taxation criterion at a fixed 10% rate, the German model works properly only by coordinating the low taxation criterion – set at a very high 25% rate – and the criterion assessed in the next subsection, namely the presence of a preferential regime.

This value was probably directly imported from the German CFC-rule framework system, in which §8 para. 3 AStG considers taxation to be "low" when the income tax paid by the foreign company is less than 25%.[669] It is important to note that the value suggested by the OECD for determining low taxation for CFC-rules should be "significantly" below the tax burden of the

[667] *Ibid*., P. 43ff.

[668] There has been a bit of debate concerning the possibility of circumvention of this rule through the usage of a non-related party, that is, if the licensing chain moves *outside* the corporate group. While the chances for tax planning are lower in this fashion, some authors see this possibility as being nevertheless covered due to a specific interpretation of §4j para. 1 sentence 2 EstG. Refer to the work of Woitok, Niklas (2020): (Fast) Keine Umgehung der Lizenzschranke durch Zwischenschaltung einer fremden Person? In *DStR* 58 (24), P. 1228ff. For other examples, see Staccioli (2017): §4j. In: Frotscher (Ed.) - Kommentar zum Einkommensteuergesetz. P. 13ff.

[669] For more information, see Kraft (2022): §4j EStG. In: Kanzler/Kraft – Einkommensteuergesetz, P. 593ff.; and Geurts, Matthias; Staccioli, Guido (2017): §4j EStG-E - das neue Abzugsverbot für Lizenzaufwendungen. In *IStR* (13), P. 517.

country that determines the rule.[670] Thus, the other discussions surrounding the amount established by this provision are also automatically brought in, in which it is questioned whether this rate would in fact represent a low taxation, considering that the current tax burden paid in corporation tax in Germany is 15%.[671] In this sense, one could expect greater consistency from the legislator when establishing the rate that would lead to the triggering of the rule, or at least – as is the German case – the accumulation with other requirements that restrict the incidence of the regulation.

If the value of the effective – and not the nominal – tax rate charged abroad is less than 25% *and* there is the presence of a preferential treatment,[672] the expenses with payments of royalties will be non-deductible proportionally to this rate. This means that in the analysis of the final tax rate used, not only the numerical value will be taken into consideration, but also any reductions, exemptions, tax credits, discounts etc. that are granted.[673] Some authors also argue that an existing German or even foreign applicable withholding tax – used for example in the case of another payee in a third jurisdiction – should be included in this calculation.[674] This occurs not only on the basis of a justice and fairness criterion, but also pursuant to §4j para. 2 sentence 3 EStG, which provides that all the different tax burdens must be added together in order for the low taxation criterion to be assessed, which would also include the entirety of foreign tax burdens. As a result, the general application structure of §4j EstG is *very complex*, since employment issues are ultimately based on foreign tax law.[675]

Other problems arose due to the inclusion of a provision in §4j para. 2 EStG that, in the event there is more than one payee, that the one subject to the *lower* taxation would be used as a parameter. This leads to interpretative difficulties and may generate situations of blatant injustice, since it is not clear how the restriction on the deduction of royalty payments will be made in a proportional manner among the companies. It would be possible to imagine cases in which, when

[670] Currently, at around 75% of the local tax burden, even though no specific number is set. For more information, see Kraft (2022): §4j EStG. In: Kanzler/Kraft - Einkommensteuergesetz, P. 593f.
[671] §23 para. 1 KStG.
[672] See Staccioli (2022): §4j. In: Frotscher (Ed.) - Kommentar zum Einkommensteuergesetz., P. 29ff.
[673] See Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), available online at https://www.wiso-net.de/document/MCDB__DBDBDB1227655, checked on 12.10.18, P. 207.
[674] On the same opinion, see Kramer, Jörg-Dietrich (2017): Germany's New Royalties Barrier Rule: Preventing Tax Evasion By Limiting Deductibility in Specified Cases. In *Tax Notes International* 88, P. 881 and Schnitger, Arne (2017): Weitere Maßnahmen zur BEPS-Gesetzgebung in Deutschland. In *IStR* (6), P. 223.
[675] Refer to the analysis by Kahlenberg, Christian (2020): Das neue BMF-Schreiben zu §4j EStG als Arbeits- und Entscheidungshilfe. In *Praxis Internationale Steuerberatung* (05), P. 126ff.

a company D located in Germany owes royalty payments for the same IP to company H (located in a high tax country, above the 25% tax limit) and company L (located in a low tax country, below the 25% tax limit), the payments to company H would be impaired given the non-deductibility of the amounts arising from D, if only the lowest rate were to be taken into consideration.[676]

Even in cases in which the evaluation of the amounts is made proportionally and separately, the complexity of the calculations with more robust corporate structures ends up jeopardizing the legal certainty and predictability of the provision. In this sense, a clearer rule is needed to settle disputes in practice when multiple creditors are involved, which is a feasible and even relatively common situation to occur.

As the German rule proposes to make a proportional restriction on deductions, as will be seen below, the criterion of low taxation must be better structured in its application, avoiding to the maximum to leave to the tax practitioner unresolved or ambiguous issues. Although the numerical value of 25% is very clear, it depends directly on other factors, such as the structure employed by the business group and the existence or not of a preferential regime. Since this is a very high value that would encompass a multitude of tax legal systems, one cannot be careful enough when devising this criterion, especially to ensure that it is both fair and effective.

3.2.2.2.4 Preferential treatment

The main specificity of the German system, used to restrict the effects of the relatively high tax rate threshold used as a parameter of low taxation, is the need for this taxation to be carried out mandatorily through a rule of preferential treatment.[677] This means that only those rates that deviate from the "regular" tax burden will be covered by the provision, while, in the event of there being a foreign general rule that allows for a lower taxation, the deduction of the corresponding expenses may take place normally. One can say that these are requirements divided into

[676] For more practical examples, see Jochimsen, Claus; Zinowsky, Tim; Schraud, Angélique (2017): Die Lizenzschranke nach §4j EStG - Ein Gesellenstück des deutschen Gesetzgebers. In *IStR* (15), P. 597.

[677] In the French case, although a high tax rate threshold of 25% is also used, the restriction is made by applying the rule only to countries outside the EU or the EEA and which, at the same time, have a regime classified as harmful by the OECD. Refer to PwC (Ed.) (2019): Non déduction partielle des redevances de propriété intellectuelle versées par des entreprises françaises. Available online at https://www.pwcavocats.com/fr/ealertes/ealertes-france/2019/01/loi-de-finances-2019-les-mesures-pour-les-entreprises/non-deduction-redevances-proprietes-intellectuelles.html, checked on 08.07.19.

quantitative and *qualitative* aspects[678] for the preferential regime: quantitative in the sense that it must comply with the low taxation requirement presented above; and qualitative insofar as it must be a regime that differs from the "regular" taxation – whatever it may be – of revenue derived from intellectual property.

Even before evaluating what characterizes a preferential system, the German legislative decision to direct all its efforts only against such regimes as the IP- or patent-boxes is evident, leaving tax havens that do not have a specific incentive system for intellectual property entirely excluded from it. That is to say, the royalty deductions restriction will not apply if the payee is under a general low taxation rule on his entire income. They will, however, be applied in the case of a preferential regime that applies to intangibles *alongside* other incentives.[679] Despite it being a conscious decision of legislature,[680] this choice is a hard blow to the effectiveness of the rule in combating base erosion and profit shifting, since it deals only with one of the main tools used for aggressive tax planning with regard to intellectual property, leaving a clear planning path through tax havens entirely free.

Thus, the purpose of this rule is to target the known forms of IP-Boxes, which are characterized by a partial or full tax exemption of revenues related to the payment of royalties and intellectual property, or also by differentiated tax rates for this type of revenue. However, it cannot be inferred from the wording of §4j EStG nor from the justification for the legislation that this application is restricted to license boxes only,[681] but rather any and all low taxation that arises from a preferential rule that is distinct from the standard taxation. There is, however, no clear definition of what a preferential rule and ordinary taxation would be. There is only a reference to the need for a form of differentiated treatment, which does not necessarily need to be exclusively directed

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678 For more on the usage of these terms, see Ritzer, Claus; Stangl, Ingo; Karnath, Susan (2017): Zur geplanten "Lizenzschranke". In *Der Konzern* (02), P. 69ff.
679 Recently cleared-up by the German Federal Ministry of Finance (*Bundesministerium für Finanzen*) in Bundesministerium für Finanzen (2022): Anwendungsfragen zur Lizenzschranke (§ 4j EStG). BMF Schreiben v. 5.1.2022 - IV C2 - S 2144-g/20/10002:007, DOK 2022/0000838. In *DStR* (5), P. 203. For an interpretative explanation, refer to Kraft (2022): §4j EStG. In: Kanzler/Kraft – Einkommensteuergesetz, P. 583f.; and Eisbach, Anne-Kathrin (2022): Aktuelle Anwendungsfragen zur Lizenzschranke (§4j EStG). In *IStR* 31 (12), P. 414ff.
680 As expressed on the official justification fort he law, Bundesregierung (2017): Regierungsentwurf eines Gesetzes gegen schädliche Steuerpraktiken im Zusammenhang mit Rechteüberlassungen. BR-Drucks 59/17. Deutscher Bundestag. Available online at http://dipbt.bundestag.de/dip21/brd/2017/0059-17.pdf, updated on 11/16/2018, checked on 08.01.19, P. 8.
681 *Ibid*., P. 12.

to intellectual property, it being sufficient, for example, that this type of revenue is punctually affected in a concrete case.[682]

The absence of a clear delineation of what would or would not be considered a preferential regime in face of the usual taxation generates a lot of legal uncertainty regarding the application of this rule, which may cause distrust in investments and fear of long and burdensome legal disputes. One might imagine, for example, that regimes based on other incentive criteria – such as promoting regional development; certain branches of the industry (distinct from those of research and development); or new businesses such as start-ups – fall within the scope of the rule, and prevent or restrict the deductibility of royalty payments made by the licensee, despite the rule applicable to the licensor not being specifically directed at intellectual property.

In addition, it is worth noting that there are already several legal systems that have a standard income tax burden of less than 25%, and that any discounts, however minimal, could lead to the triggering of the German rule, possibly greatly increasing the final tax burden of the business group.[683] Doubts arise, in particular, in relation to tax systems that have, as a general rule, progressive tax rates or differentiated tax rates, in addition to possible specific rules directed at intellectual property.

Theoretically, this article would also allow for the application of the barrier to exclusively domestic cases, *i.e.*, payments made between companies of the same business group resident in Germany, since it is possible, in some cases and regions due to differing rates on a trade tax (*Gewerbesteuer*), that a tax burden of less than 25% is obtained. However, as is the case with the Austrian rule, in practice this provision affects exclusively cross-border cases, since despite the possibility of lower taxation, it does not occur due to a *preferential system*, but rather due to the general rule of each German municipality. Even if, internally, an attempt is made to avoid unfair tax competition between municipalities, it is not, directly or indirectly, considered a differentiated

[682] For more on this opinion, see Gosch (2022): §4j. In: Kirchhof/Avvento/Mellinghoff (Eds.) - Einkommensteuergesetz., P. 512ff.; and Holle, Florian; Weiss, Martin (2017): Einschränkung des Abzugs für Aufwendungen aus einer Rechteüberlassung. In *FR Finanz-Rundschau Ertragssteuerrecht* (5), P. 221.
[683] See Schnitger, Arne (2017): Weitere Maßnahmen zur BEPS-Gesetzgebung in Deutschland. In *IStR* (6), P. 224, for a deeper analysis.

regime for intellectual property.[684] This also possibly poses problems with higher-ranking legislation, in particular European law, which will be dealt with later in Chapter 4.

It is clear that, although the problem with IP-Boxes was addressed by the OECD through its BEPS Action Plan n° 5 in 2015, Germany saw fit to act on its own to combat these preferential regimes employed in aggressive tax planning schemes. Nevertheless, at first, even those regimes considered non-hazardous by the OECD because they meet minimum requirements of transparency and economic substance would be covered by the German rule, if they allow for a taxation lower than 25% – which is almost always the case. To avoid this, there is an exception to the exception in §4j EStG, as follows.

3.2.2.2.5 Reverse exception: License-box regimes in line with the OECD nexus-approach

Certainly, the most exotic and interesting aspect of the German standard is expressed in the final part of §4j para. 1 EStG. In its last sentence, it is established that the regulation will not be applicable in cases where the low taxation obtained by the payee (or "other payee") occurs through a preferential rule that is in accordance with the requirements of the nexus-approach[685] developed by the OECD in chapter 4 of its 2015 final report on action plan n° 5.[686] This is a rather interesting legislative choice, which reflects much about the real purpose of the rule: here it is evident the *voluntas legislatoris* to combat harmful tax practices, in which this provision is utilized in the form of an anti-avoidance rule,[687] hence the need for this reverse exception – linked, in this case, to the work developed at the international level by the OECD.

Without the inclusion of this clause, as seen previously, absolutely every single preferential regime that resulted in a rate lower than 25% would be covered by the rule, which in practice would reach the overwhelming majority – if not all – of these incentive regimes. As the specific

[684] For more on this opinion, see Schneider, Norbert; Junior, Björn (2017): Die Lizenzschranke - Überblick über den Regierungsentwurf zu §4j EStG. In *DStR* 55 (8), P. 420.
[685] A deeper analysis of this approach and its characteristics was made on Section 2.2.
[686] OECD/G20 Base Erosion and Profit Shifting Project (2015): Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. Action 5: 2015 Final Report, checked on 03.08.18.
[687] An opposing opinion on this classification can be found among authors who argue that its general purpose is merely to combat harmful tax competition, since it does not, as a rule, address the specific behavior of the taxpayer. Refer, for example, to Hagemann/Kahlenberg (2011): §4j. In: Herrmann, Heuer et al. (Ed.) - Einkommensteuer- und Körperschaftsteuergesetz, para. 3.

purpose of the rule is not to directly combat such preferential treatment, which are to a certain extent accepted by the international community, but rather to prevent aggressive tax planning strategies *through* these regimes, this exception to the exception is an essential one to better delineate the framework of application of the rule.[688] Thus, according to this logic, there should only be a restriction on deductions with expenses of royalty payments in cases in which, from a low taxation obtained through a preferential regime, the latter does not meet the minimum requirements of economic substance and transparency established by the nexus-approach.[689]

Interestingly, German law makes direct reference to the OECD report, thus indirectly including in its legal system a document and concepts that have not been enacted in accordance with the democratic principles usually employed. Although it is not the focus of this work to evaluate the internal legal feasibility of this reference,[690] it should be noted that, initially, the bill had exceptions explicitly clarified in its body. However, in order to avoid further interpretative difficulties and potential asymmetries with the meaning of the report, the German Federal Council did suggest the exclusion of these exceptions,[691] to be replaced by a direct reference to the OECD document.

This allows the German tax administration, instead of being compelled to an analysis of each concrete case and an in-depth study of the taxpayers' specific documentation, to establish in unison with international standards whether the preferential regime fits the necessary parameters of the nexus-approach or not, affecting all taxpayers who make use of this incentive in the same manner. Nevertheless, in a letter from the German Ministry of Finance dated February 2020 setting out clarifications as to how §4j EStG is to be applied,[692] an annex is provided setting out which preferential arrangements are not considered in accordance with the modified nexus-approach. Surprisingly enough, this chart does *not* correspond to the results found by the OECD itself when

[688] For more on this matter, see Staccioli (2017): §4j. In: Frotscher (Ed.) - Kommentar zum Einkommensteuergesetz, P. 18.
[689] See also the comments by Loschelder (2022): §4j. In: Schmidt/Heinicke et al. – Einkommensteuergesetz., P. 350f.
[690] This was, however, heavily criticized by some authors, especially with regard to the principles of democracy, clarity and precision of legal norms. See Haarmann, Wilhelm (2017): Die neue Lizenzschranke nach §4j EStG. In *BB*, P. I, and Adrian, Gerrit; Tigges, Corinna (2017): Die geplante Lizenzschranke nach §4j EStG-E. In *StuB* (6), P. 229ff.
[691] For a deeper analysis on the procedures, see Jochimsen, Claus; Zinowsky, Tim; Schraud, Angélique (2017): Die Lizenzschranke nach §4j EStG - Ein Gesellenstück des deutschen Gesetzgebers. In *IStR* (15), P. 595.
[692] Refer to Bundesfinanzministerium (2020): Anwendungsregelung zu §4j EStG. In *Der Betrieb* 10, P. 472–473; or Bundesfinanzministerium (2020): Anwendungsregelung zu §4j EStG. In *IStR* 6, P. 240.

reviewing preferential regimes,[693] and there is a clear divergence on the classification with regard to the tax regimes of several countries. It is very striking that Germany did not use the Forum on Harmful Tax Practice's list as a reference for its license barrier rule, since §4j does make direct reference to OECD work on the subject. Instead, they decided for its own review of regimes worldwide,[694] which can bring about even more asymmetries internationally.

Although at first this structure seems reasonable and more straightforward, it brings with it a very severe complication, until now seemingly unsolved. As it is formulated, §4j gives the impression that the subjection to restrictions on deductions are a natural consequence of the decision of the corporate group to take advantage of a preferential regime when structuring itself in order to carry out a tax planning. However, these consequences are independent of the payee's behavior, with the exception of the choice of country of residence. This is because the requirements of the nexus-approach are addressed to the foreign *legislator*, and not to the company, which cannot do anything with regard to the requirements established by law.[695] This reverse-exception does not come down to whether the concrete business activities of the creditor of the payment are present or not, as the conformity to the nexus-approach is abstractly determined.[696] This means that, even if a company meets, on its own, the economic substance and transparency requirements advocated by the OECD, if the foreign legislator does not structure an incentive regime for intellectual property according to these stipulations, the German royalty barriers will be triggered because the foreign rule was inadequately structured.

Particularly problematic are cases where the company is unable to opt out of a system of preferential treatment for intellectual property that does not comply with the dictates of the nexus-approach. This means that, in not being optional the use of the "advantages" of this system, the business group may, in the end, be subject to a higher tax burden due to the activation of the German barrier given the structure of the foreign incentive regime, regardless of the attitude of the

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[693] As discussed previously on Chapter 2.2.

[694] See the comments by Greinert, Markus; Karnath, Susan; Siebing, Theresa (2020): Germany's License Barrier Rule and Its Application of the Nexus Approach for Preferential Tax Regimes. In *Tax Notes International* 98 (3), P. 343ff.

[695] For clarification on this issue, see Max, Marcel; Thiede, Jesko (2017): Der Gesetzesentwurf zur Einführung einer Abzugsbeschränkung für Lizenzaufwendungen - "Lizenzschranke". In *StB* (6), P. 175ff. and Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), available online at https://www.wiso-net.de/document/MCDB__DBDBDB1227655, checked on 12.10.18, P. 208.

[696] For more information, see Lüdicke, Jürgen (2017): Wogegen richtet sich die Lizenzschranke? In *Der Betrieb* 26, P. 1482.

payee. Few preferential regimes allow for an optional or *à la carte* application of their tax benefits, precisely because of the belief that such differentiated treatment is solely advantageous for the company.[697] This is generally true when only domestic taxation cases are considered, however the design of the IP-Boxes is also extremely relevant for other countries in an international taxation scenario, as evidenced by the German rule. Furthermore, as there is no provision in §4j allowing for the possibility of counterevidence[698] to be presented by the business group, the payee is in a situation of blatant disadvantage. The possibility of proving that, despite the national rule not meeting the requirements of the nexus-approach requirement, the corporate group meets the requirements of economic substance when developing and exploiting intellectual property, should be – preferably explicitly – ensured to the taxpayer.

The major criticism of the reverse exception making reference to the OECD report actually translates as a general criticism of the structuring of this norm around the BEPS project. This is because, according to the nexus-approach proposal, all preferential tax treatment regimes should have been adapted to this rule with effect for the year 2021. Indeed, in the OECD's progress report of 2018, updated several times until 2022,[699] most of the arrangements had already been modified to suit the proposal, with France being the main exception of relevance. Even so, as of January 2019 through the Finance Act 2019,[700] France saw fit to implement a License-Box that meets the requirements of the nexus-approach proposed by the OECD. The granting of the benefit is more restrictive in this respect, but presents several new opportunities for saving taxes through intellectual property.[701] Thus, the German rule loses much of its object and meaning, suffering even in its revenue collection aspect, since more than tackling companies that carry out aggressive tax planning, its barrier in the deductions of royalties hits *countries* that have regimes considered

[697] See a counterexample with the newly introduced French IP-Box in Clot, Laurence; Springael, Brent (2019): Très Bon: France's Appealing New Intellectual Property Tax Regime. In *Tax Notes International* 95 (1), P. 46f.

[698] The lack of such an escape clause is one of the greatest weaknesses this rule has. On this matter, see Greinert, Markus; Siebing, Theresa (2022): Jüngste Entwicklungen zu § 4j EStG angesichts BMF Schreiben v. 5.1.2022 und 6.1.2022. In *ISR* 11 (3), P. 85ff.

[699] With its last update on January 2022, see OECD/G20 Base Erosion and Profit Shifting Project (2022): Harmful Tax Practices - 2018 Progress Report on Preferential Regimes. Inclusive Framework on BEPS: Action 5. Update (as of January 2022). Available online at https://www.oecd.org/tax/beps/harmful-tax-practices-peer-review-results-on-preferential-regimes.pdf, checked on 21.04.22. Refer to section 2.2 for more information on this matter.

[700] For more information, see Silberztein, Caroline; Bricard, Rémy (2019): Reform of the French IP Regime: Overview of Conditions and Opportunities. In *International Transfer Pricing Journal* 26 (3), P. 205ff.

[701] See the analysis on Clot, Laurence; Springael, Brent (2019): Très Bon: France's Appealing New Intellectual Property Tax Regime. In *Tax Notes International* 95 (1), P. 45ff.

harmful in an international taxation scenario.[702] In addition, the engagement with unilateral measures by Germany was seen by many as hasty given the deadline set by the OECD, even setting up in a way a "BEPS override",[703] encompassing within its framework preferential regimes that are internationally considered admissible.

However, despite the fact that this is a minimum standard provided for in the BEPS project, there was absolutely no binding character in the decisions taken, even if by consensus, and there was no guarantee that all countries – especially those that are not part of the OECD – would (i) reform their rules in time; (ii) refrain from modifying them later on, or (iii) that they will not create other distinct incentive mechanisms that can be considered as preferential regimes in disagreement with the nexus-approach. Thus, the German rule will never completely lose its meaning,[704] and will cause differing impacts considering the way in which the consequences of its triggering are proportionally calculated, as will be seen on the next subsection.

Lastly, another mechanism that precludes the application of §4j EStG that deserves to be mentioned was the wise decision by the legislator to exclude payments covered by CFC rules from the scope of the restrictions on deductions from royalty payments, as was done recently with the Austrian rule. In §4j para. 1 sentence 5 EStG, it is clear that the German CFC rules – provided for in §§7 to 14 German Foreign Taxation Act – have primacy over the application of royalty barriers,[705] *i.e.* the latter will apply if and only if the former have not been so.[706] The purpose of this provision is to explicitly resolve a possible conjugation of these rules, which would lead to an economic double burden to the extent that, on the one hand, it would (partially) prevent the deduction of expenses with royalty payments, and on the other hand that these amounts would be taxed internally by the territorial fiction of a controlled foreign company.[707] This will only be applicable, though, in proportion to the amounts taxed in accordance with the CFC rules, which is

[702] See a recent analysis by Hemmerich, Aaron (2019): Abzugsbeschränkungen im internationalen Steuerrecht. Analyse und Wirkungsvergleich der deutschen und österreichischen Lizenzschranke. In *IStR* (8), P. 294ff.
[703] For more on the usage of this term, see Titgemeyer, Marion (2017): Steuergestaltung bei multinationalen Konzernen: kritische Diskussion der deutschen Lizenzschranke. In *DStZ* 20, P. 749.
[704] On this opinion, see the views of Max, Marcel; Thiede, Jesko (2017): Der Gesetzesentwurf zur Einführung einer Abzugsbeschränkung für Lizenzaufwendungen - "Lizenzschranke". In *StB* (6), P. 177f.
[705] See Loschelder (2022): §4j. In: Schmidt/Heinicke et al. – Einkommensteuergesetz., P. 352.
[706] For the relation of §4j EStG and other German rules, see Kraft (2022): §4j EStG. In: Kanzler/Kraft - Einkommensteuergesetz, P. 587ff.
[707] For a deeper insight into this topic of CFC-rules, see Staccioli (2017): §4j. In: Frotscher (Ed.) - Kommentar zum Einkommensteuergesetz, P. 23ff.

perfectly feasible when considering the structure of the legal consequences of activating the barrier provision.

3.2.2.2.6 Legal consequences

Bearing in mind the previously presented requirements of low taxation arising from a preferential regime, as well as the absence of a system suited to the nexus-approach as an exception to the exception, it will only be possible to deduct royalty payments made to related companies in the manner set out in §4j para. 3 EStG.[708] This will occur independently of an existing double taxation agreement, *i.e.*, the German legislator has expressly provided for the possibility of the infamous treaty override[709] – to be seen in depth in Chapter 4.3 – giving preference to the application of its new anti-BEPS rule.

Unlike the Austrian system, which has a binary system when it comes to whether or not the requirements for applying the rule are met – with a total prohibition of the deduction of the amounts – the German rule is more elaborate and provides a formula for the calculation of the amount affected by the restriction on deductions.[710] Thus, this restriction will be proportional to the value of the tax levied in the country of residence of the payee, so that the higher the value of the tax paid, even if deemed as "low taxation" given the high limit of 25%, the higher the royalty payment quota that can be deducted at the end will be, in the following manner:

$$\frac{25\% - income\ tax\ burden\ in\ \%}{25\%}$$

The non-numerical part of this formula refers to the percentual income tax burden paid by the creditor of the payment in his place of residence, and the result will indicate the share of expenses that are *not* eligible for deduction, in percentage points. Thus, the closer the effective income tax burden is to 25%, the closer to 0% the final result of the non-deductible share of royalty expenses shall be. On the contrary, if the amounts paid in royalties are free of taxation in the country of residence, that is, if their final tax rate is 0%, the formula used will result in all expenses being treated as non-deductible.

[708] Refer to Gosch (2022): §4j. In: Kirchhof/Avvento/Mellinghoff (Eds.) - Einkommensteuergesetz., P. 508ff.
[709] Refer to Moritz/Baumgartner (2022): §4j EStG. In: Bordewin/Brandt (Eds.) - Einkommensteuergesetz. Kommentar., P. 21f.
[710] Such is also the French rule, with an almost identical provision.

It is immediately noticeable that this rule has a much fairer application given its proportionality, avoiding the Austrian stigma of a sharp line while adopting a smoother sliding scale[711]: while its triggering occurs from a relatively high rate, each percent more paid as taxes in the country of residence of the payee is taken into consideration, having, in the end, a direct and proportional impact on the deductibility of the payer's expenses. This German style of structuring the rule, by contrast, is evidently more complex than that of its neighboring country, since it is necessary to determine which tax rate is actually paid in each specific case. Especially problematic might be, as seen above, the cases in which there is a progressive tax rate for royalty revenues – in which it would likely be possible to determine the final income tax burden through an average value – or even when there is a multiplicity of creditors to which different rates apply, where the general rule is to take into account the lowest rate when it comes to royalties for a given intellectual property.[712]

All in all, this restriction on the deduction of royalties based on a proportionality formula is much better directed at combating BEPS that uses preferential regimes, finding a fairer and more considered solution when it is activated. However, much of this legislative technique is for naught, since it affects only such regimes, leaving tax havens aside entirely. Furthermore, contrary to the general purpose of the license barrier, this rule bases itself solely on the abstract interpretation of a foreign preferential regime, not taking into consideration if the business fulfills, on its own, the requirements of substance advocated by the nexus approach.[713] Thus, despite having excellent intentions and a very specific form of calculation, this restriction on the deductibility of royalties is still far from solving the problem in its entirety.

3.2.2.3 Other barriers on the deduction of royalty payments and similar rules worldwide

Considering that the Austrian and German models, alongside the new French one, currently represent in the European Union the major examples of rules established in the form of a barrier in the deductions of royalties, it was expected that other countries within Europe and across the

[711] As discussed previously on Fox, Edward G.; Goldin, Jacob (2019): Sharp Lines and Sliding Scales in Tax Law. In *SSRN Journal*. DOI: 10.2139/ssrn.3339656.
[712] For more on such cases, see Schnitger, Arne (2017): Weitere Maßnahmen zur BEPS-Gesetzgebung in Deutschland. In *IStR* (6), P. 226.
[713] See Greinert, Markus; Siebing, Theresa (2022): Recent Developments on the German License Barrier. In *Tax Notes International* 106 (4), P. 545f.

globe would follow this initiative or, at least, adapt their existing rules in combating BEPS through royalty payments and intellectual property to those models, as was made in France. This actually was and is done in the most different ways, in which the emphasis can be established primarily on preferential regimes – as is the case in Belgium and Germany; on hybrid entities – as in the United States; or with a list of low-tax jurisdictions – as in Luxembourg and Ukraine.[714]

3.2.2.3.1 The vanguard example set by Ukraine

In fact, through the vote on the new tax code in Ukraine passed by the *Verkhovna Rada* (Ukrainian national parliament) as early as December 2010,[715] with most of its provisions coming into force on January 1st, 2011, there were already sightings of rules directed at base erosion and profit shifting that takes advantage of the movability and difficulty of valuation of intellectual property. In this code, the deductibility of royalty payments made to non-residents was restricted to a mere 4% of the revenue from the sale of products and services received in the previous tax year, with a few exceptions in the case of copyright for literary, musical or artistic works, as well as in the area of television and radio.[716]

This legislative technique is even more rudimentary and restrictive than those described above, since it restricts the deductibility to a maximum amount arbitrarily determined by the legislator, depending on the previously obtained profits of the company.[717] It is immediately apparent that this system can lead to enormous injustices given the variable nature of a company's profits each year, causing a large margin of unpredictability and legal uncertainty with the deduction of expenses related to royalties. Moreover, there is a considerable difficulty in

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[714] A detailed analysis of each country and the various models can be found in the Appendix.

[715] The full text is available in english online under https://www.wto.org/english/thewto_e/acc_e/ukr_e/WTACCUKR88_LEG_3.PDF, checked on 25.09.19.

[716] The more "rudimentary" version of a royalty barrier, as mentioned previously. For more information, see RULG - Ukrainian Legal Group (2010): Ukraine: Overview of the new Tax Code. Kyiv & Washington, D.C. Available online at http://www.usubc.org/site/member-news/ukraine-overview-of-the-new-tax-code, checked on 12.08.18.

[717] This method is commonly favored by developing countries, such as Brazil and India, due to its practicality and relative low cost of supervision by tax authorities. Refer to Müller, Sergej (2020): Die Lizenzierung an brasilianische Tochterunternehmen. In *IWB* 3, P. 94ff. for the Brazilian example. More recently, whilst trying to become part of the OECD, it has been suggested that Brazil might readapt its system to a royalty deductibility barrier like the German model. Refer to the talk Receita Federal do Brasil (2022): High-level virtual event - A New Transfer Pricing System for Brazil: For Integration into Global Value Chains and Development Confirmation. Zoom Conference (OECD and Receita Federal do Brasil), 12.04.22.

determining *prima facie* the impact that intellectual property and the royalties resulting from it have on a company's profits, which may represent much more or much less than 4% of its total revenue.

Furthermore, even stricter rules – at times preventing any and all deductions in royalty payments – are applied in the Ukraine in cases where (i) the non-resident receiving the payments has off-shore status; (ii) the non-resident receiving the payment is not the final beneficiary of the royalties; (iii) the royalties paid are due because of an IP that was originally developed or belonged to an Ukrainian; and (iv) the non-resident receiving the payments is not subject to any kind of taxation on these royalties in his/her country of residence.[718]

This "off-shore" status is nothing more than a blacklist established by the Cabinet of Ministers of Ukraine that can be amended when deemed necessary, where jurisdictions considered to be tax havens and generally used for tax-planning purposes are laid down.[719] Thus, Ukraine ensures differential treatment in law for payees who are resident in these tax havens – regardless of their individual behavior in the country – as well as for those who reside in jurisdictions in which they are not subject to any taxation. It also deals quite brutally with the possibility of employing an intermediary who will pass on the payments to third parties to circumvent the rule, preventing promptly the deduction in such cases. Finally, in the case of intellectual property developed by a Ukrainian who transfers it to a non-resident and then licenses it internally, it is assumed immediately that such is an aggressive tax planning scheme, and the possibility of deduction of royalties is also instantly restricted.

In some situations, the payer is allowed to present proof that the amounts paid are in arm's length to rule out the application of the restriction on deductibility. While the possibility of presenting evidence to the contrary is to be welcomed, this evidence is, however, not possible in several cases, given the unique character of intellectual property and the common disconnection

[718] For further detail, please see PwC (2018): Ukraine Corporate Deductions (Worldwide Tax Summaries). Available online at http://taxsummaries.pwc.com/ID/Ukraine-Corporate-Deductions, checked on 20.06.19.

[719] Much like the European system of blacklisting non-cooperative jurisdictions. Some EU countries such as Germany have proposals for similar legislation, see for instance Werthebach, Felix (2021): Erste Anmerkungen zum Entwurf eines Steueroasen-Abwehrgesetzes (StAbwG). Neue Details zur Undertaxed Payments Rule und zur Subject-to-tax-Klausel. In *IStR* (9), P. 338ff.

between the amount invested in its research and development and the final financial returns arising from it.[720]

3.2.2.3.2 The United States and its *sui generis* rules

Meanwhile, on the other side of the globe, in the United States, with the approval of the Tax Cuts and Jobs Act of 2017,[721] some modifications were also made in order to curb aggressive tax planning practices and BEPS that make use of intellectual property. One of the most notorious rules associated with barriers to the deduction of royalties is the limitation on deductions for interest or royalties paid to hybrids in the new section 267A of the US Internal Revenue Code.[722] This rule prevents any deduction of royalties paid between disqualified related parties pursuant to a hybrid transaction by, or to, a hybrid entity.[723]

The term "disqualified" related party indicates that not only must these parties be parts of the same group under United States law in section 954(d)(3), but also that (i) the amount paid is not included in the income of such related party under the tax law of the country of which this related party is a resident for tax purposes or is subject to tax, or (ii) such related party is allowed a deduction with respect to such amount under the tax law of such country. A hybrid transaction, on the other hand, represents any transaction in which there is an asymmetric classification of the revenue – for example, it is regarded as royalties in the USA and as another form of revenue in the payee's country of residence. Finally, a hybrid entity represents an entity that is treated as fiscally transparent under the laws of one of the two countries (be it the USA or the country of residence), that is, as an entity where the taxation is due at the level of the partners, and not its own; while it

[720] More on arm's length and IP has been discussed and can be seen under Section 2.1.1.
[721] Available online under https://www.govinfo.gov/content/pkg/PLAW-115publ97/html/PLAW-115publ97.htm, checked on 26.06.19.
[722] For more information on tax planning opportunities with IP in the US and the functioning of this rule, refer to Fassu, Franck (2021): Deductibility of Royalty Payments to Foreign Affiliates. In *Journal of International Taxation* (4), P. 45ff. This is much like the UK diverted profits tax, see HM Revenue & Customs (2018): Diverted Profits Tax: Guidance. Available online at https://assets.publishing.service.gov.uk/government/uploads/system/uploads /attachment_data/file/768204/Diverted_Profits_Tax_-_Guidance__December_2018_.pdf, checked on 18.12.19; and Baker & McKenzie (2015): UK Tax Development Update. Diverted Profits Tax. Available online at https://www.bakermckenzie.com/-/media/files/insight/publications/2015/01/diverted-profits-tax/files/read-publication/fileattachment/ar_london_dpt_jan15.pdf, checked on 18.12.19.
[723] For more information, see Rödl & Partner (2018): Limits on Deductions for Interest or Royalties Paid to Hybrids (Tax Reform: Key Business Tax Provisions). Available online at http://www.roedl.net/us/tax_reform/key_business_tax_provisions/limits_on_deductions_for_interest_or_royalties_paid_to_hybrids.html, checked on 15.08.18.

does not receive the same treatment in the other country, being considered a body different from its partners with its own individual taxes.[724]

As it has been drafted, the struggle against BEPS occurs only to the extent that these hybrid structures are part of aggressive tax planning, leaving eventual preferential regimes and some tax havens beyond its framework. This is probably because the U.S. stance so far has been to encourage the use of intellectual property and to allow greater competitiveness in the global market for their domestic companies.[725] This is confirmed, for example, by the introduction of other rules parallel to this restriction on deductions in the Tax Cuts and Jobs Act, such as the Foreign Derived Intangible Income (FDII), which behaves in a similar way to an IP-Box, although it is not considered as such by part of academia,[726] reducing the effective tax rate of corporate tax based on the use of intellectual property at national level for foreign trade, encouraging the IP as a value to remain in US territory.

There is also a concern that the rule restricting deductions is very broad in the treatment of hybrids, while leaving out other relevant hypotheses. Theoretically, the Secretary of the Treasury is free to broaden the scope of the rule where necessary and to create exceptions in cases where there is proper taxation.[727] However, there is no guarantee if and when this will be done, and to what extent.

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[724] For further definition of hybrid entities, please see Parada (2017): Double non-taxation and the use., P. 116ff.

[725] What has been consistently exploited by American companies, as seen in Grubert, Harry (2012): Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, are Being Globalized. In *National Tax Journal* 65, P. 247ff, which has led to huge revenue losses as shown by Clausing, Kimberly A. (2016): The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond. In *National Tax Journal* 69 (4), P. 919. These new rules represent a shift in the American take on the international taxation of intellectual property, with an intended policy goal of location neutrality, which is the US corporations' indifference from a tax perspective on where they hold their IP, as seen in Foster, Emily L. (2019): TCJA Incentives to Locate IP in U.S. Working for Some Companies. In *Tax Notes International* 93 (10), P. 1122–1124.

[726] For more on this opinion and the relation to the German „Lizenzschranke", see Port, Christian; Heusel, Ruben (2018): US-Steuerreform: FDII in Kürze erklärt. In *Kompass*. Available online at http://www.bakermckenzie-kompass.de/us-steuerreform-fdii-in-kuerze-erklaert/, checked on 29.10.18; and Kahlenberg, Christian (2020): Das neue BMF-Schreiben zu §4j EStG als Arbeits- und Entscheidungshilfe. In *Praxis Internationale Steuerberatung* (05), P. 131f. A final decision has not been made by the German Ministry of Finances on this matter, Greinert, Markus; Karnath, Susan; Siebing, Theresa (2020): Germany's License Barrier Rule and Its Application of the Nexus Approach for Preferential Tax Regimes. In *Tax Notes International* 98 (3), P. 344f; although some do see the possibility for the non-application of the German license barrier concerning the FDII, as Rennar, Thomas (2022): Lizenzschranke bei Outbound-Betriebsstätten in den USA. Zukünftige Nexus-Exkulpation nach § 4j EStG auch in USA-Besteuerungsfälle? In *IWB* (7), P. 256ff.

[727] For more information, see KPMG LLP (2018): KPMG Report: Initial impressions, proposed regulations implementing "anti-hybrid" provisions of new tax law. KPMG. Available online at https://tax.kpmg.us/content/…/tnf-hybrid-regs-dec21-2018.pdf, checked on 26.06.19, P. 2.

Other rules introduced through this US tax reform in 2017 that deserve some attention are the Global Intangible Low Tax Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT), which are of great influence on the OECD GloBE proposal project.[728] Despite not dealing with the deductibility of royalties, the former has the noble intention of avoiding the flow of US intellectual property abroad, through the establishment of a minimum tax on foreign profits. Thus, it is an anti-BEPS provision that would ensure a minimum taxation ranging between 10.5 and 13,125% in cases where an investment of assets abroad brings a return greater than 10% of the amount invested – which would be a proxy to determine the use of intellectual property, reinforcing what had been previously asserted on its mobile nature and the difficult measurement of its real value and of the return obtained. However, there is an exemption for the returns of real investment, in order to avoid distortions in the investments of U.S. companies abroad.

Even though it has good intentions, this provision has been criticized for not working as expected, despite its attempt to balance concerns about base erosion on the one hand, and eventual hindrances to investment that may arise from such anti-avoidance measures on the other. The biggest problem occurs in the interaction with other US tax rules, which ends up excessively increasing the portion of revenues that is considered as foreign income, causing the rule to be activated even in cases in which the amounts are duly taxed abroad, thus leading to international double taxation. This rule will not, however, be a specific focus of the present work, firstly because it is a regulation that deals with *outbound* cases, *i.e.*, companies that have their residence in a certain country, but earn profits abroad. This thesis focuses as stated on *inbound* cases, in which base eroding royalty payments are sent abroad by local affiliates to their respective parent companies. Furthermore, given its atypical nature considering the US tax model, which would contribute little to determine a general international model to combat BEPS that makes use of intellectual property; and the evident recognition by the doctrine of immediate need for reform for the GILTI rule to achieve its objectives in a more efficient and coherent manner – being considered by some as a mistake of the US National Congress[729] – this topic will not be further discussed.

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[728] See Avi-Yonah, Reuven (2020): Constructive Dialogue: BEPS and the TCJA. In *International Tax Journal* (march-april), P. 25ff. and refer to Chapter 3.4 for more information. For a comparison on both systems, see Kim, Kyungjin; Billings, B. Anthony; Mitra, Santanu (2022): The OECD's Global Minimum Tax and GILTI: A Comparison. In *Tax Notes International* 105 (4), P. 417ff.

[729] For more on this opinion and on the GILTI rule, see Pomerleau, Kyle (2019): What's up with Being GILTI? The Tax Foundation. Available online at https://taxfoundation.org/gilti-2019/, checked on 27.06.19.

The BEAT rule, however, is much closer to a royalty deductibility barrier – even though it is not identical to the denial of a deduction[730] – as it acts as a minimum tax add-on as an *inbound* rule, adding back and taxing the deductible payment made by a multinational corporation to an affiliate in a low-tax country. This will apply only to large multinational enterprises, that is, those with gross receipts of more than $500 million (on a 3 year average) *and* if these deductible payments make up for more than 3% of base erosion within the company.[731] This shows, much like the GloBE proposal that will be discussed later, an attempt to prevent the regular occurrence of BEPS and profit shifting,[732] showing a tendency toward cooperation in contrast to the simultaneous reduction of the corporate tax rate to 21%, in a competitive stance.

Like the royalty deductibility barriers, this measure has stirred much skepticism regarding its compatibility with treaty law and even WTO law.[733] But more than that, the BEAT was structured as an alternative tax to the income tax, and this design choice was seen as both over-inclusive and under-inclusive,[734] which currently has brought up discussions about a replacement for the BEAT, the Biden SHIELD proposal – the "Stopping Harmful Inversions and Ending Low-Tax Developments" , all very catchy names. This rule would truly be a royalty deductibility barrier, in that it would stop royalty payments from being deducted, and not impose a minimum tax. Like the BEAT, it would apply to related-party cross-border payments only, insofar as they are below a certain threshold,[735] resembling greatly the undertaxed payments rule of the OECD GloBE

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[730] For more information on the functioning of this rule, see Avi-Yonah, Reuven (2018): Beat It: Tax Reform and Tax Treaties. In *University of Michigan Law & Economics Working Papers* (Research Paper nº 587), P. 3f; and Rosenbloom, H. David; Shaheen, Fadi (2018): The BEAT and the Treaties. In *Tax Notes International* 92 (1), P. 53–63. DOI: 10.2139/ssrn.3229532.

[731] Refer to the many works on the topic of Elliot, Carrie Brandon (2020): Beat the BEAT, Part 2: Partnership Antiabuse Rules. In *Tax Notes International* 97 (4), P. 359. The problem with this threshold is that it would in some cases allow for a waiving in deductions of base eroding payments to lead to a reduction in tax liability to circumvent the 3%. See Elliot, Carrie Brandon (2020): Beat the BEAT: Waiving Base Erosion Deductions. In *Tax Notes International* 97 (3), P. 236f; and Elliot, Carrie Brandon (2020): Proposed BEAT Regs Clarify Aggregate Group Rules. In *Tax Notes International* 97 (2), P. 127ff; as well as Lipeles, Stewart; Maydew, Jeff; Weber, Julia; Odintz, Joshua; Minkovich, Alexandra; Rimpfel, Katie (2020): The Final and Proposed BEAT Regulations: A Favorable Turn. In *International Tax Journal* (march-april), P. 41ff.

[732] As indicated by Moyal, Shay (2020): Don't Stop the BEAT. In *Tax Notes International* 97 (5), P. 534ff.

[733] Refer to Chapters 4.3 and 4.4 for more information on these limitations. See also Kysar, Rebecca (2018): Will Tax Treaties and WTO Rules 'beat' the BEAT? In *Columbia Journal of Tax Law* 10 (Tax Matters 1).

[734] Underinclusive because it did not cover cost of goods sold payments; overinclusive because of its failure to distinguish between base-eroding payments made to low-tax affiliates and those made elsewhere. See the criticisms made by Velarde, Andrew (2021): BEAT Being Both Over- and Underinclusive Led to Treasury Rebuff. In *Tax Notes International* 102 (10), P. 1396ff.

[735] Finley, Ryan; Johnston, Soong Stephanie (2021): Biden Administration's 'SHIELD' Proposal Would Replace BEAT. In *Tax Notes International* 102 (2), P. 257ff.

proposal,[736] but operating independently, *i.e.* without regards for the results of multilateral discussions.[737]

3.2.2.3.3 Further examples from individual countries

It is also worth highlighting the recent attempts by India to include in its legal system a rule that aims to restrict the possibility of making royalty payments abroad in any amount. Similar to the Ukrainian structure, the intention would be to prevent payments above a certain percentage of the revenue obtained by the company in its domestic sales and/or exports from being made, so that there is no undue flow of profits abroad by cause of intellectual property – especially through trademarks and brand names. According to the proposal, under discussion since mid-2018,[738] these payments will be capped at 4% of domestic sales and 7% of exports for the first four years, being gradually reduced in three-year periods until reaching the very low final level of 1% of sales and 2% of exports of an entity.

Despite the fact that a consensus has not been found to date with respect to this regulation, as it has suffered resistance not only from the market, but also from the Indian Ministry of Finance, there is wide acceptance in the country of the importance of its implementation. This is because, since 2009, there has been an exponential and unrestricted growth in India of this type of transaction with royalties, leading the government to set-up an inter-ministerial group to determine the impacts of this surge in royalty outflow, and whether or not there is an excess of payout from companies located nationally to international partners. Thus, the ultimate purpose of the restriction is to avoid that royalty payments abroad are made in excess, transferring eventual profits obtained in Indian territory and market to countries with low taxation.[739]

However, it is easy to see why the implementation of this rule is suffering so much resistance from the market, since it establishes a maximum – and extremely low – arbitrary rate so

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[736] See, after a very long digression on dogs, Sheppard, Lee A. (2021): SHIELD and GLOBE Treaty Issues. In *Tax Notes International* 102 (13), P. 1737ff.
[737] For more on this issue, refer to Chapter 3.4
[738] For more information, see the reports on The Times of India (2018): Govt considering restrictions on royalty payments. Available online at https://timesofindia.indiatimes.com/business/india-business/govt-considering-restrictions-on-royalty-payments/articleshow/65212638.cms, checked on 03.08.18.
[739] See Upadhyay, Jayshree (2019): Sebi's plan to restrict royalty payments to 2% runs into hurdles. Available online at https://www.livemint.com/companies/news/sebi-s-plan-to-restrict-royalty-payments-to-2-runs-into-hurdles-1556255544749.html, checked on 18.05.19.

that royalty payments can be sent to companies abroad. Although most of the companies affected are from the telecommunications and automobile industries, it is difficult to evaluate the impact that this may have on different business models that are more dependent on intellectual property, especially multinational companies and in the technology industry. Thus, although effective in avoiding BEPS, it excessively limits international trade and investment possibilities in an arbitrary manner, perhaps requiring a more refined and specific rule to be equally effective, efficient and fair.

Finally, some more recent, relatively successful implementations worth mentioning were made by Mexico and Luxembourg. The latter is a very similar rule to those seen previously in Germany and Austria, as it is a disallowment of the deduction of royalties paid or owed by Luxembourg corporate residents to related enterprises established in a jurisdiction or territory included in the EU list of non-cooperative jurisdictions.[740] Thus, the final criterion is the mere inclusion in the list – already extremely restricted – and not any criteria of effective taxation. This reveals a tendency of Luxembourg to do only the minimum required by the European Union, which was reproaching the country for the non-adoption of defensive measures *vis-à-vis* the listed jurisdictions. The former, Mexican rule, is a premature implementation of the standard proposed by the OECD in its GloBE pillar 2 works,[741] denying the deductibility of any payment – including royalties – made to a related party subject to a low effective tax rate. This provision will therefore disallow deductions based solely on low taxation, the threshold being of 75% or less of the income tax that would originally have been paid nationally.[742] Even though Mexico has had a similar rule for decades in its income tax code, it would only apply to non-arm's length payments, which clearly shows the need for more than just TP rules to deal with this issue.

In both rules, deduction will not be denied if there are valid commercial reasons present, a common and understandable feature of such rules that, unfortunately, undermines its effectiveness

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[740] Pouchard, Alex (2020): A Closer Look at Luxembourg's Nondeductibility Of Payments Draft Law. In *Tax Notes International* 98 (6), P. 632f. This is very similar to the system currently under implementation in Germany, as seen in Eberhardt, David (2021): Der Regierungsentwurf des Steueroasen-Abwehgesetzes. Ein Überblick. In *StuB* (8), P. 317ff. Considering its very restrictive scope of application, its usefulness is quite limited.

[741] Both rules attempt to prevent BEPS through intragroup deductible payments, even though there are some slight differences in implementation so far, as the Mexican rule mirrors the Austrian provision by denying the full deductibility once the rule is triggered. Refer to Brandt, Eduardo; Avalos, Susana Jimena (2021): Mexico's Undertaxed Payment Rule and Its Interplay With FDII, GILTI, and Subpart F. In *Tax Notes International* 101 (13), P. 1676ff.

[742] van't Hek, Koen (2020): Mexico Introduces 'Undertaxed Payments Rule' Based on OECD's Pillar 2. In *Tax Notes International* 98 (7), P. 821ff.

in fighting off aggressive tax planning strategies. These rules also have other very clear problems and limitations. While the Luxembourg rule is limited only to those cases included in the EU blacklist, the Mexican rule may be considered premature because it was implemented just before the deadline for the GloBE proposal discussions, and does not have any of the design features of the OECD model such as *de minimis* rules, substance carve-outs and rules that aim to reduce compliance costs and facilitate administrative analysis of effective tax rates.[743]

It is interesting to note that, in spite of all these rules having the same purpose, being linked to royalty payments, restrictions and their deductibility in national tax law, they have very different ways of operation. Its emphasis, depending on the legislator's intention, may be on the broader fight against BEPS, regardless of possible impacts on investments and market reactions; or on the specificity of the rule, narrowing its scope of application as much as possible so that only the cases in which there are strong indications of (undesirable) aggressive tax planning schemes are covered by the rule. In this sense, it should be noted that each country has different priorities regarding such tax planning, placing either preferential regimes, hybrid entities or low tax jurisdictions at the forefront of its royalty barriers. This allows us to better understand the distinct arrangements available for this type of rule and the logic behind them, so that, in the end, the ideal model for each can be found.

3.2.2.4 Interim conclusions on royalty payment deduction barriers

After an in-depth analysis of the functionality of a royalty payment deduction barrier, as well as its effectiveness based on practical examples already implemented in different countries, it can be perceived that, ultimately, this method of combating artificial profit shifting resembles economically – as a result of its practical tax consequences – a withholding tax on the outflow of royalty payments. This occurs due to the fact that, if the deductibility of the sums at the source country level is denied, the payment of royalties will be subject to taxation by the payer and subsequently by the payee at the level of his residence country.

However, this methodology has two relevant distinctions in relation to a withholding tax: firstly, there is, in general, no opportunity to use the payment of taxes on non-deductible amounts

[743] They do present, however, many similarities with the current GloBE project. For more information on this and further similar rules to the UTPR, refer to Morales/Popa (2021): The Undertaxed Payments Rule. In: Perdelwitz/Turina (Eds.) - Global minimum taxation?, P. 138ff.

as credits in the country of residence of the payee, commonly leading to double taxation; and secondly, while the economic aspects are similar between these two systems, since royalty barriers function as a restriction for the deduction of certain expenses in respect to the *full tax liability* of the payer, this rule falls legally within the scope of residence-based tax and the principle of territoriality, only indirectly related to the one receiving the payment.[744]

In particular this last aspect has great relevance for the jurisprudence of the European Court of Justice, which in its decisions on the Interest and Royalties Directive made it clear that the scope of application of this directive is restricted to a taxpayer with limited tax liability.[745] Thus, it can be seen that the implementation of a restriction on the deductibility of expenses with royalty payments actually has a historical background of trying to circumvent European secondary legislation when compared to WHT, considering the restrictions the former has. The idea that these rules would apply to both national and cross-border cases was, in the European designs implementing the rule, only a fiction that aims mainly at avoiding the constitution of a discrimination in relation to international trade within the single market, which would in turn be a violation of European (primary) law.[746]

Yet this system is relatively simple to implement and apply – depending on the design of the rule – and is a unilateral measure that is extremely effective in achieving its objectives, since it will ensure a minimum level of taxation at the level of the payer based on the tax due by the payee. Especially when it comes to a restriction proportional to the deductibility of royalties, the problem of double taxation can be greatly diminished. Notwithstanding, the criteria to determine what will be considered a fair level of taxation are extremely sensitive, and any structure that does not take into account the *de facto* situation of companies that develop economic activities is reprehensible. Thus, legislation that does not observe the reasons why a tax relief or a differentiated tax rate for intellectual property was granted, as well as the company's relative market position in respect of these rates ends up leading to a general presumption of abuse,[747] which hits international

[744] For more information on this opinion, see Hemmerich, Aaron (2019): Abzugsbeschränkungen im internationalen Steuerrecht. Analyse und Wirkungsvergleich der deutschen und österreichischen Lizenzschranke. In *IStR* (8), P. 296.
[745] This will be discussed in depth in Chapter 4.
[746] For more, see Peyerl, Hermann (2014): Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern. In *ÖStZ* 314, P. 225.
[747] Which can, by itself, be hard to justify under EU law. For more information, see Chapter 4.2.

structures that have a rational justification with a heavy restriction on the deductibility of business expenses.

That being said, it should be noted that even rules that take into account the specifics of each case end up reducing the consistency and internal coherence of the tax system of a country as a whole. This occurs due to the existence of an exception for the deductibility of expenses with payments that, as a rule, should occur, but which, due to external factors – such as the level of taxation of the recipient of the payment – is denied to the taxpaying licensee. This will usually have negative impacts on the level of investment because it is treated, in a way, as an extension of source taxation. This can be proven both theoretically as well as empirically in the case of a tax definitively levied at source without any kind of compensation in the residence country of the payee.[748]

With the reduction of the tax profitability of investments in a country that introduces such a rule, it is important to carry out a tailored, in-depth economic analysis prior to implementation in order to determine the feasibility of the measure: since, although probable that the national tax revenue will increase, in the long run it is possible that R&D investments and the production of value and revenue within the country will be lost.

Therefore, it is necessary to find a balance between the anti-BEPS character of the measure on the one side, and the eventual impacts it can have on the economy on the other side, as well as the balance of the final tax collection that will occur. Therefore, if a rule that restricts the deductibility of royalty payments as a method to combat aggressive tax planning with intellectual property is decided upon, it is essential that this rule (1) clearly stipulates which criteria lead to non-deductibility, so that it is restricted to situations of "harmful tax practices"; (2) that both tax havens as well as countries that have some kind of preferential regime disconnected from economic substance are covered by the rule, but allowing proof of the contrary by the taxpayer; and (3) that the consequences of the activation of the rule are proportional and gradual, in order to avoid double taxation as best as possible and ensure fairness and less negative economic impacts in its

[748] For more information, see Fuest/Spengel/Finke/Heckermeyer (2013): Profit shifting and "aggressive" tax., P. 14. Economic data on this matter can be read on Vilsmeier (2016): Die Nutzung von immateriellen Wirtschaftsgütern., P. 252ff.

application, whilst offering strong impediments or disincentives for base erosion and profit shifting with royalty payments.

Moreover, it should not be forgotten that this rule should always be developed and analyzed in correlation with any other rules or systems that may have any kind of overlapping in the fight against BEPS. This holds especially true for those developed at the international level, such as the GloBE proposal[749] and the Anti Tax-Avoidance Directive (ATAD)[750], which may, on one side, establish the very mechanisms of implementation and design of the rule; but, on another, side run the risk of generating asymmetries and legal insecurity in the hypothesis of concomitant implementation of bi- or plurilateral international criteria and the unilateralism of the royalty deduction barriers seen until now. In some cases, one might even speak of the replacement of one regulation by another entirely,[751] depending on what the future of international taxation holds for royalty barriers.

Although in the last two decades the introduction of limitations to the deductibility of interests has become relatively common,[752] we still have few practical examples of rules that promote the non-deductibility of royalties, since many of the countries have decided to adopt a different – but actually not excluding – stance: that of attracting investments as well as of promoting research and development of intellectual property through IP-Boxes. Considering the experience of unilateral implementation of this type of measure, it is safe to say that one of its greatest risks is the occurrence of double taxation, which could unduly harm this sector. Hence the importance of outlining the rule with well-defined contours, since there is no contraindication or impossibility of simultaneously promoting the development and use of intellectual property with a license box and to combat the artificial profit shifting resulting from royalty payments that abuse said structures, as seen by the recent German initiatives[753] in both directions.

Certainly, the barriers to the deduction of royalty payments show promise and have great potential in the fight against base erosion and profit shifting. However, the design of the rules

[749] Discussed in depth on Chapter 3.4.
[750] Seen further on Chapter 4.2.1.2.
[751] For more information on this discussion, see Loose, Thomas (2019): Status Quo und Zukunft der Lizenzschranke. Was folgt noch aus Aktionspunkt 5 des BEPS-Projekts? In *IWB* 17, P. 687ff.
[752] For more data, see Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 35.
[753] See, for instance, Bärsch, Sven-Eric; Barbu, Yannick (2020): Germany Introduces Long-Overdue R&D Tax Incentives. In *Tax Notes International* 97 (10), P. 1077ff.

implemented in practice so far has left much to be desired. Thus, we will briefly turn our eyes to different approaches for the resolution of this same problem, in the form of the proposal of an inverted tax credit system.

3.3 Inverted tax credit system as an alternative pathway

Of the measures studied so far, the most peculiar is certainly the one proposed by the Swedish professor Sven-Olof Lodin, who seeks a far greater paradigm break to deal with the problem of BEPS that takes advantage of intellectual property. His ideas were initially presented for discussion as a solution to intra-group loans in a scientific paper[754] in 2011, which after receiving broad feedback and criticism, was presented in a second, complementary paper[755] that expanded its plan of action to royalties as well, at the end of 2013, giving his theory the name it has today of an *inverted tax credit*.

By envisaging transactions that include intangibles between companies of the same business group as a key pressure area; as well as international profit shifting as a large-scale crisis that increasingly exploits innovative methods to artificially transfer profits from a high-tax country to a low-tax country using intangibles, Lodin sought a solution entirely different from the ones seen until now.

3.3.1 General characteristics

The overall proposition of this innovative system is to provide a solution to the problem that is at the same time effective and compatible with both European legislation and the OECD model tax convention on income and capital. This would be achieved by completely revamping the deductions system, in which instead of allowing the deduction of royalty (or interest) expenses, legal entities would receive a tax credit at the exact value of the corporate tax rate of the country seeking the implementation of this system. The final economic consequence of this change would initially be null, since the tax credit would have an identical effect to the deduction of expenses –

[754] Lodin, Sven-Olof (2011): Intragroup Lending in Sweden - A Vehicle for International Tax Arbitrage. In *Tax Notes International* (62), P. 177–180.
[755] Lodin, Sven-Olof (2013): Intragroup Royalties as Vehicles for International Tax Arbitrage. In *Tax Notes International* (71), P. 1317–1319.

even in the case of losses, allowing the credit to be used in subsequent periods if it cannot be used in its year of issue, carrying it forward. Thus, any expenses arising from the payment of royalties will be taxed by the tax authorities as if they had not been expenses; however, they will be offset through the granting of this tax credit.

Initially, there would be no apparent significant change in the cases of taxation of companies of the same corporate group resident in the country where this provision is implemented; as well as in the case of royalty payments being made to a company resident in a country with a corporate tax rate equal to or higher than that of the implementing country – since the maximum amount for issuing a tax credit will usually be limited to a country's own tax rate. However, the major distinction would be in cases where this payment was made into a country with a tax rate *lower* than the corporate tax rate of the country of residence of the payee, since this system would allow the granting of a tax credit of a maximum amount equal to the tax rate due by the payee on the amounts received. Thus, if a company resident in a country with a corporate tax rate of, say, 25% makes a royalty payment to another company of its own business group resident in a jurisdiction with a tax rate of 25% or higher, the value of the tax credit will be identical to this, compensating it fully. Nevertheless, if the payment is made to a company resident in a country with a corporate tax rate of *e.g.* 12.5% for this kind of income, the tax credit will be limited to this amount.

The logical consequence of this system is the achievement of tax neutrality within the business group, as there will be a compensation of the tax due by the payer on the basis of the amount due by the payee in his country of residence. Thus, the final amount paid by the consortium of companies would be the same as if payee and payer were residents of the same country that implemented this rule, whose amount due would be equal to its respective corporate tax rate.[756]

It is important to highlight that this rule, unlike the restriction on the deductibility of royalties previously seen, does not figure as an anti-tax avoidance regulation as such, that restricts the deductions of expenses with royalties in some cases, but rather a regulation that completely changes the way to treat the deductibility of this type of business expense, unrestrictedly to be applied to all transactions of royalties between legal entities.[757] This would also be somewhat

[756] *Ibid*., P. 1319.
[757] *Ibid*., P. 1318.

necessary to avoid the incidence of discriminatory effects of the rule, allowing it to act both in transactions between unrelated parties and between related parties; as well as transactions of a national or international nature, in which minor distinctions could be used to the extent that they are necessary to avoid tax arbitrage.

With the implementation of this structure there will be no tax advantage to be gained from paying a royalty to a company in a low-tax country, eliminating altogether any incentive for royalties to be sent to a tax haven. At the same time that this result is partially desired, as it tackles BEPS extremely effectively, it is questionable how viable a measure is that in an unilateral manner virtually eliminates any kind of international tax competition by leveling the tax rate charged in a corporate group by the corporate tax rate of the country that implements this rule. Despite the fact that, in theory, an inverted tax credit system sounds extremely appealing, it is necessary to be very careful in its design in order to determine beforehand the eventual fiscal and economic consequences of its operation, especially since there has not yet been any *de facto* implementation of this type of measure.

3.3.2 Practical application

The practical implementation of this tax credit system would allow the elaboration of a scheme that not only avoids the occurrence of double taxation – which in itself is quite an achievement – but also allows the residence country to fully maintain its taxing rights, thus avoiding losing any tax revenue as long as the business behavior is not changed after the enactment of the new rule.[758] The situation of the source country adopting the inverted tax credit, however, is quite different, since it would only have some kind of tax revenue in case the payment is made to a country that has a corporate tax rate lower than its own. If this payment is made to a country with a higher tax rate instead, the full amount of the tax will be offset internally in the source country through the tax credit.

Precisely because of this function, nevertheless, one of the main functional weaknesses of this system is the well-known possibility for the business group to control the value of the tax credit to be granted – normally as high as possible – through the interposition of an intermediary

[758] For a deeper analysis on revenue impacts, see Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 15f. and 33ff.

company resident in a country with high taxation to receive royalty payments,[759] one that does not have efficient anti-avoidance rules or an inverted tax credit system. To prevent this, there are two significant possibilities: (a) that this system is not only unilaterally implemented but is also functional in other high-tax countries; and/or (b) that the granting of the tax credit is restricted to the rate due by the final beneficiary of the royalty payment.

Both solutions to the problem of interposition of an intermediary company have their own difficulties. The need for multilateral implementation – at least for countries with a high corporate tax rate – defeats the purpose of having a rule of relative ease of implementation and immediate results, since achieving consensus on this type of measure is invariably challenging. This is aggravated by the fact that this proposed system makes taxation in the source country definite,[760] which especially reduces the attractiveness as a business location for these high-tax countries, considering that any step that decreases the possibilities for profit shifting, resulting in a higher final tax burden than the original one, may lead to changes in corporate structure (and location) in order to obtain tax advantages. This applies, of course, to a greater or lesser extent also to the other viable solutions to the problem, however an inverted tax credit system would *always* lead to final taxation based on the local corporate tax rate, which can represent, in some cases, a tremendous increase in the overall tax burden in a business group. This would result almost in a comprehensive requirement for high-tax countries to also have to implement the measure for it to be effective – or at least to significantly increase the efficiency of this system as a whole.[761]

Conversely, in order to restrict the granting of the tax credit to the rate due only by the *final* beneficiary of the payment, a high level of information exchange and clarity in the business structure is needed. Frequently, the payer will not even have the necessary information to provide, and there is no clear incentive like in the case of a punitive withholding tax or in the conditional triggering of a barrier to the payment of royalties, where the licensee directly suffers the consequences of the rule, for the information to be diligently provided. Lodin points out, however, that in the specific case of royalties it would be easier to keep track of the payment trajectory – at least in comparison with interests – since there are greater difficulties in structuring chain

[759] Very similar to the problematic on a withholding tax as a subject-to-tax clause. See Section 3.1.2.2.2 for reference.
[760] See Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 16.
[761] See Lodin, Sven-Olof (2011): Intragroup Lending in Sweden - A Vehicle for International Tax Arbitrage. In *Tax Notes International* (62), P. 180.

transactions with royalties, and it would be in any event necessary that the royalty payer can prove that the one who receives the payment is the IP owner and that he is therefore entitled to receive the payment.[762] It is not clear though what would the consequences be for the tax credit in the event that the payer cannot indicate the final recipient of the payment.

A viable solution to this particular problem could be a complete restriction on the granting of a tax credit in the event that a payment is made to an intermediary, *i.e.*, a conduit company that is not the owner of the intellectual property. This harsh consequence could be mitigated by the possibility of the payer providing evidence to whom the final recipient of the payment is – and the corporate tax to which he is subject – at any time, possibly even with a retroactive effect. This approach may, of course, put at risk one of the greatest advantages of the inverted tax credit system so far: that of preventing double taxation. By denying the granting of a tax credit for a payment made to a company resident in a high-tax country under suspicion of being a mere structure to circumvent the rule, royalty payments run the risk of being doubly taxed. Thus, in an ideal world, the implementation of this measure would take place multilaterally at least between high-tax countries of the European Union and the OECD to avoid the problem of circumvention of the rule. But then again, we are far from an ideal world when it comes to international taxation.

3.3.3 Juxtaposition with other systems

Considering that the answers provided so far are far from an ideal solution to the present problem of profit shifting through royalty payments, in addition to the fact that this inverted tax credit system model has not yet been implemented on a practical level, it is necessary to compare the advantages and disadvantages of this proposition with the others. This becomes even more evident when one realizes that Lodin's proposal has many similarities – and at the same time fundamental distinctions – with systems already discussed by the academia and legally introduced.

In light of the Austrian rule restricting the deductibility of royalty payments as business expenses of §12 para. 1 Nr. 10 KStG, for example, the inverted tax credits model works as a more general version of the rule, changing the paradigm of the usual deduction of expenses sided with an eventual prohibition as an exception in the case of intra-group payments to parent companies

[762] Lodin, Sven-Olof (2013): Intragroup Royalties as Vehicles for International Tax Arbitrage. In *Tax Notes International* (71), P. 1318.

on low-tax jurisdictions; to a general non-deductibility regime applicable to different types of payments made both nationally and internationally, be it between companies within the same corporate group or not.[763] This certainly contributes greatly towards ensuring that the unilateral implementation of this type of measure is not deemed to be discriminatory, since it is applied in an unrestricted manner and compensated on the basis of the tax credit.[764]

An even closer parallel can be made with the rule of the same nature introduced by Germany through §4j EStG, since the non-deductibility by the German rule is proportional to the low tax rate arising from a preferential regime in the country of residence of the payee, just as in Lodin's system the amount of the tax credit in that type of international transaction is based on the corporate tax rate to which the payee is subject to. In addition, in the event that the payment is made to a country where taxation is higher than in the source country, the payment will be fully deductible/creditable, leading in practice to the same result. Therefore, despite the inverted tax credit system, as mentioned above, not being an anti-avoidance rule *per se*, but a complete modification of the framework on expenses deduction, in some cases the economic burden will be identical to that of the German royalty barrier system, and generally lower in the case of triggering of the Austrian rule, given the absolute character of prohibition on deductions of the latter.[765]

Moreover, when discussing the issues surrounding withholding taxes and making a parallel with the system advocated by Lodin, it is clear that one of the major problems with the withholding idea is a possible double taxation caused by the absence of compensation from the residence country of the payee.[766] An inverted tax credit system is the ultimate implementation of a compensation regime, since the source country takes responsibility for offsetting any tax paid by the payee through the tax credit in its own hands, thus seeking to ensure that the maximum amount paid by the business group remains the same regardless of the country of residence of its parties.

Even so, economically, countries that have a higher corporate tax rate would benefit more from the implementation of this rule and consequent granting of tax credits, significantly

[763] For more information on this idea, see Drummer, Verena (2017): Lizenzschranke: Abzugsbeschränkung vs. Tax Credit aus EU-Rechtlicher Sicht. In *IStR* (15), P. 604.
[764] A deeper insight on this matter will be explained on Chapter 4.2
[765] Hemmerich, Aaron (2019): Abzugsbeschränkungen im internationalen Steuerrecht. Analyse und Wirkungsvergleich der deutschen und österreichischen Lizenzschranke. In *IStR* (8), P. 298.
[766] For more on this discussion, see Jochimsen, Claus; Zinowsky, Tim; Schraud, Angélique (2017): Die Lizenzschranke nach §4j EStG - Ein Gesellenstück des deutschen Gesetzgebers. In *IStR* (15), P. 596.

increasing their tax collection. There would be no loss of revenue on the part of countries with lower tax rates if the inverted tax credit system did not fully replace the withholding tax mechanism. On the other hand, if the WHT system were to disappear with the implementation of an inverted tax credit, especially countries with low corporate tax rate that are usually royalty net payers, that is, that have more royalty payments being made to companies in foreign countries than being received, could suffer losses of tax revenue.[767]

And finally, it is worth mentioning that one of the most sensitive problems of a WHT, that is, the asymmetry between source taxation on a gross basis and residence taxation on a net basis also applies to a certain extent to an inverted tax credit.[768] This occurs because, in spite of double taxation being largely avoided, there may still be small imbalances in source state taxation, given that the mechanism of inverted tax credits do not take into account the expenses incurred by the payee (and licensor), occurring on a gross basis.

Despite the problems indicated above, it can be seen that the inverted tax credit system has multiple advantages and improvements in relation to the other systems, and lacks mainly in relation to its effectiveness – given the ease of circumvention, with the need for international cooperation – and its economic impacts, by leveling the scenario of international taxation based on countries with a high corporate tax rate, possibly hampering investments. Thus, it is important to have in mind the positive aspects of this rule, which with its innovative character has shed light on a possible new path to be traced in the winding struggle against base erosion and profit shifting that takes advantage of intellectual property.

For a long time, the proposals presented so far have been the only ones available to combat artificial profit shifting that takes advantage of the use of royalty payments and intellectual property. A problem of this magnitude not only has complex solutions to be deployed, but also an innate difficulty in coordinating the multiple interests involved in maintaining or counteracting this system. It is under this framework, in early 2019, when another form of implementation of the ideas presented so far emerges through the OECD, in response to the growing dissatisfaction on the part of some countries with the *status quo* of the international taxation, including issues with

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[767] Extensive data can be found in Finke/Fuest/Nusser/Spengel (2014): Extending Taxation of Interests and., P. 33ff.
[768] For more information, see Evers (2015): Intellectual property (IP) box regimes. P. 228f.

license fees and the aggressive tax planning resulting from it, which is that of a minimum tax in the form of the GloBE proposal, which will be from thereon the focus of this analysis.

3.4 The OECD GloBE proposal

Initially appearing in the form of a public consultation document in February 2019[769] of French and German initiative,[770] the BEPS project is addressing one of its major unsolved problems: the tax challenges of the digitalization of the economy. While the OECD action plans presented partially satisfactory results on several fronts – for example with regard to transfer pricing rules and economic substance requirements – the marked presence of a digitalized economy remains a major issue to be resolved in the international taxation scenario. But more than that, this international organization realized that its work in this spectrum cannot be separated from what they refer to as the "remaining BEPS challenges", given that there is a character of complementarity between the challenges that still need to be solved, it being necessary that they be dealt with simultaneously,[771] under penalty that no satisfactory answer be found through the coordination of the different wills of the countries involved. These latter discussions were very well received,[772] despite their complexity and tight schedule, as the general need for new corporate tax reform proposals for some of the topics that were not as successful in the initial BEPS discussions was recognized.

Thus, this present OECD work – or "BEPS 2.0" – is divided into two basic pillars,[773] parallel but nevertheless complementary, in which, on the one hand, there are matters of a digital economy with profit allocation and nexus rules,[774] and, on the other hand, the remaining BEPS

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[769] OECD (2019): Addressing the Tax Challenges of the Digitalization of the Economy. Public Consultation Document. Available online at https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf, checked on 18.09.19.
[770] See the comments on Johnston, Soong Stephanie (2019): German EU Presidency to Move On BEPS 2.0 Minimum Taxation. In *Tax Notes International* 96 (4), P. 358f.; and Kreienbaum, Martin (2019): Fortschritte bei der Digitalbesteuerung - Zweisäulenstrategie in der Diskussion. In *IStR* 28 (4), P. 122f.
[771] More recently, however, the Pillars are thought to be independent, especially considering how advanced pillar two is in relation to pillar one. Refer to the talk by Saint-Amans, Pascal (2022): Pillar 2: What will be the impact? Zoom Conference (Oxford University Centre for Business Taxation), 04.04.22.
[772] See Johnston, Soong Stephanie (2019): Countries Cheer OECD's Latest Corporate Tax Reform Proposal. In *Tax Notes International* 96 (2), P. 113f.; opposing opinion in Schreiber, Ulrich; Spengel, Christoph (2021): Die Steuerpläne der OECD: Ausweg oder Irrweg? In *Der Betrieb* 74 (43), P. 2512ff.
[773] OECD (2019), *op. cit.*, Fn. 769, P. 5ff.
[774] Also referred to as Pillar one. Currently, this proposal has moved much beyond the digitalization of the economy. Refer to Tandon, Suranjali (2021): Making Pillars 1 and 2 Effective. In *Tax Notes International* (104), P. 665.

challenges, among which is the so-called global anti-base erosion proposal, or GloBE for short, which is certainly the most relevant for the present work. As it stands today, and seeing the need for action since the BEPS Action Plan has been unable to address complex structures that allow multinationals to take advantages of preferential regimes,[775] 136 member countries of the so-called "inclusive framework" of the OECD have reached simultaneously a political agreement that encompasses a new international corporate tax framework, with others to follow.[776] Furthermore, at the end of 2021, the OECD decided to release a model for the GloBE rules, to be implemented on a very tight schedule by participating countries.[777] The objectives pursued by this proposition, as well as the general outline accepted – but not yet adopted – by the countries involved and the impacts of these measures for cross-border royalty payments will be highlighted in the following subsections.

3.4.1 Basic structure and background justification

As previously mentioned, the structure of this project is based on two distinct pillars: one focused on the digital economy – at least initially –, which despite its general relevance does not have a strict direct relationship with the issue of royalty payments; and the other focused on a global solution to base-erosion issues. Our attention will focus in particular on this second pillar, the general purpose of which is to present a solution that, in the first place, respects the sovereign rights of each jurisdiction to determine the amount with which it wishes to tax a certain form of income, as it may, of course, establish rates and incentives in accordance with its priorities and national *de facto* and legal realities; and then reinforce the possibility for countries to "tax back"

[775] See Herzfeld, Mindy (2020): Want a Pillar 2 Exemption? Get in Line. In *Tax Notes International* 97 (5), P. 470.
[776] OECD (2021): Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. Available online at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf, checked on 11.10.21.
[777] OECD (2021): Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two). Available online at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf, checked on 22.12.21; and the respective comments on OECD (2022): Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two). Available online at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf, checked on 22.04.22.

with a top-up tax the profits that are deemed to not have been duly or sufficiently taxed by countries that have exercised – or rather refrained from exercising – their primary taxing rights.[778]

The conciliatory nature of this proposal is immediately evident, since the purpose it has is to satisfy and coordinate the different national interests involved in the elaboration of this type of anti-tax avoidance measure, respecting the national (tax) sovereignty of different countries, while minimum standards of taxation are established in the international scenario. This not only increased the chances of finding consensus in a joint plurilateral response, but also seeks to avoid – considering the limited deadline that was set for the end of 2020 and ultimately postponed to the end of 2021[779] – the elaboration of uncoordinated unilateral responses such as those observed until now, which may lead, in some cases, to tax and investment distortions in the global market, as well as to double taxation, that are all highly undesirable.

Therefore, this concept would be developed as a multilateral framework aiming at international consensus in order to ensure that multinationals pay a minimum level of tax whilst, at the same time, (i) avoiding double taxation; (ii) keeping administrative and compliance costs to a minimum; and (iii) making their decision-making process less dependent on tax-saving considerations.[780] This represents the general idea behind a foreign minimum tax, for instance, which aims to counter the relocation of direct investments abroad for purely fiscal reasons by diminishing the international tax competition perceived as harmful or excessive.[781]

Following public consultations with members of the private sector[782] and periodic publication of the progress of discussions over the years,[783] a generic agreement was finally made

[778] OECD (2019): Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy. Inclusive Framework on BEPS. Available online at https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf, checked on 18.09.19, P. 4ff.
[779] The implementation should, however, occur until 2024.
[780] OECD (2019), *op. cit.*, Fn. 778, P. 24.
[781] On this topic, see the extensive contribution of Junge, Aaron; Russo, Karl Edward; Merrill, Peter (2019): Design Choices for Unilateral and Multilateral Foreign Minimum Tax. In *Tax Notes International* 95 (10), P. 953ff.
[782] OECD (2019): Public Consultation Document, Global Anti-Base Erosion Proposal ("GloBE") (Pillar two). Tax Challenges Arising from the Digitalisation of the Economy. Available online at https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf, checked on 09.12.19.
[783] The focal points were presented in October 2020, to be accepted more widely in mid-2021. For more information about these intermittent documents, see Wehnert, Oliver; Kunkel, Alexander (2021): Pillar 2's Innovation Problem: How GLOBE Threatens IP Regimes. In *Tax Notes International* 101 (1), P. 55ff. and Schwarz, Magdalena (2021): Report on Pillar Two Blueprint. Neue Details zur Undertaxed Payments Rule und zur Subject-to-tax-Klausel. In *IStR* (6), P. 198ff.

by the inclusive framework of the OECD in the middle of 2021, followed by the proposition of model rules at the end of that same year. The biggest controversies certainly involved in particular pillar one and the digitalization of the economy, while pillar 2 had avoided dissent so far due to it's vague design[784] until the end of 2021. Today, pillar 2 is moving forward much faster than pillar 1, also due to the need to obtain revenue lost to the Covid-19 pandemic expenses. However, there are many options for implementing a minimum tax,[785] especially given the distinct nature of the problems it seeks to solve: the GloBE does not aim at countering specific abusive practices[786] – such as the issue with royalty payments –, but rather at promoting international tax coordination in a way that reduces BEPS. As a consequence, the situation of cross-border royalty transactions is indirectly affected.

Therefore, the final plan for pillar 2 was further developed in two different fronts, since base erosion and profit shifting may occur both on *outbound* as well as on *inbound* cases. Much like CFC rules,[787] the GloBE proposal has an outbound-directed "income inclusion rule", built up on the previously seen recommendations of the Action 3 of the BEPS project,[788] as well as on the recently implemented American GILTI rule.[789] It was devised in order to protect the tax base of the parent jurisdiction, being applied within the EU both to domestic[790] and foreign subsidiaries.[791]

[784] Herzfeld, Mindy (2020): Problems With GLOBE: Scratching the Surface. In *Tax Notes International* 99 (1), P. 13ff.
[785] See the observations by Junge, Aaron; Russo, Karl Edward; Merrill, Peter (2019): Design Choices for Unilateral and Multilateral Foreign Minimum Tax. In *Tax Notes International* 95 (10), P. 947ff.
[786] Pistone, Pasquale; Nogueira, João Félix Pinto; Andrade, Betty; Turina, Alessandro (2020): The OECD Public Consultation Document "Global Anti-Base Erosion (GloBE) Proposal - Pillar Two": An Assesment. In *Bulletin for International Taxation* 74 (2), P. 63ff.
[787] Some countries, like Brazil, even have CFCs that are fully inclusive, applying to all kinds of income of a controlled or associated foreign company. Such rules are already much closer to the OECD IIR than the average CFC. Refer, for example, to Liotti, Belisa Ferreira (2021): What Does the OECD's Minimum Tax Proposal Mean For Brazil's CFC Regime? In *Tax Notes International* 104 (3), P. 308f.; and Schoueri, Luís Eduardo (2021): Some Considerations on the Limitation of Substance-Based Carve-Out in the Income Inclusion Rule of Pillar Two. In *Bulletin for International Taxation* 75 (11/12).
[788] See, for reference, Chapter 2.1.2.
[789] Refer to Blum, Daniel W. (2019): The Proposal for a Global Minimum Tax: Comeback of Residence Taxation in the Digital Era?: Comment on Can GILTI + BEAT = GLOBE? In *Intertax* 47 (5), P. 514ff.; and Schildgen, Frederik (2019): GloBE - Lehren aus GILTI. In *ISR* (11), P. 400ff. For a brief explanation on this rule, see Section 3.2.2.3.
[790] In the European case, the application to domestic subsidiaries is in order to (try to) avoid discriminations and violations of the fundamental freedoms, which will be further discussed in Chapter 4. See also Johnston, Soong Stephanie (2021): EU Ponders Options for Nondiscriminatory Pillar 2 Tax Directive. In *Tax Notes International* 104 (10), P. 1081f.
[791] OECD (2019), *op. cit.*, Fn. 778, P. 25f. The EU finance ministers, however, manifested a – not surprising – division within the EU regarding the need for a minimum tax as proposed by the GloBE, especially concerning Hungary,

On the other hand, in order to deal with base eroding payments such as the ones with royalties studied so far, this income inclusion rule would also be complemented by an inbound "undertaxed payments rule". This norm would be directed at giving source jurisdictions a means to defend themselves against base-eroding payments – such as royalty payments to low or no-tax countries – by denying the possibility of deducting expenses for a payment made to a related party subject to taxation below a minimum, acceptable rate.[792] Furthermore, a complementary modification of double taxation agreements through the inclusion of a "subject-to-tax" clause[793] could increase the effectivity of such a measure by denying the granting of certain treaty benefits – such as the common withholding tax exemptions on royalty payments – in case a specific item of income is not properly taxed in the state of residence of the payee.[794] Thus, these WHT would operate on the basis of a minimum tax, as was already envisaged in previous proposals,[795] ensuring a minimum ETR from the source country.

This second aspect of the GloBE proposal, focused on rules specifically aimed at combating artificial profit shifting that takes advantage of base eroding payments such as the license fees seen so far is certainly the most relevant to this thesis. Considering the scope of this research and a necessary clear cut for a thematic approach, we will focus exclusively on these last rules, as they are the sole facet of this proposal that deals with inbound cases of payments made to related parties in a low tax country.

Luxembourg and Ireland. Refer to Lamer, Elodie (2019): EU Divided Over GLOBE Minimum Tax. In *Tax Notes International* 96 (7), P. 634f.; and Johnston, Soong Stephanie (2021): Hungary Flags Global Minimum Tax Base Plan Concerns. In *Tax Notes International* 103 (5), P. 624f. More recently, however, such worries are said to have been (at least partially) addressed, as in Johnston, Soong Stephanie (2021): Final OECD Global Tax Deal Text Addresses Ireland's Concerns. In *Tax Notes International* 104 (2), P. 221f.; and Johnston, Soong Stephanie; Paez, Sarah (2021): Ireland, Estonia to Join OECD Global Tax Reform Deal. In *Tax Notes International* 104 (2), P. 222f.

[792] Much like a royalty deduction barrier or, in a way, even the BEAT. See Moyal, Shay (2020): Don't Stop the BEAT. In *Tax Notes International* 97 (5), P. 533ff.; and Gebhardt, Leon (2020): Einführung einer Mindestbesteuerung nach den Plänen der OECD. In *IWB* 23 (19), P. 960f.

[793] Especially for developing countries. For more information on this specific rule, see Jirousek, Heinz (2021): Pillar Two - Die Subject to tax rule (STTR). In *ÖStZ* (1-2), P. 55ff.; and a similar introduction in Austria on Dolezel, Alexandra; Höchtl, Christina (2019): §14 KStG, Betriebsstätten und Subject-to-Tax-Klauseln nach Pillar Two der OECD. Section 14 Austrian Corporate Income Tax Act, Permanent Establishments, and Subject-to-Tax Clauses under Pillar Two of the OECD. In *SWI* (12), P. 589ff. There are those, however, that see the GloBE project and the minimum tax as mainly harmful to developing countries, as Parada, Leopoldo (2022): Tailoring Developing Country Advice: A Response to Noam Noked. In *Tax Notes International* 105 (7), P. 783f.

[794] Currently accepted at a 9% tax rate.

[795] See the proposal for the digital economy by Wilkie, J. Scott (2018): An Inverted Image Inspires a Question: Comments on Professor Ulrich Schreiber's "Sales-Based Apportionment of Profits". In *Bulletin for International Taxation* (4/5), P. 276f.

3.4.2 The undertaxed payments rule as a consensus solution

From an analysis of the general characteristics of the legislative design proposed so far for the undertaxed payments rule and the subject-to-tax rule for double taxation agreements, it is clear that its ultimate goal is the prevention or reduction of the effectiveness of base eroding payments by making use of the unilateral mechanisms presented so far, namely the restriction on the deductibility of payment expenses as well as the withholding of taxes. These rules would operate in such a way that minimum taxation would be ensured on the basis of a previously established rate, currently agreed upon 15% for the UTPR and 9% for the STTR, where payments – broadly considered – made to a related party – determined from a 25% common ownership test, for example – subject to taxation below this minimum would trigger a proportionate restriction on the deductibility of payment expenses.[796] Consequently, the final taxes due would always correspond to at least the minimum established by those rules.

For the calculation of this minimum value, possible amounts retained as a WHT would have to be taken into account. Furthermore, the UTPR has a subsidiary nature when compared to the income inclusion rule,[797] whilst the STTR takes precedence over both of them,[798] which is to say that the UTPR will only apply in the cases where there was no top-up tax through a qualified IIR beforehand[799] *– much like how the relationship between a CFC rule and a deductibility barrier*

[796] As was already implemented unilaterally within and outside of the EU. Remember the Mexican case in Brandt, Eduardo; Avalos, Susana Jimena (2021): Mexico's Undertaxed Payment Rule and Its Interplay With FDII, GILTI, and Subpart F. In *Tax Notes International* 101 (13), P. 1675ff. and Subsection 3.2.2.3. For further information on the design of the UTPR, see Bush, John N. (2019): A Roadmap for a Tax on Base-Eroding Payments. In *Tax Notes International* 96 (7), P. 593ff.

[797] These characteristics were just recently established by the inclusive framework discussions, as much of the design of the UTPR was left open until late 2021. Refer to PwC (2021): Tax Policy Alert. 136 countries reach political agreement on a new international corporate tax framework. Available online at https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-136-countries-reach-agreement-on-a-new-intl-corp-tax-framework.pdf, checked on 11.10.21.

[798] Which is positive in terms of international tax justice, even though the STTR not only has not been fully developed yet, but it is also deemed by many as insufficient for developing countries. Refer to Dourado, Ana Paula (2022): Pillar Two Model Rules: Inequalities Raised by the GloBE Rules, the Scope, and Carve-Outs. In *Intertax* 50 (4), P. 282f.

[799] For more information on how the UTPR is to be implemented, see OECD (2021): Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two), P. 12ff.; and OECD (2022): Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), P. 32ff.

is.[800] It will furthermore be applied only as of 2024 according to the current agenda, one year after the IIR.[801]

Essential to the employment of both the IIR and the UTPR is that a jurisdiction's ETR is below the minimum tax threshold. In order to determine this ETR, the total amount of the "adjusted" taxes to be taken into account of all companies located in a jurisdiction is divided by the net GloBE income of this company.[802] If the ETR is below the minimum tax, the top-up tax for that jurisdiction must be calculated based on the "excess profit" of a corporate group, *i.e.* taking the values from a substance based income inclusion based on a percentage of payrolls and tangible assets. For each jurisdiction, there will finally be a calculation of the share of extra taxes due to each jurisdiction.

This proposal would theoretically respect the sovereignty of each country in determining the most appropriate rate according to its national interests, while ensuring that they would accept a minimum taxation[803] implemented by other countries on an international front for MNEs. The same holds true for the eventual drafting of a subject-to-tax rule, which in the end would depend almost solely on bi- or multilateral negotiations between countries wishing to implement a rule that requires some basal taxation for the granting of tax benefits.

3.4.2.1 The undertaxed payments rule as a multilateral proxy for deductibility barriers

This proposal thus seeks to find a *multilateral* solution to the problem of profit shifting through, among others, royalty payments, and in this respect is as aforementioned, in fact, nothing more than an international implementation of a restriction on royalty payments deduction and the possibility of a withholding tax as a subject-to-tax clause, both proposals widely discussed so far under this same Chapter. The main advantage offered by this approach, however, is that it allows

[800] There are many striking similarities between these two systems.

[801] See Sarfo, Nana Ama (2021): Pillars 1 and 2: Who Got What They Wanted? In *Tax Notes International* 104 (4), P. 384.

[802] For more information on this terminology, see OECD (2021): Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy; and, for instance, Schwarz, Magdalena (2022): Pillar Two - Es ist soweit, die finalen Regelungen zur weltweiten Mindestbesteuerung sind da! In *IStR* 31 (2), P. 44f.

[803] According to OECD justifications, as this is but a "common approach", not binding rules. Refer to OECD (2021): Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, P. 3f. Some countries are considering implementing their own domestic minimum top-up taxes to allow national companies to escape the UTPR. It is, however, questionable insofar this project does not indirectly violate the tax sovereignty of a country. See Johnston, Soong Stephanie (2022): U.K. Mulls Domestic Minimum Tax To Complement OECD Pillar 2 Plan. In *Tax Notes International* 105 (3), P. 371f.

at an international cooperative level to simultaneously reduce incentives for companies to make base eroding payments between related parties, royalties included, and to reduce any distortions in the competition environment of the source jurisdictions market caused by too low a level of taxation in the residence jurisdiction receiving the payment.[804] Another major advantage of the agreement reached is that, despite not providing for minimum standards, that the inclusive framework countries will have to accept the application of the GloBE rules implemented by other members. There are certainly valid reasons for tax competition,[805] enabling many countries that otherwise would have little to no chance to attract specific sorts of investment to stand out in some way, nevertheless this competition cannot be allowed to occur uncontrollably, since it will always lead to one direction and one direction only: to the bottom.

The GloBE proposal as a whole and, in particular, the undertaxed payments rule seek then to set a minimum threshold at which such competition could occur by providing a specific rate, although there are some other challenges beyond setting the nominal value of this minimum duty. Firstly, it is essential that not only the rate of 15% itself be agreed upon and implemented, but also to determine how the calculation will be made so as to establish whether or not taxation is below the permitted level, as it is also necessary, for example, to take account of possible losses companies might suffer. Criteria for establishing a related party status are also of the utmost importance, being usually variable from country to country, and while standardizing this criterion might be beneficial, it would certainly prove difficult to do so, especially when bearing in mind the well-known issues that conduit or indirect payments may bring about.[806]

In addition, the compatibility of an undertaxed payments rule with other international obligations and higher-ranking law[807] would be necessary just as in the case of a conventional WHT or royalty barrier, albeit this process is certainly facilitated given that international

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[804] For more information, see the excellent contribution of Becker, Johannes; Englisch, Joachim (2019): International Effective Minimum Taxation – The GLOBE Proposal. In *SSRN Journal*. DOI: 10.2139/ssrn.3370532, P. 25ff.

[805] See, for instance, Fehling, Daniel; Schmid, Mareike (2015): BEPS und die EU: Was ist die "europäische Dimension" von BEPS? Das Beispiel grenzüberschreitender Lizenzzahlungen. In *IStR*, P. 496f.

[806] On the design problematics, see OECD (2019): Addressing the Tax Challenges of the Digitalization of the Economy. Public Consultation Document, P. 27ff.

[807] In the specific case of EU law, a directive has been proposed immediately after by the European Commission (2021): Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (COM(2021) 823 final). Available online at https://taxation-customs.ec.europa.eu/system/files/2021-12/COM_2021_823_1_ EN_ACT_part1_v11.pdf, checked on 27.12.21. It's (timely) implementation is, however, doubtful due to resistance by Member States and the unanimity requirements of Art. 115 TFEU. Refer also to Smith, Michael (2022): Proposed EU Directives Build On OECD's BEPS Project. In *Tax Notes International* 105 (1), P. 80f.

cooperation is an inherent part of this project.[808] On the other hand, the same considerations made in Chapter 3.2.2 apply to the question of *how* the adjustment to be made under this rule will be conducted, that is, for instance, whether a full prohibition on the deductibility of royalty payments is necessary or whether a partial restriction would be more appropriate, whether there should be tax carve-outs[809] etc. It is essential to keep in mind that, even though these proposals are groundbreaking from a cooperative perspective within the context of international tax law, the GloBE proposal is and remains an extension of unilateral measures with their own issues, also requiring a minimum level of compatibility with higher-ranking law.[810]

So far, if one considers that the rules proposed by the OECD in December 2021 for Pillar 2 and the EU directive proposal will be implemented as they are, a partial deductibility of expenses is to be expected as a secondary measure to the IIR in the form of the UTPR.[811] Moreover, some interesting substance carve-outs[812] have been proposed in the form of payroll and tangible assets for each constituent entity.[813] These design options and their effectiveness/compatibility with higher-ranking law will be further discussed alongside the design of other rules in the upcoming chapters.

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[808] OECD (2019): Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy. Inclusive Framework on BEPS, P. 31f. Refer to Chapter 4 for more information on this discussion.

[809] Specifically on this topic, see Brokelind, Cécile (2021): An Overview of Legal Issues Arising from the Implementation in the European Union of the OECD's Pillar One and Pillar Two Blueprint. In *Bulletin for International Taxation* 75 (5), P. 219; Cipollini, Claudio (2021): Reshaping the Pillar 2 Carveouts. In *Tax Notes International* 101 (1), P. 49ff.

[810] To be discussed extensively in the next Chapter.

[811] OECD (2021): Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two), P. 12ff. For the directive, countries are expected to have some freedom when implementing a domestic top-up tax; implementing such a tax only for in-scope companies; or not implementing them at all and leaving the revenue to other countries. See Paez, Sarah (2022): EU Member States Will Have Flexibility In Implementing Pillar 2. In *Tax Notes International* 105 (3), P. 353f. For more information on how the EU wishes to implement the UTPR, refer to Dietrich, Marco; Golden, Cormac (2022): Consistency versus "Gold Plating": The EU Approach to Implementing the OECD Pillar Two. In *Bulletin for International Taxation* 76 (4), P. 188ff.

[812] *Ibid*., P. 30ff. They will naturally, however, lessen the effectiveness of the minimum tax as a whole. Refer for instance to Schön, Wolfgang (2022): Internationale Steuerpolitik zwischen Steuerwettbewerb, Steuerkoordinierung und dem Kampf gegen Steuervermeidung. In *IStR* 31 (6), P. 188f.

[813] Such carve-outs can be used to the advantage not only of companies, but also smaller economies, as they will create an incentive for substance to be created within their borders. There isn't, however, much expectations by developing countries regarding the IIR and the UTPR, but rather with the still underdeveloped subject-to-tax clause. See, for instance, Herzfeld, Mindy (2021): As the End of the OECD Project Draws Near, Country Differences Sharpen. In *Tax Notes International* 104 (11), P. 1193ff. The OECD tax agreement has been dividing opinions since its proposal, as seen in Paez, Sarah (2021): OECD Global Tax Agreement Draws Mixed Reactions. In *Tax Notes International* 104 (3), P. 342f.

3.4.3 Provisional remarks on the GloBE proposal

Although this project is extremely recent, it has been worked on quickly with many rapid developments on the discussions, partially for (a) fear of widespread unilateral action against the objects of this undertaking;[814] (b) the need to raise revenue due to the Covid-19 pandemic; and (c) fight off BEPS as a political statement, dealing with popular dissatisfaction with tax scandals such as the Panama and Pandora papers. However, it is already possible to glimpse many of the problems and questions that will have to be faced over time. It should be noted, despite the fact that this is ultimately the implementation of an international system of royalty deduction barriers and withholding taxes[815] – which would certainly ensure less distortion and greater cooperation between countries – that the greatest strength of this proposal may also be its greatest weakness.

This happens mainly because (i) the need for consensus can lead to difficulties in its implementation, and it is reasonable to question even the feasibility of such a project in the long run, especially with international actors such as the EU and its unanimity requirement in tax matters,[816] the US and its Congress etc[817] – considered so far to introduce no minimum standards, but merely present a "common approach"[818] –, also bearing in mind that a fully unilateral implementation model is certainly much more straightforward; (b) for consensus to be achieved and such a project to be practicable, concessions must be made to balance the interests involved –

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[814] However, even through consensus, chances are that unilateral measures will be as strong as ever, a fear shared by many practitioners. See Finley, Ryan (2020): Practitioners Fear BEPS 2.0 Agreement May Not Be Good Enough. In *Tax Notes International* 97 (11), P. 1203.

[815] It should be noted, however, that the extent to which one or the other should be used in the design of the rule is widely open for discussion. See the case of the subject-to-tax clause in Carvalho, Lucas de Lima (2019): GLOBE and the Supranational 'Nudges' Affecting Domestic Tax Policy. In *Tax Notes International* 95 (5), P. 423f.

[816] Considering the resistance that some countries such as Ireland and Hungary have shown regarding the OECD project, even though they have complied so far, does not mean that a EU directive will be successful. See also Goulder, Robert (2021): Pillar 2 and the Five Stages of Grief. In *Tax Notes International* 103 (6), P. 781f.; and the resistance by Hungary in Johnston, Soong Stephanie (2022): Hungarian Lawmakers Nix EU Pillar 2 Minimum Tax Directive. In *Tax Notes International* 106 (13), P. 1678.

[817] Such fears have been manifested repeatedly by different authors, see for instance Johnston, Soong Stephanie (2020): Unified Approach Adopted as Basis For OECD Tax Overhaul Talks. In *Tax Notes International* 97 (5), P. 468; Chadwick, Francois (2019): Pillar 2: Avoiding Pitfalls on the Road to Consensus. In *Tax Notes International* 96 (10), P. 899ff.; Herzfeld, Mindy (2020): GLOBE: A Process in Search of a Purpose. In *Tax Notes International* 97 (4), P. 367ff.; and Paez, Sarah (2021): More Work Remains Before Pillar 2 Model Rules Are Ready. In *Tax Notes International* 104 (10), P. 1152f.

[818] See OECD (2021): Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. Available online at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf, checked on 11.10.21.

in many cases diametrically opposed – which may lead to unsatisfactory or incomplete results;[819] (c) the attainment of an intermediary result may legitimize through the OECD approaches recognized by many countries as harmful, as was the case for many with the treatment of IP-Boxes in Action Plan 5.[820] This Plan dealt with the issue of preferential regimes from the point of view of economic substance, while from a practical point of view still allowing for aggressive tax planning that takes advantage of these systems, moreover leaving tax havens entirely out of this arrangement.

Furthermore, although this proposal initially suggested a system that would respect the national sovereignty of countries, there is a fair concern that a minimum tax at 15% would indirectly have significant impacts on their sovereignty.[821] The mere concept of a minimum tax indicates a restriction on the ability of a country to set its own tax rates.[822] This occurs even though a nation might have a *prima facie* freedom to determine which tax rates and forms of incentive it wishes to put into place, but which in practice will be strongly restricted internationally through the action of other countries,[823] whose complementary role in relation to the primary (non-exercised) tax prerogatives of a low-tax country will unveil a subject-to-tax logic, rendering many of the tax choices made by some countries irrelevant or less impactful.

This concern over restrictions on the sovereignty of some countries is not confined to problems between developing and developed countries. Even within the European Union there are very different interests at stake, as evidenced by the current attempts to pass a directive implementing the GloBE minimum tax.[824] This directive makes direct reference to the OECD

[819] Many countries – developed and developing – offer, despite the agreements on the inclusive framework, resistance to this project from a national perspective. Refer to Goulder, Robert (2020): Breaking Up With BEPS. In *Tax Notes International* 97 (2), P. 219; and Paez, Sarah (2021): Cyprus Won't Support EU Minimum Tax Rate. In *Tax Notes International* 102 (10), P. 1368.

[820] For more on this discussion, see the German take on the matter on Subsection 3.2.2.2 and the observations on Chapter 2.2.

[821] See, for example, Devereux, Michael P. (2020): The OECD Global Anti-Base Erosion Proposal. With assistance of François Bares, Sarah Clifford, Judith Freedman, Irem Güçeri, Martin McCarthy, Martin Simmler, John Vella. Oxford Centre for Business Taxation.

[822] See the debate on McLoughlin, Jennifer (2019): OECD Minimum Tax Triggers Nerves Over National Sovereignty. In *Tax Notes International* 93 (12), P. 1308.

[823] The true impacts of a widespread implementation such as GloBE must be taken into consideration, which might have unforeseen ripple effects. Refer to Herzfeld, Mindy (2020): The OECD Project That Shall Not Be Named. In *Tax Notes International* 97 (9), P. 949f.

[824] For an overview of the functioning of this directive, refer to Dehne, Klaus Jörg; Rosenberg, Dirk (2022): OECD: Modellregelungen zur Umsetzung einer globalen Mindestbesteuerung (GloBE - Pillar II) - Die Komplexität eines

project, and imports in some cases design choices *ipsis litteris* advocated by the international organization.[825] Besides the fear of restrictions on the possibility of countries with a lower corporate tax rate, such as Ireland and Hungary, to attract investments, there is a natural apprehension of the EU to accelerate a minimum tax implementation process that will put it at an international competitive disadvantage in relation to other international actors, from which it will hardly be able to get out without a sunset clause. It is also naturally questionable to what extent a "mere" national implementation of the GloBE rules would be compatible with the fundamental freedoms.[826]

Beyond a restriction indirectly established by other countries, small, insular and/or developing jurisdictions will end up suffering economic pressure from multinationals, since it will be necessary for the domestic tax policy to be adapted to circumvent the triggering of the minimum standards set internationally, under penalty of withdrawal or reduction of direct investments by these companies.[827] This is not to say that these are not desired results by the OECD and many other countries,[828] however, it is accurate to assert that distortions in the heart of international taxation due to OECD interference can have huge impacts on some countries' domestic tax systems, and consequently on investments, decreases in tax revenue etc.

This raises a question about the BEPS project itself, as it is important to determine whether the purpose of combating tax avoidance should be restricted to substance questions – as was done by BEPS Action Plan 5 – or whether it should be extended to issues of tax rate. However, it is

"dreistufigen" Ansatzes (Teil 1). In *Der Betrieb* (10), P. 556ff.; Dehne, Klaus Jörg; Rosenberg, Dirk (2022): OECD: Modellregelungen zur Umsetzung einer globalen Mindestbesteuerung (GloBE - Pillar II) - Die Komplexität eines "dreistufigen" Ansatzes (Teil 2). In *Der Betrieb* (11), P. 626ff.; and Dourado, Ana Paula (2022): The EC Proposal of Directive on a Minimum Level of Taxation in Light of Pillar Two: Some Preliminary Comments. In *Intertax* 50 (3), P. 200ff.

[825] See, for instance, Valério, Carla (2022): Proposal for a Directive on Ensuring a Global Minimum Level of Taxation for Multinational Groups in the European Union: First Steps in Pillar Two Implementation in the European Union. In *European Taxation* 62 (4), P. 155ff.

[826] As will be discussed in Chapter 4. Refer also to Rieck, Jan; Fehling, Daniel (2022): Effektive Mindestbesteuerung in der EU - der Richtlinienentwurf zur Umsetzung der GloBE-Regelungen. In *IStR* (2), P. 58ff.

[827] See also Carvalho, Lucas de Lima (2019): GLOBE and the Supranational 'Nudges' Affecting Domestic Tax Policy. In *Tax Notes International* 95 (5), P. 424f.

[828] But these go far beyond BEPS, and affect developing countries in a systematic manner. See, for example, Riccardi, Andrea (2021): Implementing a (global?) minimum corporate income tax. An assessment from the perspective of developing countries 4 (1), P. 29. The tendency would be to increase tax rates in such countries, which would most likely reduce their competitiveness. Refer to the comments by Noked, Noam (2021): Potential Response to GLOBE: Domestic Minimum Taxes In Countries Affected by the Global Minimum Tax. In *Tax Notes International* 102 (7), P. 943ff.; and Altenburg, Nadia; Geberth, Georg; Gebhardt, Ronald; Holle, Florian; Oertel, Eva (2019): Pläne zur Einführung einer internationalen Mindestbesteuerung - Ein Überblick. In *DStR* (47), P. 2452ff.

evident that by restricting itself to issues of economic substance and the nexus-approach, the OECD has limited the effectiveness of its proposals, leaving much room for maneuver for aggressive tax planning schemes which are, in our view, much more damaging than a possible indirect restriction on the national tax sovereignty of countries in the hypotheses of taxation of multinational corporations. And it is precisely this restricted effectiveness that has led several countries to adopt the now-feared unilateral measures that the OECD seeks to avoid.

In this sense, the protection of national sovereignty cannot override the equally valid efforts to ensure the due "fair share" of MNEs through a minimally adequate taxation, and it is certainly for the best if countries happen to agree on such a system and adopt the GloBE proposal. On a last note, however, one must bear in mind that the success or failure of this project lies not only within the challenge of achieving consensus and an internationally recognized acceptance of this instrument, but also – and mainly – on the *design* choices that have to be made in order for this consensus to be achieved.[829] Without this crucial attention to the artful conception of the undertaxed payments rule,[830] it will not be possible to find the desired equilibrium for all the hitherto seen proposals for effectiveness, higher-ranking law compliance and administrative ease of implementation. Nevertheless, all considerations to be made regarding the results of the GloBE proposal discussions so far are also valid for the unilateral measures discussed previously, and especially their higher-ranking law compatibility has to be assessed, a problem that will be dealt with in the following sections.

3.5 Interim results

In this chapter, the most distinct possibilities to fight off base-eroding royalty payments were viewed in depth, explained and analyzed. From simple and classic proposals – as is the case of withholding taxes – to those that changed the mindset concerning royalty payments – such as royalty deduction barriers – to the most innovative and revolutionary, such as the inverted tax credit system, which has not yet been actually implemented in any jurisdiction; and the GloBE proposal, still fighting for its implementation, but closely linked to other proposals. These are the main anti-BEPS measures related to royalty payments discussed today by academia and

[829] See Becker, Johannes; Englisch, Joachim (2019): International Effective Minimum Taxation – The GLOBE Proposal. In *SSRN Journal*. DOI: 10.2139/ssrn.3370532, P. 48.
[830] As well as the design and, especially, the relation to the other rules.

practitioners, which does not mean that there are no other possibilities or pathways, but that they are the ones that have greater visibility and probably the most chance of success.

What is immediately apparent is that there is once more no panacea or easy solution for the complex problem of aggressive tax planning with royalty payments. This happens because the implementation of each rule depends on many different factors linked to its design, namely the effectiveness of the rule in combating artificial profit shifting through royalty payments; its political and practical ease of implementation; and the eventual economic impacts from the point of view of revenue collection and distortions in direct investments resulting from it. Thus, while a rule may present excellent results in one or more aspects, there may be a fatal problem in some of the other features. This occurs, for example, with the inverted tax credit, which, in spite of solving many of the problems presented by other proposals, being the only option seen so far that completely eradicates international incentives for profit shifting and largely prevents double taxation, ends up slipping from the economic point of view by simultaneously eliminating international tax competition, which has valid reasons of existence. On the other hand, while the economic impacts of the GloBE proposal should be smoother in this sense, its political feasibility is very reduced given the need to observe how its implementation will follow, obtain consensus within the EU, within the US Congress etc., which in turn generally hampers the effectiveness of the norm, since concessions have to be made in order to actually implement such general agreement.

Moreover, despite the fact that many countries have introduced measures to limit the deduction of *interests*, relatively innovative measures such as royalty payment deduction barriers have only been timidly implemented, given the great importance ascribed to research & development and the spillovers generated by intellectual property. The modern most widespread tax policy option goes in the opposite direction, *i.e.*, to implement tax incentives for IP in the form of license Boxes, which, however, in no way should prevent the simultaneous fight against artificial profit shifting payments. A measure of limitations to royalty payment deductions may represent an excellent answer to the problem depending on its legal design, considering that the greatest challenges to be overcome when implementing this type of rule is to avoid double taxation while ensuring that intra-group royalty payments are properly taxed at an acceptable rate, whether in the country of residence or in the source country. In this sense, the mechanism of the German

rule implemented in 2018 is very similar to Lodin's proposal for an inverted tax credit system, in which taxation in the source country will be inversely proportional to that carried out in the residence state.

Contrarily, a recurring criticism to the royalty deduction barriers is that they may also be similar to a proposal of withholding taxes in the case of design as a “trigger” with absolute values and sharp lines as is the Austrian rule, however without the correlate counterpart of allowing for the taxes paid to be offset. This means that the rule goes far beyond the proposal to ensure a minimum taxation, and may cause the tax burden paid by a business group to be excessively broadened when a rule of this nature is activated in an international scenario. Therefore, in relation to the restrictions on the deductibility of royalty payments, it is clear that depending on the adopted framework – considering that there are many different nuances for the implementation of the rule – the results may be extremely different, both from the point of view of the effectiveness of the rule in achieving its objectives and the eventual legal and economic consequences resulting from its application. This reveals an enormous potential in this solution, which may, depending on its architecture, be an excellent reaction to BEPS or an economic obstacle to international trade.

Similar is the functioning of the proposed (re)introduction of withholding taxes, which despite being a widely criticized mechanism given its potential to hamper cross-border transactions, could serve, if done in a strategic way, as a simple and intelligent solution to the problem with royalty payments. It remains clear that, in fact, governments already theoretically had through withholding taxes access to a tax instrument capable of eliminating or drastically reducing profit shifting through royalty payments. Yet this system effectively reduces the savings from intra-group licensing and thus constitutes a tax barrier that could represent a competitive disadvantage for MNEs in relation to other firms, possibly resulting in a hindrance to economic integration, not only at the European level, but globally.[831] On the other hand, however, the possibilities of tax planning with a total absence of withholding have always been evident,[832] and especially at a time of tax incentives and technological boom these tax saving “opportunities” are

[831] Johannesen, Niels (2012): Optimal fiscal barriers to international economic integration in the presence of tax havens. In *Journal of Public Economics* 96, P. 400ff.
[832] See the discussion on Section 3.1.2.2.3.

more abused than ever, leading to a general feeling of dissatisfaction, in which even the OECD has had to reconsider its position regarding WHT through its GloBE proposal.

Thus, if a withholding tax is proposed as a subject-to-tax clause, there would be no shifting of tax revenue between countries that effectively tax royalty payments;[833] while double taxation could be avoided in all other cases – in which a certain change in the source/residence paradigm would actually occur – to the extent that the WHT of a source country would be credited against residence based taxes, with no major problems in the coexistence of these ways of taxation. This seems to be, in any case, a possibility of relatively easy implementation to be considered, even if on a transitory basis, in order to prepare the ground for the other measures, according to the criteria analyzed so far. This occurs because, despite the greater political difficulty of implementing a measure that depends on bi- or multilateral agreements, these measures end up with a greater degree of effectiveness and proportionality, if in fact realistically implemented.

However, one design factor that has not been discussed so far throughout this analysis remains, being also crucial – if not one of the most important – at the time of drafting any standard: the legal factor of compatibility with higher-ranking law. This is so due to there being no point in having a standard that is effective, practically feasible and economically desirable if it violates principles or rules of higher legislation that are not simultaneously modified or realistically modifiable. Hence, it is vital to understand the relationship between the possible solutions presented so far and the relevant higher legislation. Otherwise a regulation, however adequate it may seem, cannot be put into practice due to legal restrictions. The balance between effectiveness, feasibility and economic impacts, which was already convoluted by itself, gains yet another layer of complexity that establishes a *conditio sine qua non* it would be even possible to consider the applicability of a (new) legal regulation, and it is necessary to find, from the point of view of lawmaking design, a standard that not only meets the requirements proposed until now, but that is also in accordance with the pertinent superior legislation.

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[833] For more on this opinion, see Section 3.1.2 and Fuest/Spengel/Finke/Heckermeyer (2013): Profit shifting and "aggressive" tax., P. 12.

Chapter 4: Dissecting the compatibility of specific anti tax-avoidance measures concerning royalty payments with higher-ranking law

In the previous chapters, an analysis of the various rules that can help the legislator in combating aggressive tax planning tactics using licensing agreements and cross-border royalty payments was carried out. While legal and economic effectiveness, as well as the concrete operation of these rules, is certainly the central point for eventual implementation, it is also essential to assess, in a second step, the compatibility of these measures with higher-ranking rules.

This is particularly challenging in the case of royalty payments because, in the eagerness to develop a rapid and effective response to a problem that has grown exponentially in recent years, a more in-depth study of the relationship of these reactive norms to the coherence of the legal

system as a whole often ends up being overlooked. This problem is further intensified in the case of countries integrating the European Union, which are subject to yet another layer of complexity of norms to be complied with due to European primary and secondary law.

The first major "obstacle" to be observed which comes to mind is obviously of a Constitutional nature. This, however, is not the focus of this work for a number of reasons. Firstly, given the international nature of this research, it is outside its methodological scope to present tailored responses to the constitutional system of individual countries. Moreover, the complexity of the international taxation system, which ranges from European law for EU Member States, to treaty law and the double taxation treaty network, as well as to the often forgotten WTO law, represents perhaps the greatest challenge to be overcome, since it concerns an area which by its very nature directly affects the relationship between nations.

Therefore, this chapter will deal with the linkage of the rules assessed so far to higher-ranking law, as well as solutions and workarounds to possible conflicts between those anti-avoidance rules and the international taxation system. This will furthermore be complemented by the overview in the Appendix II, at the end of this book.

4.1 Introduction and methodology

As this is a highly complex subject, with differing standards and their relationship with distinct fields of international taxation, the methodology employed and the way in which this analysis is structured are of paramount relevance. In the first place, this study is restricted to the provisions discussed in the previous chapter, *i.e.* only to the *specific* anti-avoidance measures to combat profit shifting with royalty payments. This choice is due to the fact that (a) there is relative consensus regarding the possibility of employing general parameters such as transfer pricing, GAARs and CFC rules;[834] and (b) other works already exist that further discuss the compatibility

[834] Refer to Chapter 2 for more information on this discussion.

of these general norms with higher-ranking law,[835] not being restricted to this methodological cutout for licensing agreements.

This allows the analysis to focus on those rules that not only could be directly employed to solve the problem with cross-border licensing agreements, but also that could be more easily changed or adapted to the pertinent higher-ranking law. The political-legislative strain of adapting the design of these rules in a valid way to the legal system is only justified, of course, if the measure can conceivably be applied in an effective and proportional manner, which has been widely discussed in previous chapters.

Thus, each of the rules will be worked on individually – due to their unique characteristics – within each of the three main categories of higher-ranking law in play: European Law, Treaty Law and World Trade Organization Law, where applicable. As mentioned above, an in-depth study of constitutional law is beyond the scientific scope of this work. However, its problems will eventually be highlighted as examples of possible conflicts with other sources of law. The focus will therefore remain on withholding taxes, royalty deductibility barriers and also an inverted tax credit system, as the OECD GloBE proposal in the form of the undertaxed payments rule and subject-to-tax rule can be considered to great extent simply a multilateral legitimization of the first two measures, as indicated previously.[836] As much as possible, the same sequence of evaluation employed in the previous chapter for the relevant anti-avoidance measures will be observed for the discussion. However, there are, of course, overlaps between the problems of some of the proposed regulations.

4.2 European law

The first point of scrutiny will be European law, which by its very nature will have restricted application only to Member States of the European Union. This legislation of a supranational nature constitutes a series of requirements and principles to be observed in addition to any other (bilateral) international obligations that may be established by these countries. Despite this, tax law is only harmonized within the EU in some cases, since direct taxation is not, as a rule,

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[835] See, for example, Lang/Aigner/Scheuerle/Stefaner (2004): CFC legislation, tax treaties and.; and Lang/Cottani/Petruzzi/Storck (2019): Fundamentals of transfer pricing.

[836] For an overview of issues involving the GloBE proposal and higher-ranking law as well as, in particular, the proposal for a minimum taxation, refer to Pinkernell, Reimar; Ditz, Xaver (2020): Säule 2 des Arbeitsprogramms des Inclusive Framework on BEPS der OECD - kritische Anmerkungen zum GloBE-Proposal. In *ISR* (1), P. 1ff.

regulated by the European Union.[837] Moreover, in cases where harmonization within the EU is actually sought, unanimity – in many cases difficult or impossible to achieve – is required between the Member States.[838]

However, this area of law directly affects the tax sovereignty of these States, as they are obliged to observe the dictates of EU primary law and to include any harmonization measures adopted in the form of directives in their respective legal systems.[839] Moreover, the case law of the Court of Justice of the European Union outlines in some cases the limits of national (tax) legislation in relation to EU law and even of directives themselves.

It should not be forgotten, of course, that European law has as one of its major objectives the promotion of its internal market,[840] where the need to ensure individual freedoms for the taxpayer is set against attempts to curtail the (ab)use of these freedoms as a form of tax avoidance. That is, every freedom has its own limitations,[841] in this case both under European law itself and under the national attempts by EU Member States to combat aggressive tax planning structures.

In this respect, there is a delicate balance between the guarantees of freedom and the anti-avoidance rules at both European and national level when discussing cross-border royalty payments. While the internal market does not, by itself, allocate taxing rights between the Member States, one of the most intricate issues to resolve in relation to EU (tax) law is therefore this tension between the freedoms established under the internal market and the concept of tax avoidance as well as the measures taken collectively or individually to combat it. The ECJ itself indicates that the safeguards granted to the taxpayer under the fundamental freedoms ultimately expire on the

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[837] See Pedersen, Kasper; Schultz, Sandra (2017): Action 6: Are the Anti-Abuse Rules EU Compatible? In *European Taxation*, P. 323ff.
[838] Art. 115 TFEU. For more information on the possibility of majority voting within the EU in tax issues, refer to Heber (2021): Enhanced Cooperation and European Tax., P. 30ff.
[839] For information on the different sources of EU law on tax matters, refer to Adamczyk/Majdanska (2020): Chapter 1 - The Sources of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 4ff.
[840] The European Court of Justice had already concluded in the 1980s that the concept of a 'common market' involves a quest to eliminate possible market barriers within the present-day European Union, with the aim of merging the different national markets into a single market so that it has characteristics as close as possible to a fully-fledged internal market. Refer to the *Schul* decision, C-15/81, para. 33; as well as *Ryborg*, C-297/89 and *Klattner/Elliniko Dimosio*, C-389/95.
[841] As in Loukota (2010): Internationale Steuerplanung und Europarecht. In: Lang/Weinzierl (Eds.) - Europäisches Steuerrecht, P. 584f.

rational limits of the internal market.[842] It is this dynamic that will be put to the test in the sections below.

4.2.1 Compatibility with European secondary law

First and foremost, the compatibility of specific anti-tax avoidance rules, such as withholding taxes and royalty deduction barriers, should be assessed according to the dictates of European secondary law, since this is composed, *inter alia*, of directives that possibly deal directly and specifically with these measures. Those relevant to the discussion in question will be dealt with in this subsection, which, however, does not ensure that, in the event of no proven incompatibility, the anti-avoidance measures under examination are compatible with European law. This is because, after this analysis of specific directives, the measures must also be compatible with European primary law, that has a more general and principled nature.

Although *prima facie* directives are reliant on internal implementation by Member States, a compatibility analysis from a purely European perspective is simple to carry out because of the direct effectiveness these provisions entail. In the case of *Van Duyn* v. *Home Office*,[843] the ECJ recognized that due to the inherent risk of non- or poor implementation by MS of the subject matter of directives, that it would be incompatible with their binding nature for it not to be possible to have direct access to their content, depending on the specific case, in the relationship between individual and Member State.[844] Furthermore, the respective national courts must ensure that the directive implemented is interpreted in accordance with the dictates of European law, so as to ensure its compatibility with the system as a whole.[845] Thus, it is possible to proceed from an evaluation of the directives from a general European perspective, without the need to have to rely directly on the small variations that can certainly occur at the time of their national implementation.

[842] Refer to Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 290ff.
[843] Case 41/74.
[844] In spite of this not being possible in horizontal relations, as established in *Paola Faccini Dori* v. *Recreb Srl* (C-91/92) and *The Queen, on the application of Delena Wells* v. *Secretary of State for Transport, Local Government and the Regions* (C-201/02).
[845] It is the so-called principle of interpretation in accordance with EU law, as defined in the connected cases *Pfeiffer* (C-397/01) to *Döbele* v. *Deutsches Rotes Kreuz* (C-403/01).

The directives drawn up under direct taxation to date can be divided into three major categories, based on their main purpose: (a) directives aimed at enhancing tax administration;[846] (b) directives aimed at dealing with aggressive tax planning and tax avoidance;[847] and (c) directives aimed at removing market barriers.[848] In particular, the last two categories are of primary interest for this research as they either (i) address tax avoidance directly, by creating minimum parameters or by elaborating specific ways to achieve this goal; or (ii) remove – and restrict the possibility of re-establishing – barriers to the European internal market, which is precisely the opposite of what measures such as withholding taxes and royalty deductibility barriers possibly end up achieving.[849]

While it is widely accepted that the phenomenon of double taxation does not in itself violate principles of European law,[850] there is also general recognition that for the sake of the European single market Member States should strive to avoid it. The ECJ itself acknowledges on multiple occasions that this is partly achieved through directives such as the Parent-Subsidiary- and Interest and Royalties Directive, which aim to create a certain neutrality between domestic and cross-border transactions, extending beyond purely addressing double-taxation.[851] Accordingly, these directives aim in each of their respective areas to promote, directly or indirectly, the European Single Market and to eliminate possible disadvantages for cross-border transactions in relation to their national counterparts, which explains the CJEU's continuing resistance to measures taken unilaterally by Member States in order to restrict the effects of directives.[852]

One of the first rules of direct interest for the issue of royalty payment transactions between companies within the same business group is undoubtedly the Interest and Royalties Directive. Possibly, its provisions will restrict the leeway of Member States to take unilateral measures they

[846] Such as the Administrative Co-operation and Mutual assistance Directive, Council Directive 77/799/EC.
[847] Such as the Anti-Tax Avoidance Directives (I and II), Council Directive 2016/1164 and 2017/952, respectively.
[848] Such as the Interest and Royalties Directive, Council Directive 2003/49/EC. Refer also, for more information, to Adamczyk/Majdanska (2020): Chapter 1 - The Sources of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 18ff.
[849] That is why the parent-subsidiary- and interest and royalties directives are known as "pro-freedom" directives, in contrast to a "pro-fiscal" directive such as the ATAD.
[850] Case *Margarete Block* v. *Finanzamt Kaufbeuren*, C-67/08.
[851] Refer to Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 296f.
[852] As in Kofler (2010): Verhältnis zwischen primären und sekundärem. In: Lang/Weinzierl (Eds.) - Europäisches Steuerrecht., P. 441f.

consider appropriate to combat aggressive tax planning structures. This connection will be discussed in depth below.

4.2.1.1 The Interest and Royalties Directive

4.2.1.1.1 General provisions and structure involving royalty payments

The Interest and Royalties Directive contains in its Article 1 an express legal prohibition on any form of withholding of taxes at source in the scenario of interest and/or royalty payments between companies within the EU of the same business group – from a participation threshold of 25%.[853] This prohibition applies to the payee who is the beneficial owner[854] of the transaction, *i.e.* the one who receives and has rights to the payment coming from the source State. Much like the parent-subsidiary directive[855], which applies to the distribution of dividends within the European Union, this provision aims at removing trade barriers for transactions within business groups that occur in a cross-border context, so as to ensure similar or equal treatment to that which would occur if they were residents of the same jurisdiction.

In addition, this rule also counters double taxation, since it would restrict the possibility of taxation to only one of the countries involved in the transaction. Within the framework of tackling harmful tax practices within the EU, this directive has always been a pariah, as it encourages tax competition and provides for tax planning opportunities in the name of fighting off double taxation.[856] Thus, if there is a deduction of royalty payments made by the licensee in the form of business expenses, it would be solely up to the country of residence of the payee to determine the level of taxation of the amount credited as payment.[857] However, it is essential to note that there is no obligation on the source state to grant the possibility of deducting these payments as operating expenses, since this is part of the national tax powers reserved for EU member countries. That means that, *prima facie*, there is no infringement of the Interest and Royalties Directive if the possibility of deducting royalty payments is generally not granted or if there is a restriction on the possibility of deducting them, since the directive merely restricts the possibility of taxation of the

[853] As depicted previously in Graphic 1, on Chapter 4.
[854] For more information on the usage of this term, refer *inter alia* to Section 1.4.1.2.
[855] Council directive 2011/96/EU, former 90/435/EEC.
[856] For more on this opinion, refer to Cordewener (2018): The Interest and Royalty Directive. In: Wattel/Marres et al. (Eds.) - Terra/Wattel European Tax Law., P. 209f.
[857] See Haselmann/Ismer/Kaul/Ruf (2016): Quellensteuern auf Lizengebühren und Schachteldividenden., P. 62f.

payee by the source state, but not of the payer. This was settled by the ECJ in its judgment *Scheuten Solar Technology*[858], which means that a possible limitation on royalty deductions does not directly breach the directive.

In an attempt to modify and improve the functioning of this directive, there have been discussions[859] in recent years about a reduction of the participating threshold for companies from 25% to 10%, or even an extension of this provision to non-related companies. Furthermore, the inclusion of a subject-to-tax clause was considered, to avoid market distortions due to a residence state deciding to reduce its corporate tax rate or to grant tax incentives in the form of IP-Boxes to attract investment and take advantage of the directive's existence to the detriment of source states.[860] However, given the need to achieve unanimity within the EU in order to promote tax reforms, combined with the various interests of the individual Member States, no reform of the directive in this respect has been possible so far – which is a testament to future difficulties within the EU concerning the implementation and later modifications of the GloBE proposal within the EU, since a directive has already been proposed.[861]

Despite the fact that it has not been possible to introduce a subject-to-tax clause as a means of promoting the single tax principle,[862] Art. 5 para. 1 of the Interest and Royalties Directive allows for the use of unilateral measures by States or of provisions laid down *e.g.* by double taxation agreements for cases of fraud and abuse. This means that, in the most severe cases of aggressive tax planning by a business group, the exemption from withholding taxes at source may eventually be suppressed by a previously established national rule.[863] However, as this is not a subject-to-tax

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[858] C-397/09.

[859] For more information, see Fernandes, S.; Bernales, R.; Michel, B.; Popa, O.; Santoro, E.; Goeydeniz, S. (2011): European Union - A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1. In *European Taxation* 51 (9/10).

[860] As was also suggested by Fehling, Daniel; Schmid, Mareike (2015): BEPS und die EU: Was ist die "europäische Dimension" von BEPS? Das Beispiel grenzüberschreitender Lizenzzahlungen. In *IStR*, P. 497ff.

[861] A sunset clause would be adviseable, as getting into a directive in tax matters is hard, but getting out is virtually impossible, as proven by the Interest and Royalties Directive.

[862] Which, unfortunately, was also not recognized by the ECJ so far as a self-standing justification to deny deductions in cross-border situations. Refer to Vanistendael (2018): Single Taxation in a Single. In: Wheeler/Berman - Single taxation? For more information on this principle, refer to the analysis by Parada (2017): Double non-taxation and the use., P. 22ff.

[863] That is to say that Art. 5 para. 1 and 2 of the directive are not self-executing, relying on domestic norms and principles to have any effectiveness.

clause, this exception will commonly be restricted to wholly artificial arrangements only,[864] in which the absence of taxation or taxation below a level considered "fair" by the source State is not considered to be sufficient grounds for overriding the guarantees provided by the Directive.[865]

The second paragraph of the same article, however, further allows Member States to refuse to grant the benefits under the directive in cases where the main or one of the main reasons for the occurrence of a particular transaction is an abuse of rights. While the directive does not define the concept of abuse on its own, it establishes that the *intention* to practice this abuse must be in the foreground of the analysis. Nevertheless, this possibility is interpreted in an extremely restrictive manner,[866] similar to a Principle Purpose Test (PPT), in which only those cases in which it can be proven that the primary purpose of a transaction is to fraud the objectives of the directive may its benefits be denied to the taxpayer.[867] This implies a case-by-case analysis, difficult to reconcile with a general rule of withholding of taxes,[868] for example.

This is confirmed by the jurisprudence of the European Court of Justice on abuse of rights, where there is little to no differentiation in the interpretation of a directive regardless of whether it contains such a specific anti-abuse rule or not. This occurs because, although the specific provision is always cited as a legal basis if it exists, the reasoning in cases like *Halifax*[869], *Kofoed*[870] and *Leur-Bloem*[871] makes it clear that this ensues no significant deviations from the general prohibition

[864] These anti-avoidance provisions contained within the directives will naturally mirror the requirements of EU primary law concerning "wholly artificial arrangements". Refer to Chapter 4.2.2 and Geringer, Stefanie (2020): Criteria for the Application of Anti-Abuse Provisions to Holding Companies under ECJ Case Law: Their Significance in Interpreting and Applying ATAD Provisions. In *European Taxation* 60 (10), P. 450.
[865] Some questions still surround the use of this provision, under discussion in cases like *BEI ApS* v *Skatteministeriet* (C-682/16). For more information, see JFA Juristes & Fiscalistes Associés (2019): Contentieux devant la Cour de justice et le Tribunal de l'UE (fiscalité directe). In *Fiscalité Internationale* (3), 64ff.
[866] This analysis is commonly based on the extremely similar current Art. 1 para. 4 of the Parent-Subsidiary Directive, which has a restrictive interpretation based on both theoretical discussions and ECJ decisions. For more information, refert to Hristov (2020): Chapter 7 - The Interest and. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on.
[867] See Staringer/Tüchler (2010): Die Quellensteuerfreiheit nach der Mutter-Tochter-Richtlinie. In: Lang/Schuch/Staringer (Eds.) - Quellensteuern., P. 305ff.
[868] Even though Members of the European Parliament are now calling for a EU Commission proposal for an EU-wide withholding tax applying, among others, to royalties. Refer to Paez, Sarah (2022): MEPs Demand EU Withholding Tax Framework. In *Tax Notes International* 105 (5), P. 588f.
[869] C-255/02.
[870] C-321/05.
[871] C-28/95.

of European law against the abuse of rights.[872] It can be argued that this understanding may have changed dramatically in recent years, particularly due to the relatively recent ECJ decisions in the February 2019 Danish beneficial ownership cases[873] however the way in which the specific anti-abuse rules set out in the Interest and Royalties Directive are interpreted remains yet restricted to cases where there is a "wholly artificial arrangement".[874]

4.2.1.1.2 Possibility of introducing withholding taxes to prevent abuse

Despite the overwhelming majority of literature and jurisprudence agreeing with these restrictions on the possibility to withhold on cross-border royalty transactions between companies of the same business group, there are some dissenting voices with observations that are worthy noting.

a) General withholding taxes within the context of the directive

The provisions of the Interest and Royalties Directive allow Member States to levy WHT to the extent that the administrative application of the objectives of the directive – that is, the reduction of trade barriers in the single market – allows the taxpayer to provide evidence of meeting the requirements necessary to obtain the benefits granted by the directive and receive the amounts withheld by the tax authorities back. The most interesting aspect of this form of argumentation is if it would be possible to establish a single taxation requirement for this benefit to be granted, as even though it has not been so far recognized by the ECJ, it was foreseen in the recital for the elaboration of the directive.[875]

Following this line of reasoning, the objectives of this directive would include not only reducing barriers in the European market and avoiding cases of double taxation, but also ensuring

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[872] Refer to Tumpel/Prechtl (2009): Die Grenzen steuerlicher Gestaltung in. In: Lang/Schuch/Staringer (Eds.) - Die Grenzen der Gestaltungsmöglichkeiten im., P. 74f; and more recently for the Danish cases in Marres, Otto; de Groot, Isabella (2021): Combatting Abuse by Conduit Companies. The Doctrine of Abuse under EU Law and Its Influence on Tax Treaties. In *European Taxation* 61 (8), P. 329ff.
[873] Which will be discussed in the next section.
[874] For more information on the concept of tax abuse and the idea of wholly artificial arrangements defined by the ECJ case law in a series of steps following the *Gebhard* (C-55/94) formula, please refer to cases such as *Halifax* (C-255/02), *Cadbury Schweppes* (C-196/04) and *Thin Cap Group Litigation* (C-524/04). Some authors argue, nevertheless, that if the payment is made to someone other than the beneficial owner, they will not be entitled to the protection of the Interest and Royalties Directive. See the opinion of Lampert, Steffen (2019): Zur Vereinbarkeit der Quellenbesteuerung von Zinsen und Dividenden mit dem Unionsrecht in den "Dänemark"-Urteilen des EuGH (Rs. C-115/16 bis C-119/16 und C-299/16). In *ISR* 19, P. 769f.
[875] Para. 3 of the recital to the Council Directive 2003/49/EC.

that revenue from royalties is taxed once in one of the Member States. Accordingly, a taxpayer could not rely on the exemption of withholding taxes if he could not demonstrate unequivocally that the payment of royalties was subject to taxation at least once within the European Union.[876] This would be based on the premise that, when concluding the directive, all Member States clearly assumed that taxation would take place in the residence state of the payee, which would therefore allow the withholding of taxes to be waived. However, when some Member States use tax incentives such as IP-Boxes, or even serve only for the pass-through of such payments to beyond the EU – without taxation being ensured – it could be considered that the objectives of the directive when drafted are being subverted.[877]

How high the taxation in a residence state must be in order to meet the requirements of a single tax principle is, however, very controversial. At the time the directive was drafted, in 2003, the lowest corporate tax rate within the EU belonged to Ireland, at 12.5%, while most rates were higher than 25%. Today, Hungary is the EU Member State with the lowest tax rate, at just 9%. While some authors propose a rate of around 10% to assess whether the single taxation occurred in accordance with the goals of the directive, so as to allow benefits of the directive to be denied to taxpayers,[878] it is important to remember that there is no provision in the text of the Interest and Royalties Directive, but only a generic mention of this requirement in its *raison d'être*. Hence, it seems hard to believe that this argument would be accepted by the ECJ as a broad justification to deny benefits from a directive whose main purpose is to promote the European single market. So far, judgments like *Lankhorst-Hohorst*[879] and *SIAT*[880] categorically rejected the view that countries can employ discriminatory features of their tax systems with the ultimate goal of securing single taxation and to counter low or no taxation treatment in other Member States.[881] In addition, in cases such as *Eqiom*, linked to the parent-subsidiary directive and WHT, it became clear that MS

[876] Defended by Jarass/Obermair (2015): Faire und effiziente Unternehmensbesteuerung., P. 70ff.
[877] Dr. Wendelin Staats, Head of Division at the German Federal Ministry of Finance, also defended this view, as argued by Jarass/Obermair (2015): Faire und effiziente Unternehmensbesteuerung., P. 71.
[878] *Ibid*.
[879] C-324/00.
[880] C-318/10.
[881] See Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 297f.

cannot unilaterally introduce restrictive measures and subject the right to exemption from withholding tax that comes from the directive to various conditions.[882]

It cannot be ruled out, however, that it *might* be possible for this denial of benefits to be accepted in very specific cases. Admittedly, there is a recent trend within the EU to seek a balance – also through directives – between measures against base erosion and profit shifting and the protection of the internal market. More recent European Court of Justice cases such as *Cussens*,[883] indicate the possibility for Member States to invoke general principles of European law of prevention of abuse also in cases of secondary law. This decision implies that, despite the fact that a directive needs national implementation if it is to be properly employed by the Member State, the notion of a ban on abusive practices in European law is a principle already defined in case law and applies to the benefits granted by EU law regardless of whether its basis of application is a directive or not.[884]

However, at the time of drafting the Interest and Royalties Directive, this reality was distinct, and formal reforms will probably be necessary to allow for a shift in the understanding and use of its anti-avoidance mechanisms with respect to WHT. Thus, it is virtually certain that a broad-specter withholding tax[885] on royalty payments is currently incompatible with European secondary law, which prevents it from being employed as a viable solution to the problem of profit shifting with cross-border royalty payments.

b) Conditional withholding taxes within the context of the directive

With regard to the possibility of introducing a conditional withholding tax, realistically, adjustments to the Interest and Royalties Directive would also have to be made, firstly to ensure

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[882] C-6/16, para. 24. See also the decision at KBC Bank NV (C-439/07) and Beleggen, Risicokapitaal, Beheer NV (C-499/07), para. 38. This was later confirmed in the *Deister Holding* and *Juhler Holding* joined cases (C-504/16 and C-613/16, respectively), affirming that the prevention of abuse of a directive cannot go beyond targeting wholly artificial arrangements.
[883] C-251/16.
[884] That case in fact concerned the application of the Value Added Tax, in which Advocate General Kokott later advocated in his AG Opinion in N Luxembourg 1 (C-115/16) that it should not apply to directives such as the Interest and Royalties Directive, since it represents a less harmonized field of European tax law. For further information in that discussion, please refer to Arginelli (2018): Chapter 4: Open Issues of. In: Maisto (Ed.), Taxation of Intellectual Property under., P. 76ff.
[885] As seen on Chapter 3.1.2.1.

that any Member States which do not have a form of withholding for royalty payments do so; and secondly to introduce an effective minimum tax clause, *i.e.* one which extends to cases where taxation is deemed insufficient, and not just to wholly artificial arrangements, criteria following ECJ case law. Unless the far-fetched argument of the presence of a single tax principle in the justification for drafting the directive is accepted as reasonable grounds for a possible discriminatory treatment between companies of the same group making royalty payments to each other, without a reform of that directive[886] it will not be possible to use withholding taxes to solve this issue of aggressive tax planning. Implementation in any of the WHT formats without proper reform of European secondary law is risky, as it is likely to be reviewed in court at a later stage, creating legal uncertainty for taxpayers and tax administrations alike.

Nevertheless, as previously indicated, any changes to European tax law depend on unanimity among Member States under Art. 115 TFEU. Such a proposal would certainly suffer – as it has in the past[887] – from resistance from those countries which would undoubtedly have revenue and investments to lose from its implementation, for instance because they are an attractive business location for not having withholding taxes on royalties.[888] Thus, there is very limited enthusiasm on the part of some Member States to implement a conditional withholding tax and introduce a subject-to-tax clause in the Interest and Royalties Directive, and since consensus is needed and acceptance is hard,[889] withholding taxes are, within the EU, in a stalemate.

As the prospects for success of a comprehensive reform are low, the use of withholding taxes in the European context is regrettably not a realistic solution to the problem of profit shifting with cross-border licensing agreements.[890] The choices made through this directive ultimately have a political and fiscal nature, as they ensure the primacy of the investor's country of residence

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[886] Some authors argue that a directive might not even be the appropriate means of dealing with tax avoidance issues, for more information refer to de Graaf, Arnaud; Visser, Klaas-Jan (2016): ATA Directive: Some Observations regarding formal Aspects. In *EC Tax Review* 25 (4), P. 199ff.
[887] As with the EU Commission proposal of 11 November 2011, COM (2011), that tried a shift from a pure objective subject-to-tax requirement towards a true single tax principle with a minimum effective taxation feature. For more information, see Arginelli (2018): Chapter 4: Open Issues of. In: Maisto (Ed.), Taxation of Intellectual Property under., P. 67ff.
[888] It is worth recalling that in recent years, particularly due to European and international pressure, some countries like the Netherlands have decided to implement WHT to repair damage caused to their image as a country fostering aggressive tax planning structures. For more information, refer to Chapter 3.
[889] As stated by Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 6ff.
[890] For more on a solution to this stalemate and viable options, refer to Chapter 5.

over the possibility of taxation by the source state of intra-group cross-border royalty payments. The Interest and Royalties Directive therefore reflects the EU's desire to abolish source taxation in such cases, even if this decision is questionable[891] from the point of view of enabling aggressive tax planning structures. A possible WHT as a subject-to-tax clause compatible with European secondary legislation at its current stand would have to be so restrictive that this would risk a drastic reduction in its effectiveness, failing to achieve its objective of effectively restraining aggressive tax planning strategies.

This does not mean, however, that European countries should refrain from implementing or reforming their own withholding systems, since, for the most acute cases of abuse, the anti-abuse rule contained in the directive – as well as the general principle of European law – can try to ensure fair taxation. Another alternative, middle ground between a broad EU-compatible solution and a manifest violation of EU law through an unilateral WHT would be the enhanced cooperation possibility foreseen within the TFEU and TEU.[892] If an agreement were to be reached in this fashion, it would alleviate the hardship of reaching unanimity within the EU on tax issues, whilst, however, having these rules only apply between interested participating countries.[893] Thus, the prospect of simply combating no or low taxation through WHT within the EU seems, for now, to have reached a dead end. Precisely because of this, as seen previously,[894] an alternative found internally to the EU of practically "circumventing" the Interest and Royalties Directive and obtaining results similar to the withholding of taxes is that of royalty deduction barriers.

4.2.1.1.3 Possibility of restricting royalty deductibility

On the other hand, regarding the royalty deductibility barriers, the general consensus from the very beginning of the introduction of this provision within some of the EU Member States is

[891] In academia it is sometimes believed, however, that because of the need to prevent abuse and ensure tax fairness among Member States in the European single market, withholding taxes on deductible payments, such as royalties, should not only be maintained, but even increased. However, the European Union's choice in the opposite direction is made clear through the directive. See Cnossen, Sijbren (2004): Reform and Coordination of Corporation Taxes in the European Union: An Alternative Agenda. In *Bulletin for International Taxation*, P. 134ff. and Easson, Alex (1996): Fiscal degradation and the inter-nation allocation of tax jurisdiction. In *EC Tax Review* (3), P. 112f, as well as Cordewener (2018): The Interest and Royalty Directive. In: Wattel/Marres et al. (Eds.) - Terra/Wattel European Tax Law. P. 209ff.
[892] Art. 326ff. TFEU and Art. 20ff. TEU. Refer also to the work of Heber (2021): Enhanced Cooperation and European Tax., P. 30ff.
[893] This possible solution will be further discussed on Chapter 5.
[894] Refer to Chapter 3.2.

that it would be entirely beyond the scope of the Interest and Royalties Directive,[895] and is therefore naturally compatible with it. This would occur, as mentioned above, due to the fact that its application range would be restricted to the taxation of the (royalty) payment recipient, *i.e.*, the creditor of the payment. Therefore, any taxation of the payor, *i.e.* the license holder – in this case through a restriction on the deductibility of payments in the form of expenses – would not be a subject for the directive.[896]

In this sense, the Interest and Royalties Directive provides an exemption for the income of the foreign licensor from withholding taxes, and the deductibility barrier established in the source State of residence of the licensee does not constitute such a tax. However, it can be observed that the *effects* that this measure has in the group of companies is extremely similar to that of a withholding system,[897] which would continually restrict, to a certain extent, the cross-border allocation of licenses between related parties, which arguably contradicts the directive's core objective. In fact, a royalty deductibility barrier is, from an economic perspective, very much like a withholding tax, but without the possibility of offsetting the taxes paid at the residence State of the payee. Therefore, from a minority viewpoint,[898] a violation of the directive cannot be excluded outright.

It so occurs that the directive, in its Art. 1 para. 1, by ensuring that royalty payments arising in one State should be free from taxes on that State, provides that this cannot occur by deduction at source *or* by assessment. However, it may be argued that the effects produced by a royalty deductibility barrier are exactly the same as those that arise as a consequence of a royalty payment

[895] Which has been confirmed by several authors, such as Titgemeyer, Marion (2017): Steuergestaltung bei multinationalen Konzernen: kritische Diskussion der deutschen Lizenzschranke. In *DStZ* 20, P. 750; van Lück, Kolja (2017): Gesetzentwurf zur Einführung einer Lizenzschranke durch §4j EStG. Verfassungsrechtliche und europarechtliche Herausforderungen. In *IStR* (10), P. 390ff.; Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), P. 210f.; and Max, Marcel; Thiede, Jesko (2017): Der Gesetzesentwurf zur Einführung einer Abzugsbeschränkung für Lizenzaufwendungen - "Lizenzschranke". In *StB* (6), P. 180f.

[896] As decided by ECJ in *Scheuten Solar Technology*. Refer to Fn. 858.

[897] Schneider, Norbert; Junior, Björn (2017): Die Lizenzschranke - Überblick über den Regierungsentwurf zu §4j EStG. In *DStR* 55 (8), P. 425.

[898] See, for instance, Müllmann (2021): Die Lizenzschranke als Abwehrmaßnahme im., P. 330ff.; and Hagemann, Tobias; Kahlenberg, Christian (2017): Die Lizenzschranke (§ 4j EStG) aus verfassungs- und unionsrechtlicher Sicht. In *FinanzRundschau* (24), P. 1127f.

and a subsequent assessment that would not have occurred had the payment not been made.[899] Therefore, it cannot be ruled out that in an eventual CJEU decision on the matter of royalty deductibility barrier within the EU, a violation of the objectives of the Interest and Royalties Directive is deemed to exist. Such an understanding, however, seems extremely unlikely, not only due to the fact that it currently is a very minoritarian opinion, but also because it presents an argument linked to more general and principled aspects of the Directive, which would possibly be better analyzed from a European primary law perspective.[900] Thus, barriers to the deductibility of royalties can *prima facie* be considered perfectly compatible with the Interest and Royalties Directive, as they are beyond its scope.

Finally, regarding the possibility of introducing an inverted tax credit system, the Interest and Royalty Directive does not deal, directly or indirectly, with the type of tax credit technique proposed. The method of widely granting tax credits instead of deductions concerns the national law of each country, promoting a neutral treatment within the corporate group, not being featured as any of the restrictions imposed by the directive.

4.2.1.2 The Anti-Tax Avoidance Directive (ATAD)

Following the OECD BEPS-project, the European Union decided to implement the ATAD as a directive capable of delivering the measures and proposals discussed at an international level within the EU in a rapid and coordinated manner. The directive introduces, as discussed previously,[901] a series of measures theoretically capable of preventing various forms of tax avoidance. However, the ATAD deals in particular with broad measures such as CFCs and GAARs, and despite containing a rule to restrict the deductibility of intra-group cross-border *interest* payments,[902] no mention is made of a limitation on the deductibility of royalties.

While the ATAD in itself does not represent an obstacle to the introduction of stricter anti-avoidance rules or even rules not provided for by the directive, the introduction of a barrier to the deductibility of interests, but none to the deductibility of royalties is a clear indication that these

[899] As argued by Wimpissinger, Christian (2014): Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach §12 KStG unionsrechtswidrig? In *SWI*, P. 226f. From a substantive perspective, it makes little to no difference whether there is a withholding tax on royalties or whether their deductions are disallowed, see *e.g.* Peyerl, Hermann (2014): Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern. In *ÖStZ* 314, P. 226.
[900] On this same opinion, refer to Schreiner (2020): Die Lizenzschranke gem. § 4j EStG., P. 243f.
[901] See Chapters 2.1.2 and 2.1.3.
[902] Art. 4 ATAD, corresponding to OECD Action Plan nº 4.

measures adopted unilaterally by some European countries were not part of the plans of the EU as a whole in a harmonized fashion.[903] This is not to say that royalty deductibility barriers or even rules such as subject-to-tax withholding taxes are in conflict with the ATAD, as they are not directly regulated by it.

However, some opposing opinions deserve to be briefly mentioned with respect to the compatibility of such measures with the ATAD, where some authors argue that Art. 9 of ATAD, by regulating general preference rules for deductions in order to neutralize hybrid entities, may generate conflicts in the application of barriers to the deductibility of royalties between source and residence state. This should, however, be analyzed only on a case-by-case basis.[904] On the other hand, in relation to conditional withholding taxes, it cannot be ruled out that Article 6 of the ATAD, which contains the GAAR of the directive, may be used as an argument for denying any benefits granted by the Interest and Royalties Directive if it is considered that withholding taxes fall into the scope of calculating the corporate tax liability of a taxpayer that is part of a group of companies; and if it is used with an anti-abuse purpose.[905]

In relation to the inverted tax credit system, there are no points of intersection with the directive. Despite these few dissenting voices, there appears to be no direct conflict of royalty deductibility barriers or even withholding taxes with the ATAD, with the exception of specific particular instances which should be analyzed on a case-by-case basis. As such, the directives – as part of European secondary law – that are possibly applicable to the rules under discussion have been inspected.

4.2.2 Compatibility with European primary law

After a more detailed study of the relevant European secondary law rules for measures to combat aggressive tax planning structures with royalty payments, it remains to be seen whether measures which are compatible with the directives also pass this test in relation to European

[903] Refer to Schneider, Norbert; Junior, Björn (2017): Die Lizenzschranke - Überblick über den Regierungsentwurf zu §4j EStG. In *DStR* 55 (8), P. 418f.
[904] As was defended by Hagemann, Tobias; Kahlenberg, Christian (2017): Die Lizenzschranke (§ 4j EStG) aus verfassungs- und unionsrechtlicher Sicht. In *FinanzRundschau* (24), P. 1127ff.
[905] As stated by Arginelli (2018): Chapter 4: Open Issues of. In: Maisto (Ed.), Taxation of Intellectual Property under., P. 76. It seems, however, that the Interest and Royalties directive might already be able to solve this issue with its own provisions.

primary law. Furthermore, it is also questionable whether the directive proposal[906] for an implementation of the OECD GloBE would be compatible with the fundamental freedoms.[907] For a long time, the main relevant European primary law provisions were the fundamental freedoms, which, by defining the basic parameters governing the European single market, set limits for the exercise of a national tax jurisdiction, configuring a form of negative integration. More recently, the State Aid rules contained in Arts. 107 and 108 TFEU have also gained greater importance and visibility, especially in the field of direct taxation, and therefore of interest to the provisions under consideration.[908] This is not to say, of course, that fundamental freedoms have been denied their prevailing place in European law, but rather that other rules and requirements have gained prominence besides them in the fostering of the internal market.

Cases of the ECJ from the beginning of the century, such as *Bosal*[909] and *Keller*[910] indicate that issues which are not covered or decided by directives should be interpreted in the light of European primary law.[911] This is to say that the Court has confirmed the direct application of fundamental freedoms to national measures which have a cross-border impact in so far as the *de facto* situation is not part of the objective or subjective scope of a directive.[912] Furthermore, in cases such as *Deister Holding*[913] the ECJ has pointed out that the fundamental freedoms run alongside directives, given the fact that there is no full harmonization in direct taxation issues within the EU as of now.[914]

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[906] European Commission (2021): Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (COM(2021) 823 final). Available online at https://taxation-customs.ec.europa.eu/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf, checked on 27.12.21.

[907] The same issues that arise with a royalty barrier can be transposed in great part to the GloBE untertaxed payments rule, thus their analysis will be conducted in unison. Refer also to the opinion of Englisch, Joachim (2021): Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed. In *EC Tax Review* 30 (5&6), P. 210f.

[908] See Adamczyk/Majdanska (2020): Chapter 1 - The Sources of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 9ff.

[909] C-168/01.

[910] C-471/04.

[911] As stated by Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 297ff.

[912] Confirmed in cases such as *Amurta* (C-379/05) and *ACT Group Litigation* (C-374/04). For further comments, refer to Kofler (2010): Verhältnis zwischen primären und sekundärem. In: Lang/Weinzierl (Eds.) - Europäisches Steuerrecht., P. 443ff.

[913] Joined Cases C-504/16 and C-613/16, para. 45.

[914] For more on this discussion, refer to Geringer, Stefanie (2020): Criteria for the Application of Anti-Abuse Provisions to Holding Companies under ECJ Case Law: Their Significance in Interpreting and Applying ATAD Provisions. In *European Taxation* 60 (10), P. 449f. Naturally, this would chance with the directive intenting to implement the GloBE proposal. It is, however, doubtful whether this will succeed.

The employment of European primary law is therefore also essential for the proper functioning of the internal market as it helps to abolish its own barriers. And as phenomena such as double taxation represent an obvious restriction on the free movement of goods, persons, services and capital within the European single market,[915] the occurrence of double non- (or very low) taxation, often relegated, can also generate impacts from the perspective of competition for investment and economic efficiency within the EU. Thus, European primary law can present, where directives do not, limits and responses to the problem of cross-border aggressive tax planning with royalties.

In this section, both the fundamental freedoms and the current European state aid rules will be put into forefront of the analysis concerning their compatibility with the rules assessed in the previous chapter.

4.2.2.1 The fundamental freedoms of the EU

The four freedoms of the European single market – namely the free movement of goods, people, capital and services (plus establishment) – represent the core values necessary for its existence and in order to promote the most efficient allocation of resources possible within the Union. Through their application, these protections, by ensuring freedoms in a market of a supranational nature, end up setting limits on the national power of taxation of Member States, who are neither allowed to penalize cross-border activities in relation to their national counterparts through (tax) restrictions nor to create illegal national incentives in the form of state aid.[916] That is to say that the four fundamental freedoms are a materialization of this general idea of non-discrimination between cross-border[917] and national situations within the market, ensuring market *access* and market *equality* alike.[918]

[915] Which has even led several scholars to study the possible use of fundamental freedoms in favour of the taxpayer to protect themselves against double taxation in a European context, refer to Marchgraber (2018): Double (non-)taxation and EU law., P. 25ff

[916] The issues of state aid will be discussed in the following section of the chapter. For more information, see also Lazarov (2018): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 63ff.

[917] Purely internal direct taxation matters fall outside of the scope of Union law, and therefore are left untouched by the fundamental freedoms.

[918] Refer to Wattel (2018): General EU Law Concepts and. In: Wattel/Marres et al. (Eds.) - Terra/Wattel European Tax Law, P. 35ff.

As a country's national tax sovereignty is essential to ensure its internal and external financial independence in order to achieve its political and economic objectives, it is not surprising that this is a sensitive issue and one of frequent conflict between Member States and the EU, especially with the European Court of Justice. This also further explains why attempts at harmonization and positive integration in the field of direct taxation, which requires unanimity under Art. 115 TFEU,[919] are so resisted by some countries. Thus, harmonization in this field occurs rather through the indirect influence of ECJ case law on conflicts that arise between the fundamental freedoms and domestic tax legislation that is not harmonized and may damage the freedoms of the single market.[920] This is stated openly by the Court, which has indicated in trials such as *Schumacker*[921] and *Eurowings*[922] that, even though direct taxation is not generally a determining competence of the European Union, the powers retained by the Member States must be exercised within the limits offered by (primary) European law.[923]

To assess whether a national tax law is contrary to the fundamental freedoms, the European Court of Justice commonly determines (a) which of the four fundamental freedoms is most relevant, if applicable; (b) whether that national (tax) measure constitutes or has the potential to constitute a restriction on the exercise of that freedom; (c) whether there is a possible justification for the occurrence of that restriction, if any; and (d) whether there is observance of the principle of proportionality, without an unduly restriction of the freedoms to achieve a given goal.[924] This has to be done by the ECJ in a conciliatory and balanced manner, weighing the protection of the single internal market and the legitimate interests of Member States to preserve their tax sovereignty and revenue.

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[919] Recently, there have been some discussions especially on part of the Commission on the usage of Art. 116 TFEU – that only requires a qualified majority – in some cases of competition-distorting regimes in MS. This seems, however, to not be applicable in the case of these anti-avoidance measures. Refer to Paez, Sarah (2021): EU Wants to Curb Member State Tax Avoidance. In *Tax Notes International* 102 (1), P. 79f.
[920] See for example the contribution of Kofler, Georg (2006): Wer hat das Sagen im Steuerrecht – EuGH (Teil II). In *ÖStZ* (299), P. 154ff.
[921] C-279/93.
[922] C-294/97. This is also confirmed in *Commission v France ('Avoir Fiscal')*, C-270/83, para. 13.
[923] For further information, refer to Marchgraber (2018): Double (non-)taxation and EU law., P. 71ff.
[924] As discussed and determined in cases such as *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, C-446/03. Refer, for more information, to Pedersen, Kasper; Schultz, Sandra (2017): Action 6: Are the Anti-Abuse Rules EU Compatible? In *European Taxation*, P. 323ff.

Considering the ECJ's jurisprudence over the years, as well as the Court's ever-changing and increasingly broad concept of “discrimination”,[925] there are few cases in which a national tax rule – such as a royalty deductibility barrier – will be drawn up in a way that will be readily regarded as neutral, and therefore not constituting a restriction on the exercise of any of the fundamental freedoms.[926] Even if such a rule is drafted in an objectively fair-minded manner, it is possible and even likely to be expected that it will affect taxpayers and domestic transactions differently from their cross-border counterparts. Thus, a *de facto* discrimination will be virtually inevitable and in violation of Union law if it cannot be justified. It is precisely for this reason that it is necessary to evaluate more thoroughly which freedoms are possibly affected in each of the issues under analysis, namely, withholding taxes,[927] royalty deductibility barriers and an inverted tax credit system, in order to be able to assess the possible justifications in the event of *de facto* discrimination.

4.2.2.1.1 Relevant freedoms and compatibility analysis

The ECJ case law on direct taxation generally indicates that the most relevant freedoms in this area are those regarding capital, of establishment and in services. However, it is not always clear which of these freedoms will be applied when considering, in a particular case, whether a certain measure is compatible with European law or not, which is all the more important to be determined as the ECJ has had in some instances a clear tendency to dissect a national measure regarding one freedom and one freedom only.[928] This means that if the Court decides to make an analysis of a national measure based on a freedom such as the freedom of establishment, the free movement of capital will not be simultaneously applicable, due to its subsidiary nature.[929]

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[925] On the concept of discrimination by the ECJ, see Wattel (2018): General EU Law Concepts and. In: Wattel/Marres et al. (Eds.) - Terra/Wattel European Tax Law. P. 36f.

[926] This also applies in the authors opinion to the more recent EU attempts at implementing a directive with an EU minimum tax in the context of the OECD GloBE proposal discussed in Chapter 3.4. Whilst trying to implement the IIR and UTPR also within a purely domestic context is a laudable measure, it leads to the same practical issue of indirect discrimination – as cross-border cases are ultimately the ones affected. The discussion on the royalty barrier also applies to the directive.

[927] Although, in the specific case of withholding taxes, it is already known that they fail the test with respect to EU secondary law. The analysis will therefore focus on the other regulations under consideration and merely hypothesize when it comes to withholding.

[928] Refer to the observations of Pedersen, Kasper; Schultz, Sandra (2017): Action 6: Are the Anti-Abuse Rules EU Compatible? In *European Taxation*, P. 324.

[929] *Ibid*.

Seemingly, the facts of each case are the determining factors in ascertaining which fundamental freedom will be applied preferentially.[930] This may, in turn, generate a number of difficulties in that it may be rather complicated to determine beforehand whether a particular situation will be covered – if at all – by one or another fundamental freedom, which might lead to different results from a legal perspective. This difficulty is increased in the case of closely related freedoms, such as the free movement of capital and the freedom of establishment, which are commonly applicable to cases of transactions between business groups.

a) Methodology to identify the pertinent freedom within the context of royalties

Considering the difficulties of relying solely and exclusively on the facts of each different case, part of the literature and also of the jurisprudence of the ECJ[931] lean towards a different direction, aiming at considering the purpose of the respective national tax legislation, *i.e.*, the legislative objective sought by the provision. This approach is likely more attractive for the analysis of the anti-avoidance measures proposed to avoid profit shifting through royalty payments, as it allows a more general evaluation of the rule, detached from each individual case. This has, however, also its own flaws. The legislator's ultimate purpose is often likewise difficult to identify, and a given provision may have two or more relevant objectives for its examination. Hence, one can understand why the ECJ's jurisprudence regarding the delimitation of fundamental freedoms and their relevance to each case is still surrounded by ambiguities and changes every few years.[932]

[930] This is suggested in cases such as *Aberdeen Property Fininvest Alpha* (C-303/07), para. 32ff.; *SGI* (C-311/08), para. 28ff.; *Accor* (C-310/09), para. 29ff. and *Haribo Lakritzen Hans Riegel and Österreichische Salinen AG* (C-436/08 and C-437/08). See the opinions of Englisch, Joachim (2010): Einige Schlussfolgerungen zur Grundfreiheitskompatibilität des § 1 AStG - zugleich Anmerkung zum Urteil des EuGH in der Rs. SGI. In *IStR* (4), P. 139ff., Zorn, Nikolaus (2010): Nochmals: Kapitalverkehrsfreiheit für Drittstaatendividenden. Eine Reaktion auf den Beitrag von Dietmar Völker in IStR 2009, 705 ff. In *IStR* (6), P. 190ff. and Marchgraber (2018): Double (non-)taxation and EU law. P. 84f.

[931] Suggested in cases such as *Test Claimants in the FII Group Litigation* (C-35/11), para. 100ff.; *Glaxo Wellcome* (C-182/08); and *Fidium Finanz* (C-452/04). Refer to Köhler, Stefan; Tippelhofer, Martina (2007): Kapitalverkehrsfreiheit auch in Drittstaatenfällen? Zugleich Anmerkung zu den Entscheidungen des EuGH in den Rechtssachen Lasertec (C-492/04) und Holböck (C-157/05) sowie zum BMF-Schreiben v. 21. 3. 2007 (IV B 7 – G 1421/0). In *IStR*, P. 645ff., Lang (2010): Der Anwendungsbereich der Grundfreiheiten - Maßgeblichkeit. In: Lang/Weinzierl (Eds.) - Europäisches Steuerrecht., P. 530ff. and Spies (2015): Die Kapitalverkehrsfreiheit in Konkurrenz zu., P. 197f.

[932] Refer to Schön, Wolfgang (2016): Free Movement of Capital and Freedom of Establishment. In *European Business Organization Law Review* 17 (3), P. 229ff.

Thus, the specific anti-avoidance provisions under discussion must be assessed for each of the fundamental freedoms that could possibly be applied to them, from one perspective or another. It is true that, even if reforms were to be undertaken in the Interest and Royalty Directive, which currently prevents almost any kind of WHT for intra-group royalty payments, that the withholding rules provided for in the respective national tax systems of the Member States, as well as in their bilateral double taxation agreement networks, would have to comply not only with the possible new dictates of a reformed directive, but also with the requirements of the fundamental freedoms. This means that, regardless of the existence of directives, the withholding of taxes with discriminatory effects without due justification are indubitably to be considered contrary to community law.[933]

Of special relevance to WHT are the freedom of services,[934] freedom of establishment,[935] and free movement of capital.[936] However, in the specific case of royalty payments, despite the fact that licensing agreements may be seen as constituting a service between licensee and licensor,[937] the freedom of establishment is actually the one with most prominence in disputes, as it governs the events of installation and management of companies in other MS; and where group affiliation is involved, the ECJ's preference for this freedom is made clear through case-law.[938] Of particular interest is the *Truck Center* case, which dealt with withholding in interest payments, where it was held that there would be no infringement of the fundamental freedom on account of the different treatment amid payments made between companies located in the same country and cross-border transactions, since in both cases the payments would be subject to taxation, the withholding tax being, however, much lower than the corporate tax rate currently employed in Belgium.[939] Therefore, provided that it is structured in a way that gives similar and non-

[933] See Dziurdz (2010): Bemessungsgrundlage und Steuersatz von Quellensteuern. In: Lang/Schuch/Staringer (Eds.) - Quellensteuern., P. 49f.
[934] With cases such as *Scorpio* (C-290/04) and *Commission of the European Communities v. Kingdom of Belgium* (C-433/04).
[935] With cases such as *Denkavit* (C-170/05), *Truck Center* (C-282/07) and *Aberdeen* (C-303/07).
[936] With cases such as *Amurta* (C-379/05).
[937] Although the materially relevant fundamental freedom in licensing cases is, as a rule, the freedom of services - as laid down for example in Germany by the BFH in I R 32/10 - other freedoms are commonly used due to the impact of this measure on establishment decisions. In any case, a precise delimitation is relatively unnecessary due to the identical spatial scope of protection such freedoms offer. Refer to Hagemann/Kahlenberg (2011): §4j. In: Herrmann/ Heuer et al. (Ed.) - Einkommensteuer- und Körperschaftsteuergesetz, para. 5.
[938] For further information, see Simader (2010): Die Zulässigkeit der Erhebung von. In: Lang/Schuch/Staringer (Eds.) - Quellensteuern., P. 17ff.
[939] C-282/07 para. 47ff.

discriminatory treatment between purely domestic and international situations, a WHT may be perfectly compatible with the freedom of establishment. There are dissenting opinions on this subject, especially when it comes to introducing a withholding tax by means of the Pillar 2 of the OECD GloBE proposal in the form of a subject-to-tax rule, as it might, if applied only to cross-border payments, result in a restriction of the fundamental freedoms.[940] So far, GloBE and the EU directive proposal have been based on assumptions and carve-outs that directly collide with EU primary law requirements[941] as they have been interpreted so far by the ECJ.[942]

It is also conceivable that the freedom of establishment could be applicable to the cases involving licensing agreements, where the example we have through *Amurta* and withholding taxes on dividends reaffirms the above with regard to this freedom, where the tax treatment applied nationally and in cross-border situations should be similar and non-discriminatory. It is therefore likely that, in the absence of restrictions in secondary European law on the subject, a WHT would be feasible from the point of view of the fundamental freedoms.[943] It is important to follow minimum guidelines in the design of withholding taxes so that comparable situations are not treated differently without a justification, or that for different situations the same standard is applied, as often confirmed by ECJ jurisprudence.[944] Thus, comparisons will be *e.g.* carried out between an internal national situation and another with cross-border character;[945] or even through horizontal comparison parameters, in which a side-by-side comparison is made between two international cases.[946]

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[940] As stated by Englisch, Joachim (2021): Designing a harmonized EU-GloBE in compliance with fundamental freedoms. In *SSRN Journal*. DOI: 10.2139/ssrn.3829090., P. 10f.

[941] See Brokelind, Cécile (2021): An Overview of Legal Issues Arising from the Implementation in the European Union of the OECD's Pillar One and Pillar Two Blueprint. In *Bulletin for International Taxation* 75 (5), P. 213ff; and Devereux, Michael P. (2020): The OECD Global Anti-Base Erosion Proposal. With assistance of François Bares, Sarah Clifford, Judith Freedman, Irem Güçeri, Martin McCarthy, Martin Simmler, John Vella. Oxford Centre for Business Taxation, P. 57.

[942] Even while attempting to implement the directive in a nondiscriminatory fashion by extending GLoBE to domestic groups, it is uncertain whether these efforts will succeed before the ECJ. Refer to Paez, Sarah (2022): EU Proposal Extends Pillar 2 Rules To Domestic Groups. In *Tax Notes International* 105 (1), P. 78f.; Paez, Sarah (2021): EU Should Consider Nondiscriminatory Implementation of Pillar 2. In *Tax Notes International* 104 (3), P. 333f.

[943] Somewhat of an opposing opinion on Schaumburg, Harald (2021): Quellensteuern zwischen Verfassungsrecht und Unionsrecht. In *ISR* (4), P. 140ff.

[944] Refer to cases such as *Schumacker* (C-279/93), para. 30ff.; and *Lakebrink* and *Peters-Lakebrink* (C-182/06), para. 27.

[945] As is usually the procedure by the Court, as in *Metallgesellschaft and Others* (C-397/97), para. 60, *Papillon* (C-418/07), para. 27, and *Oy AA* (C-231/05), para. 38.

[946] For more information on both forms of comparison, refer to Schmidtmann, Dirk (2008): Zur vertikalen und horizontalen Vergleichspaarbildung des EuGH aus ökonomischer Sicht. In *IWB* (22), P. 938ff.

In this sense, a WHT as a subject-to-tax clause would certainly have more chances to pass through the Court's scrutiny without being considered discriminatory, as it would be better tailored to treat each case according to its specific characteristics. In the event that they were still considered discriminatory treatments, it would remain to prove the possibility of justifying such an occurrence based on the main grounds accepted by the ECJ.[947]

It should also be remembered that the ECJ, in its case law in recent years, has always been faced with the problem of delimitation between the free movement of capital and the freedom of establishment. In spite of carrying out its analyses of the compatibility of national rules commonly using only one of the freedoms at a time, the result of analyses of multiple possibilities tends to converge towards the same common point, as was demonstrated in *X&Y*[948]. Therefore, the greatest difference found in the employment of the free movement of capital is its applicability to cases with third countries.[949] That is to say that, considering the convergence of the fundamental freedoms, in which the ECJ applies a similar pattern of analysis to all of them,[950] commonly reaching the same result, the crucial difference will be in cases where the suitability of the free movement of capital is decided, since it might apply beyond a purely European scenario.

It is therefore clear that the ECJ has been considering the specific scope of each national legislation to determine the applicable freedom. Regarding the relationship between the freedom of establishment and the free movement of capital, there is a strong tendency to evaluate whether the impact of the measure under analysis occurs in a manner exclusive to shareholders who can exercise control over the company's decisions.[951] If this tendency is confirmed, the preference is, as a rule, for probation through the freedom of establishment, since market insertion and market access operations are usually linked to the decision-making process of the shareholders. If this is not the case, the free movement of capital will apply, in a residual manner.[952] A similar delimitation occurs with regard to the free movements of services and of capital, and the Court

[947] As will be discussed in the following subsection.
[948] C-436/00, for further comments, refer to Simader, *op. cit.*, Fn. 938.
[949] See Köhler, Stefan; Tippelhofer, Martina (2007): Kapitalverkehrsfreiheit auch in Drittstaatenfällen? Zugleich Anmerkung zu den Entscheidungen des EuGH in den Rechtssachen Lasertec (C-492/04) und Holböck (C-157/05) sowie zum BMF-Schreiben v. 21. 3. 2007 (IV B 7 – G 1421/0). In *IStR*, P. 646ff.
[950] Albeit examining, as a rule, only one of them at a time.
[951] As it was established in *Deister Holding* (Joined Cases C-504/16 and C-613/16), para. 77ff.
[952] After ECJ case law on the matter, refer to Lang (2010): Der Anwendungsbereich der Grundfreiheiten - Maßgeblichkeit. In: Lang/Weinzierl (Eds.) - Europäisches Steuerrecht., P. 523f.

ultimately differentiates between what consists in market access through establishment or services and purely capital movement and investment transactions, based on the purpose of the national provision.[953]

b) Compatibility overview for royalty barriers

It is based on this knowledge that an analysis regarding the royalty deductibility barriers has to be carried out, since there is still no case-law on this issue by the ECJ. Through its distinct impact for cross-border and exclusively national royalty payments situations, a restriction on the deduction of royalties would possibly violate, depending on its design, the freedom of establishment[954] and/or the freedom of services[955], insofar as it restricts the market access of companies within the same business group that carry out transactions based on licensing agreements. A violation of the free movement of capital might also come into question, as long as the other freedoms are not applicable.

The freedom of establishment covers the freedom of business activity and the choice of location within the EU-Member States, and a violation occurs when a national rule prevents or restricts the activities of a company within the territory of a Member State, *e.g.* by directly or indirectly reducing the attractiveness of carrying out international activities within the EU compared to its national correlate.[956] The freedom of services protects any service provided for a fee within the EU, and not only in relation to the provider of the service, but also to its recipient.[957] Its main differentiation in relation to the freedom of establishment is concerning the temporary nature of the rendering of a service, as opposed to the idea of permanence that an establishment in another Member State has – even if it may also be temporary.[958]

A barrier to the deductibility of royalties could violate these freedoms to the extent that, by restricting the possibility of deducting royalty payments as business expenses in a cross-border

[953] Lazarov (2020): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 71.
[954] Art. 49ff. TFEU.
[955] Art. 56ff. TFEU.
[956] See Schaumburg (2017): Gleichbehandlungsgebote und Diskriminierungsverbote im Internationalen. In: Schaumburg (Ed.) – Internationales Steuerrecht. P. 70ff.
[957] According to consistent case-law of the ECJ, in *Eurowings Luftverkehr* (C-294/97), for. 34; *Dijkman and Dijkman-Lavaleije* (C-233/09), para. 24 and *X NV v Staatssecretaris van Financiën* (C-498/10), para. 23 for example.
[958] Refer to the contribution of Herzig (2017): Wie kann die Regierung steuerliche., P. 69ff.

scenario, this would reduce the attractiveness of providing an international service in the form of a licensing agreement and even the opening of a branch office abroad, in order to avoid a higher tax burden due to the activation of the restrictive provision. Even in the hypothesis of structuring this provision in an apparently neutral way, covering national and cross-border situations equally, chances are that, due to the anti-avoidance character of the rule, commonly linked to taxation below a given threshold or to the existence of preferential regimes, it will lead to a disproportionately – or even exclusively – activation oriented to international royalty transactions. This constitutes, therefore, an indirect or concealed discrimination, in which a *prima facie* egalitarian standard in its form ends up, due to its scope, affecting far more cases of a cross-border nature than national ones.[959] Such discrimination is, of course, also a violation of the fundamental freedoms,[960] and would necessarily need a justification for its maintenance in the European legal system.

Unlike the relationship between royalty deduction barriers and the Interest and Royalties Directive, where the fact that only the payer being affected by the measure removes it from the scope of the directive; regarding the freedom of services, for example, by encompassing both the recipient and the service provider – in this case, a license – will cause the effects of the royalty barrier to fall within its scope and, therefore, within its prohibition of discrimination. Furthermore, considering the design of the provisions seen so far, such as the German and the Austrian, it can be seen that the references to the BEPS Action Plan and to low taxation are clearly directed at a cross-border context, necessary for the applicability of the fundamental freedoms. Therefore, it is undeniable that the freedoms of establishment, services and/or capital have applicability in cases of national provisions containing royalty deductibility barriers.[961] The same holds true to the undertaxed payments rule of the current GloBE proposal and the EU attempt to implement it in the form of a directive, considering the similarities this rule has to a deductibility barrier.[962]

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[959] Such was the case decided by the ECJ, for instance, in *Lankhorst-Hohorst* (C-324/00), where the “great majority” of the cases affected were of a cross-border nature.

[960] Established primarily in Art. 18 TFEU and definitively in the provisions for each of the freedoms. See, for example, in the case of freedom of establishment and of services, Müller-Graf (2018): Art. 49-62 AEUV. In: Streinz (Ed.) - EUV/AEUV, para. 43ff.

[961] This is recognized by many authors insofar as a royalty barrier has the *potential* to breach any of these EU norms. See, for instance, Kessler, Wolfgang; Spengel, Christoph (2022): Checkliste potenziell EU-rechtswidriger Normen des deutschen direkten Steuerrechts. Update 2022. In *Der Betrieb* (Beilage 01 zu Heft Nr. 05).

[962] On the possibility of justifications, refer tot he next chapter and see also Englisch (2020): Diskriminierungs- und Beschränkungsverbote im direkten Steuerrech. In: Schaumburg/Englisch (Eds.) - Europäisches Steuerrecht., 185ff.

Some dissenting voices, however, argue that the freedom of services might not be applicable due to the fact that a royalty payment, despite coming from a licensing agreement, is not *per se* a service, but only the granting of the right to use a certain asset.[963] Thus, only the freedom of establishment or the free movement of capital would be applicable, since the investor – payee of the royalties – as well as the investment recipient of the license – payer of the royalties – would be incurring in a capital transaction between themselves. However, there would still be the problem of differentiation between these two freedoms, and considering that in this particular case only transactions between companies within the same corporate group are affected, but not outside the group, it is conceivable that rather the freedom of establishment would be involved. This also makes sense insofar as, in order for there to be manipulation and shifting of profits between companies of the same group, one would almost necessarily have to exercise control over the other.[964] As previously mentioned, in an ECJ analysis, the results obtained regardless of the fundamental freedom under analysis chosen will most likely be the same or point towards a very similar direction.

The main concern is, therefore, linked to the pairs used for comparison[965] with the purpose of determining whether or not there is discrimination – where deductibility of royalty payments would normally occur for domestic transactions between companies, but not for payments made to a foreign company of the same group in cases of activation of the royalty deductibility barrier.[966] In this case, the only differentiating factor between a royalty payment made between companies from the same business group resident in a single country and an identical transaction occurring between companies resident in different Member States – which could even include the relationship with third states, if a ruling is made for a violation of the free movement of capital – would be its cross-border reference. In these circumstances, there are many conceivable cases in which, due to the activation of the rule, there will be disadvantageous treatment for foreign

[963] Refer to the opinion of Wimpissinger, Christian (2014): Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach §12 KStG unionsrechtswidrig? In *SWI*, P. 221f. Diverging opinions for example on Hagemann, Tobias; Kahlenberg, Christian (2017): Die Lizenzschranke (§ 4j EStG) aus verfassungs- und unionsrechtlicher Sicht. In *FinanzRundschau* (24), P. 1128f; and Schneider, Norbert; Junior, Björn (2017): Die Lizenzschranke - Überblick über den Regierungsentwurf zu §4j EStG. In *DStR* 55 (8), P. 425.
[964] See Jerabek, Richard; Neubauer, Nikolaus (2014): Unionsrechtskonformität des §12 Abs. 1 Z 10 KStG? In *SWI*, P. 372ff.
[965] See the analysis by Hagemann/Kahlenberg (2011): §4j. In: Herrmann/Heuer et al. (Ed.) - Einkommensteuer- und Körperschaftsteuergesetz, para. 5.
[966] For a complete method of assessment on the fundamental freedoms, refer to Frenz (2016): Europarecht. P. 76ff.

constellations and, considering the rule designs seen so far,[967] it is highly unlikely that the triggering of the royalty deductibility barrier in a purely national context will occur.

Of course, countries that unilaterally introduce such a provision into their legal system will adapt their activation requirements so that the competitiveness of their domestic industry is preserved in the best possible way. However, if this means reducing the attractiveness of a particular Member State as a business location, an impairment of the scope of protection of the freedom of establishment can be expected. Thus, even if the wording of a royalty barrier formally covers national cases, as long as the granting of licenses and the restriction on the deductibility of their payments fall within the protective scope of the fundamental freedoms, this intervention based on an unequal, internationally unfavorable treatment will necessarily have to be justified, which will be discussed in the following section.

Finally, some brief remarks regarding the inverted tax credit system of *Lodin* should be made, since the proposer of this measure assumes that such a tax system would be compatible with the fundamental freedoms and EU law as a whole.[968] In fact, by completely subverting the logic of deductions with respect to royalty payments, there is little point in arguing for discriminatory treatment between cross-border and national circumstances, since this proposal is based on the assumption that the whole system of deductions – as it is flawed – will be reformed. This type of strategic decision falls naturally within the scope of the Member States, which, by exercising their tax sovereignty, can decide what tax treatment will be accorded to business expenses arising from royalty payments.[969]

Thus, both in purely national and international cases the deduction would be *always* disallowed, and tax credits would be conceded based on the amount actually paid as taxes. As long as this is not structured in a way that constitutes discriminatory treatment in relation to a cross-border context, the scope of application of the fundamental freedoms will not be affected and there will thus be no infringement of European law. However, due to the fact that it exists only on a rather superficial theoretical level, further considerations regarding the *Lodin* proposition are not

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[967] Refer to Chapter 3.2.2.

[968] Lodin, Sven-Olof (2011): Intragroup Lending in Sweden - A Vehicle for International Tax Arbitrage. In *Tax Notes International* (62), P. 177ff.

[969] For further comments, refer to Hummel, Roland; Knebel, Andreas; Born, Alexander (2014): Doppelbesteuerung und BEPS. In *IStR*, P. 838ff.

feasible. Nevertheless, in the way it has been presented so far, it seems that there would be no problems of compatibility with EU law, be it of a secondary or primary nature.

4.2.2.1.2 An attempt to justify royalty anti-avoidance measures in the EU context

As previously determined, the introduction of national tax rules in the European context has boundaries that tangibly affect the fundamental freedoms, and any discrimination against those freedoms is prohibited under EU law. This does not mean, however, that the fact that a domestic tax measure restricts one or more freedoms will invariably result in its non-permissibility in the EU legal system, considering the possibility that it may be justified. At first glance, the written justifications found in the TFEU such as public policy, public security or public health[970] have, however, a negligible relevance in the field of direct taxation, as they are also commonly interpreted very narrowly by the ECJ, which makes their use in this area virtually impossible.[971] Thus, only the justifications based on case-law and developed by the court under the so-called "rule of reason"[972] persist.

On this matter, the ECJ has always taken a relatively rigid stance regarding the attempts of Member States to justify their respective tax provisions with a discriminatory nature based on the need to combat what would be considered an aggressive tax planning strategy and/or an abuse of the asymmetries between different tax systems. This is meaningful as these freedoms protect the core values of the single market, the unification and promotion of which is one of the objectives of the European Union as a whole, which would be highly undermined in the event of easily justifiable unilateral measures by Member States that diminish cross-border transactions within the market.

Thus, the ECJ jurisprudence has evolved so as to create a "catalog" of justifications accepted and not accepted by the Court to justify discrimination, and the national measures are henceforth evaluated according to these pre-established criteria and settled by case-law. Among the accepted justifications are, namely, a) the coherence of the tax system; b) a balanced allocation of taxing rights; c) the need to combat tax avoidance; and d) the effectiveness of tax supervision;

[970] Seen for example in Arts. 45 para. 3, 52 para. 1, 62 and 65 para. 1 *lit*. "b" TFEU for the fundamental freedoms.
[971] Refer to Lazarov (2020): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 86f.
[972] Firstly introduced in the *Cassis de Dijon* decision, C-120/78, based on justification grounds and the principle of proportionality.

the first three being commonly the most relevant to the provisions under analysis.[973] Each of these justifications has distinct limits and requirements, which are analyzed in each specific case to determine whether a restriction to fundamental freedoms is justifiable, followed by an evaluation of its proportionality.

However, in more recent years there has been a stronger tendency of the European Court of Justice to deviate from this rigid line of requirements in order to embody a stance that is more oriented towards the spirit of the OECD BEPS project, that is, along an anti-avoidance logic. This is highlighted in cases such as *X-GmbH*[974], *T-Denmark*[975] and *N-Luxembourg*[976], where the Court moves to accept broader concepts of tax avoidance, which consequently expands the possibilities of justification for discriminatory treatment within the EU through national tax measures. While it is certainly desirable to develop stronger mechanisms to combat tax avoidance – since this is also responsible for hindrances to competitiveness in the internal market – such progression of the case-law should not and cannot be allowed to undermine the methodological rigor of assessing whether a discriminatory tax rule can actually be justified on the basis of the criteria carefully developed over the years by the ECJ.[977] Thus, the following subsections will proceed to the analysis of the specific anti-avoidance rules in light of the relevant justifications accepted so far by the Court.

a) Balanced allocation of taxing powers

The argument of ensuring a balanced allocation of taxing powers between Member States represents an attempt to reconcile the objective of promoting a single European market without (tax) obstacles for cross-border relations on the one hand, and the prevailing national tax and budgetary sovereignty of the Member States on the other. This would represent the settlement of a conflicting situation between the fundamental freedoms and the resulting restrictions to the taxation goals of member states. In its revolutionary decision *Marks & Spencer*[978], which marked

[973] For a complete list of this repertoire on its positive and negative justifications, refer to Schaumburg (2017): Gleichbehandlungsgebote und Diskriminierungsverbote im Internationalen. In: Schaumburg (Ed.) 2017 – Internationales Steuerrecht., P. 70ff.
[974] Case C-137/17. For more information, see Kahlenberg, Christian (2019): Cadbury-Test auch für Drittstaaten - Folgerungen aus der EuGH-Entscheidung in der Rs. X-GmbH für die anstehende AStG-Reform. In *Der Betrieb* 29, P. 1590ff.
[975] Joined Cases C-116/16 and C-117/16, which will be discussed in the following subsections.
[976] Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16, which will be discussed in the following subsections.
[977] See Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 287f.
[978] C-446/03.

a transformation of ECJ case law in relation to a near impossibility of justifying discrimination under primary European law within this framework,[979] a previously denied justifiable force was recognized in order to preserve the allocation of taxing rights.

The aim of ensuring that this allocation respects the autonomous exercise of the tax sovereignty of each Member State – from both a national and international perspective, for example through public international law and the existence of a "genuine link" or with regards to restrictions established bilaterally by double taxation agreements[980] – characterizes a possible justification for the use of a discriminatory national tax provision, which has been confirmed in many subsequent decisions.[981] Over time, this justification ground was gaining more and more independence and strength in relation to others, as in *Marks & Spencer* a cumulative assessment of this justification with other requirements was originally necessary.[982] In later decisions such as *Lidl Belgium*[983] and *Oy AA*[984] these requirements were reduced, so that the concept of a balanced allocation of taxing rights gained full independence in *X Holding*[985].

Nevertheless, although it was established as a justification ground through multiple decisions, its use was commonly restricted to cases where a tax benefit was granted or was apt to be applied in two different MS simultaneously, in particular the possibility of carrying forward tax losses.[986] Thus, its relevance for royalty payments cases is very restricted, not only because it is a situation where the tax benefit of deductions is granted in only one of the States involved, but also because – despite extensive case-law on the matter – the outlines of this justification have never been properly defined by the ECJ.[987]

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[979] Englisch (2008): Aufteilung der Besteuerungsbefugnisse., P. 7ff. Diverging opinion on Kokott, Juliane; Henze, Thomas (2007): Ist der EuGH - noch - ein Motor für die Konvergenz der Steuersysteme? In *BB* (17), P. 913ff.
[980] For more information on the criteria used to determine the allocation of taxing rights between Member States, refer to Tippelhofer (2016): Der Einfluss des Unionsrechts auf., P. 65ff.
[981] See Lang (2011): 2005 - Eine Wende in der. In: Mellinghoff/Schön/Viskorf - Steuerrecht im Rechtstaat. P. 317ff.
[982] Para. 43 of the decision.
[983] C-356/04.
[984] C-231/05.
[985] C-337/08.
[986] See Wimpissinger, Christian (2014): Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach §12 KStG unionsrechtswidrig? In *SWI*, P. 225.
[987] As was denounced by the Advocate General, "And once again it will have to examine the ground of justification of 'preservation of the allocation of the power to impose taxes between Member States', which it expressly recognised for the first time in Marks & Spencer and the scope of which *still does not appear to have been sufficiently clarified.*" (emphasis added) in: Kokott, Juliane (2014): Opinion of the Advocate-General. Case C-48/13.

In the few cases involving withholding taxes, such as *Aberdeen*, *Amurta* and *Denkavit*, when the balanced allocation of taxing rights was used as an argument to justify discrimination – despite being on the basis of a double taxation agreement[988] – it was widely rejected by the ECJ. The Court decided that Member States certainly have the possibility to divide their taxing rights in a balanced manner among themselves and according to a principle of territoriality, however this would not justify interference with the fundamental freedoms.[989] Nonetheless, this decision also indicated the cases in which it would conceivably be feasible to apply this justification in the context of national tax measures, namely when the system established by the provision has a design that is capable of preventing conduct – such as aggressive tax planning – harmful to the Member State's right to tax activities that occur in its national territory.[990]

In this sense, it is possible to imagine that a withholding tax aimed specifically at combating profit shifting strategies through cross-border royalty payments could fall within this category of protection of the taxation of activities that occurred in the national territory. It could be deemed so insofar as in the hypothesis that royalty payments are used as a mechanism to transfer profits obtained by a company from one jurisdiction to another, in order to reduce the tax burden on these values, there is a clear threat to the possibility of taxing the activities carried out nationally by the licensee and therefore paying company. A balanced allocation of taxing rights could justify, in the case of a withholding tax, that the country that allows the full deduction of royalty payments made abroad does so in the legitimate expectation that these amounts will be taxed subsequently, coordinating its taxing rights with other member states under this premise, avoiding double taxation. If this does not occur, it would be possible to withhold part of the royalty payments as a way to ensure that the founding principles of this allocation are respected.[991]

Hence, the use of a withholding tax as a subject-to-tax clause proves once again to be the most pondered measure, with the best chances of achieving its specific objectives in a manner compatible with the fundamental freedoms. However, it is of course worth remembering that in

[988] Refer to *Denkavit* (C-170/05), para. 26. For more information on cases referring to the withholding of dividends such as these, see Tippelhofer (2016): Der Einfluss des Unionsrechts auf., P. 237ff. and 271ff.
[989] For more information, see Simader (2010): Die Zulässigkeit der Erhebung von. In: Lang/Schuch/Staringer (Eds.) - Quellensteuern., P. 31ff.
[990] See cases *Rewe Zentralfinanz* (C-347/04), para. 42, *Oy AA* (C-231/05), para. 54, and *Amurta* (C-379/05), para. 58.
[991] For a differentiation of this line of reasoning with respect to the justification to combat tax avoidance, refer to Subsection *c* of this Chapter.

the particular case of withholding royalty payments, the influence of the Interest and Royalties Directive takes precedence over the way this issue is handled. This assessment indicates notwithstanding that it would perchance be feasible from a legal point of view – albeit politically difficult to implement – to reform the directives to allow for a subject-to-tax withholding clause compatible with European primary law.

On the other hand, a distinguishing factor against the use of this justification, not only in cases involving WHT, but also royalty deductibility barriers, is the realization that this justification, as mentioned above, has only been examined in situations where a tax benefit ran the risk of being used in two Member States simultaneously. This does not occur in the hypothesis that this said tax benefit is the mere deduction of payments made abroad as business expenses, as is commonly the case in aggressive tax planning structures with royalty payments. In this case, the deduction occurs in one country to supposedly be taxed in another – which then has the autonomy to decide *if* and *to what extent* it will occur. Therefore, this possibility of double dipping would not occur with respect to royalties, thus excluding the main cases in which the justification of a balanced allocation of taxing powers has been argued and accepted so far.

Despite the fact that there are no ECJ decisions regarding royalty deductibility barriers to this moment, there are some cases related to the more popular cousin of this type of provision: thin capitalization rules in the form of limitations on interests.[992] In the recent *Lexel* decision, about a Swedish anti-avoidance rule[993] explicitly aimed at preventing the erosion of the tax base in Sweden that could result from aggressive tax planning structures related to the deduction of interest charges in a cross-border context,[994] the Court clearly decided that the measure could not be justified under European law.[995] For the ECJ, the mere protection of tax revenue cannot be regarded as sufficient

[992] For further decisions on the deductibility of interests and its use for other justifications, refer to Subsection 4.2.2.1.2, *lit*. "b". A pre-ATAD analysis regarding interest deductions and EU law was made by Colombaioni (2017): Compatibility with EU Law of. In: Pinetz/Schaffer (Ed.) – Limiting base erosion., P. 369ff.

[993] While this rule has its differences in relation to other European (royalty) deductibility barriers, being on the one side less strict as it allows through a *bona-fide* clause for the taxpayer to prove it develops economic activities; but more strict on the other as it applies the barrier independently of a low-taxation criteria; it shares many similarities with the Austrian and German royalty deductibility barriers, and it is easy to trace a parallel between them. Refer, for instance, to Jerabek, Richard; Neubauer, Nikolaus (2021): Rs Lexel AB: Neues vom EuGH zu Zinsabzugsverboten und dessen Bedeutung für §12 Abs 1 Z 10 KStG. In *SWI* (3), P. 42ff.

[994] Case C-484/19, para. 65ff.

[995] Which is not a huge surprise, but more of a continuation of a line of jurisprudence, as indicated by Schön, Wolfgang (2021) on his speech at the *72. Steuerrechtliche Jahresarbeitstagung*.

reason to be invoked to justify a measure in violation of the fundamental freedoms.[996] To admit such a possibility would be tantamount to allowing Member States to restrict, on this ground, the freedom of establishment.[997]

It is worth remembering that, since these are broad principles in the form of fundamental freedoms, linked to justifications without very well defined outlines, the test of compatibility of these rules with European law is more an exercise of creativity and imagination than the production of a certain result. What can be done is to apply scientific rigor as precisely as possible to the alternatives and patterns presented by the European Court of Justice over the years through its jurisprudence and, at the moment of a definitive decision by the Court, hope for the best. Considering its track record of decisions, the chances of a rejection of this line of reasoning are high, since in none of the cases did the ECJ accept for a Member State to compensate with a higher tax burden a tax advantage obtained by making deductible payments to another MS.[998]

Therefore, even though the applicability of this justification for royalty deduction barriers is not inconceivable,[999] it seems at the moment unlikely at best. As this justification basically mandates Member States to tax the economic activities that happen within their territory in a harmonized manner, as a manifestation of territoriality in the form of a justification,[1000] the defense of a national provision such as a royalty deductibility barrier that spares national royalty payments but not those conducted on a cross-border context will be difficult.

[996] As it was once decided at e.g. *Marks & Spencer* (C-446/03), para. 44ff.

[997] Moreover, the ECJ established in this case that the factual situation of an intra-group cross-border transaction and a transaction between unrelated parties corresponding to arm's length conditions would provide no justification for different treatment in view of the balanced allocation of taxing power between Member States. This means that, at least in the circumstances involving interests, it could be assumed that the simple fact that the anti-avoidance rule affects only intra-group transactions, excluding transactions between non-related parties, would be considered discriminatory. See C-484/19, para. 69.

[998] As was decided in *SIAT* (C-318/10), para 39. See comments by Jerabek, Richard; Neubauer, Nikolaus (2014): Unionsrechtskonformität des §12 Abs. 1 Z 10 KStG? In *SWI*, P. 382 and Kaul (2018): Der Nexus-Ansatz., P. 44.

[999] Interestingly, in the specific case of the German royalty barrier, the justifications in the government's draft bill indicate a clear objective of ensuring the allocation of tax revenue, as in Bundesregierung (2017): Regierungsentwurf eines Gesetzes gegen schädliche Steuerpraktiken im Zusammenhang mit Rechteüberlassungen. BR-Drucks 59/17. Deutscher Bundestag. Available online at http://dipbt.bundestag.de/extrakt/ba/WP18/795/79562.html, updated on 11/16/2018, checked on 08.01.19, P. 2.

[1000] Even though the court took a diametrically opposed view on this matter on the recent decision *AURES Holdings a.s.* v *Odvolací finanční ředitelství* (C-405/18), para. 53, where it states that territoriality is rather a matter of comparability, and not of justification. See also Lazarov (2020): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 92.

Finally, as mentioned previously, an inverted tax credit system will hardly have a discriminatory effect, and therefore does not require justification within the framework of European primary law.

b) Cohesion of the tax system

Another justification commonly accepted by the ECJ for discriminations regarding national tax measures is in the name of defending a coherence of the tax system. This rationale originated in two decisions reached on the same day, namely *Bachmann* v *Belgian State*[1001] and *Commission* v *Belgium*[1002], as early as 1992, and aims to ensure that there is a link between the taxpayer obtaining a tax advantage and the occurrence of a future tax levy that is responsible for offsetting this advantage. This justification is based on the idea that there are some correlations between benefits and tax burdens so intimate that they need to coexist harmoniously, at the risk of jeopardizing the very foundations of the tax system.[1003] That is to say that, according to the logic of cohesion as a justification ground, a deduction granted today would have to be taxed at a later point in time to ensure that the tax system as a whole works harmoniously.[1004] Although this *prima facie* seems to be valid for the problem of royalties, the application method of this justification by the ECJ has been very restrictive from the outset, and its use by the MS as a form of justification was repeatedly denied by the Court in subsequent cases.

The great comeback of the cohesion of the tax system occurred many years later, through judgments such as *Krankenheim Ruhesitz am Wannsee*[1005], *Papillon*[1006] and *K*[1007], in which a strong tendency to analyze this justification together with that of a balanced allocation of taxing powers, scrutinized in the previous subsection, is noted. This makes sense as an apportionment of taxing powers is an integral part of the tax system as a whole, being also responsible for its coherence and cohesion. The European Court of Justice has even stated in some of its judgments that the requirements of the coherence of the tax system and of a balanced allocation of taxing

[1001] C-204/90.
[1002] C-300/90.
[1003] See Schilcher (2010): Grenzen der Mitwirkungspflichten im Lichte., P. 138f.
[1004] See this concept also on Lazarov (2020): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 87f.
[1005] C-157/07, para. 43.
[1006] C-418/07, para. 42.
[1007] C-322/11, para. 49.

powers would be indivisible.[1008] However, in other rulings,[1009] the Court went back and indicated that there was some differentiation with respect to these requirements.

Despite having started in the opposite direction of the justification of a balanced allocation of taxing powers – that is, being initially seen as an independent requirement and then essentially linked to others – the common denominator that both have is the lack of clear outlines and of a strict methodology for their analysis. Of course, both of these requirements are commonly evaluated concomitantly and therefore have overlap points, which, however, need not necessarily occur. Their distinctive feature, through the analysis of the most recent jurisprudence on the subject, can be summarized as the more *specific* character of the cohesion of the tax system, which requires that the link between obtaining a tax advantage and the tax levy occurs with respect to the same tax and the same taxpayer,[1010] whereas there is no such restriction with respect to the balanced allocation of taxing rights, that carries a broader character, rather linked to state tax sovereignty than to the taxpayer itself.[1011]

Considering the similarities between these two requirements, it is to be expected that the results regarding a possible justification for national tax measures would also be similar. With regards to WHT, in cases such as *Aberdeen* and *Amurta*, where the argument of cohesion of the tax system was also indicated, it was not possible to justify the withholding, since it is necessary that there be a direct link between the tax advantage obtained and the proposed tax burden. Even in the hypothesis of a withholding tax as a subject-to-tax clause, despite it being possible to argue that there may be a direct link between obtaining a "benefit" in the form of a lower taxation of royalty payments in another jurisdiction and the retention of amounts at the payer's level, not only the taxpayers affected will be distinct, but there will even be different taxing States, which prevents the application of this requirement. Therefore, it would also be difficult to justify the implementation of a discriminatory withholding tax based on the cohesion of the tax system.

The same goes for a royalty deductibility barrier, where this direct connection between tax benefit and tax burden is missing since it also affects different taxpayers. A restriction on the possibility to deduct royalty payments as business expenses directly affects the licensee, while the

[1008] As in *National Grid Indus* (C-371/10), para. 80, and *Timac Agro Deutschland GmbH* (C-388/14) para. 47.
[1009] Such as *Bevola* (C-650/16), para. 41 and 44ff.
[1010] Reiteraded in *Petri Manninen* (C-319/02), para. 42, and funded in *Svensson and Gustavsson* (C-484/93), para. 18
[1011] On this same opinion, see Tippelhofer (2016): Der Einfluss des Unionsrechts auf., P. 260f.

tax benefit is obtained through an IP-Box or a low(er) taxation by the licensor in another jurisdiction. The criterion that excludes this type of provision from the scope of the interest and royalties directive is, in a way, the same that excludes the possibility of using this justification before the ECJ for violations of primary law.

As was the case with the argument of a balanced allocation of taxing powers between the Member States, the justification for the cohesion of the tax system is also found as a line of reasoning in some decisions regarding the deductibility of interests, although there is none – so far – involving the deductibility of royalties. The Court decided in judgments such as *Thin Cap* and *Lankhorst-Hohorst* about rules that can be, to a greater or lesser degree, compared to a royalty deductibility barrier. However, it was settled that it was not possible on these issues to justify discriminatory measures on the grounds of cohesion of the tax system, since a subsidiary company would be put at a (tax) disadvantage by the fact that its parent company is resident abroad *without* a corresponding tax benefit.[1012] Key to understanding these decisions was the finding that there was, in these hypotheses, no connection between non-deductibility and the obtaining of a tax benefit, since the possibility of deducting an expense is commonly not linked to the need for taxation, but is rather a corollary of the objective net income principle. Thus, cross-border situations would be treated unfavorably in relation to domestic ones without necessarily maintaining a coherence in the tax system.

If, however, there were a link between the possibility of deducting royalty payments and a corresponding taxation at the licensor's level, it would be possible to argue for a justification through a cohesion of the tax system. This might not have been possible at the time these decisions were made, but the reality of the tax system in EU countries is quite different from that of 20 years ago. The European system itself has seen a turning point in its priorities with the OECD's BEPS project, and there is a growing tendency not only to fight double taxation, but also double non-taxation and profit shifting strategies as a whole.[1013] In this line of thought, one can defend the position that the deductibility of expenditures only makes sense to the extent that these amounts are taxed at another point in the corporate chain, and obtaining a tax benefit that eliminates or

[1012] C-324/00, para. 41f. and, to some extent, C-524/04, para. 66ff.
[1013] For a differentiation with respect to the requirement of need to combat tax avoidance, see Subsection *c* below.

drastically reduces the level of taxation could hurt the cohesion of the (modern) tax systems as a whole.

Even so, this line of argument would ultimately have to go through the sieve of the European Court of Justice. Moreover, this way of advocating for cohesion and coherence of tax systems would only be consistent to the extent that there is in fact a correspondence and proportion between the benefit obtained and the tax disadvantage of non-deductibility. This means that rules such as the Austrian one, which has a sharp line[1014] with respect to its regulation, prohibiting any type of deduction from a given minimum threshold, would be much less likely to be considered consistent with the tax benefit obtained from a preferential tax treatment or low taxation than, for example, the German rule, which restricts deductions in proportion to the level taxed abroad.

Yet, the fact that taxpayers affected by the tax benefit and the restriction on deductibility are different makes it very difficult and unlikely to provide justification through this requirement. If the ECJ maintains its jurisprudence that goes as far back as the last century,[1015] without a strict correlation between the measures aimed at one and the same person, it will not be possible to argue for the implementation of a national rule of non-deductibility of royalty payments based on the cohesion of the tax system.[1016]

The same observations made previously about the inverted tax credit system of *Lodin* are valid for this requirement, its test not being necessary since there is no discrimination in its implementation.

c) Need to combat tax avoidance

Finally, the requirement that apparently has the most relevance for the anti-avoidance measures under analysis is also the one with the greatest number of controversies. Despite having a seemingly convincing importance at first, its application in practice is rather tricky. By its very

[1014] For more on this concept, see Fox, Edward G.; Goldin, Jacob (2019): Sharp Lines and Sliding Scales in Tax Law. In SSRN Journal. DOI: 10.2139/ssrn.3339656; and on this opinion Jerabek, Richard; Neubauer, Nikolaus (2014): Unionsrechtskonformität des §12 Abs. 1 Z 10 KStG? In SWI, P. 378f and Drummer, Verena (2017): Lizenzschranke: Abzugsbeschränkung vs. Tax Credit aus EU-Rechtlicher Sicht. In *IStR* (15), P. 604.
[1015] Argued for example in *Wielockx* (C-80/94), para. 24. For more on this opinion, refer also to van Lück, Kolja (2017): Gesetzentwurf zur Einführung einer Lizenzschranke durch §4j EStG. Verfassungsrechtliche und europarechtliche Herausforderungen. In *IStR* (10), P. 391f.
[1016] Diverging opinion on Schilcher (2010): Grenzen der Mitwirkungspflichten im Lichte., P. 139, as he believes that the ECJ has been showing a less strict view on the need for coinciding taxpayers for this justification to be accepted.

nature, the justification of the need to combat tax avoidance deals with diametrically opposed forces, since the ECJ, as the guardian of the fundamental freedoms, has always defended the possibility for taxpayers to make use of these opportunities to benefit from more favorable tax regimes, promoting a healthy competition among Member States, without necessarily constituting abuse.[1017] On the other hand, the MS try to preserve their tax base and avoid profit shifting through anti-avoidance measures, as is the case with royalty deductibility barriers. Considering that this type of rule, as seen before, will invariably affect primarily cross-border cases, a violation of the fundamental freedoms is almost inevitable.

c.1) Case-law and the anti-abuse doctrine by the ECJ

Therefore, this requirement treads the thin line between the protection of the fundamental freedoms on one side and the justification to combat tax avoidance and aggressive tax planning strategies on the other. Recognized within the scope of direct taxation in decisions such as *Rewe Zentralfinanz*[1018] and *National Grid Indus*[1019], the anti-avoidance or anti-abuse doctrine developed by the ECJ ought to be applied to these cases. In this field, the decision probably best known and of enormous importance is *Cadbury-Schweppes*[1020], which establishes that justifications will be accepted uniquely in cases of "wholly artificial arrangements", which characterizes the (a) objective aspect of the Court's anti-abuse doctrine. This means that the justifications for the measures taken by the Member States depend on an aspect of artificiality of the contested structure, that is, that fails to demonstrate economic reality. This would apply either to the corporate structure as a whole or to the (sham) transaction that is to be invalidated.

Moreover, there is commonly a (b) subjective aspect in the ECJ analysis, which refers to the taxpayer's purpose or objective when carrying out a certain transaction or structuring its business group in a given way.[1021] A taxpayer's intention to use or abuse some aspect of the

[1017] See cases such as *Centros* (C-212/97), para. 27f.; *Inspire Art*, (C-167/01), para. 96; and *Polbud - Wykonawstwo* (C-106/16), para. 40; as well as the opinions of Lazarov (2018): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 89f.
[1018] C-347/04 , para. 50ff.
[1019] C-371/10 , para. 83f.
[1020] C-196/04 , para. 51. See also *De Lasteyrie du Saillant* (C-9/02), para. 50; and *Marks & Spencer* (C-446/03), para. 57.
[1021] As has been developed in the *Emsland Stärke* case (C-110/99), para. 52ff.

asymmetry between different tax systems is deemed necessary, which must be proven[1022] through evidence based on the taxpayer's actions and what a logical approach through an economic perspective would be.

This anti-abuse doctrine has actually already been declared by the ECJ in its decisions to be valid under any aspect of EU law,[1023] which means that this applies to any area of taxation – including direct taxation – and at any level of European legislation – be it primary or secondary.[1024] It is therefore important to recognize that the Court views this concept of tax avoidance as an *autonomous concept* within EU law, that is to say that, insofar as the scope of application of European provisions is opened through cross-border transactions, that Member States are bound by these definitions and cannot rely on their domestic assessment of abuse.[1025]

However, despite having its own requirements, this justification coincides in its way of assessment, in many instances, with a balanced allocation of taxing rights. Advocate General *Kokott* has even argued that the use of abusive arrangements is in fact simply a particular form of interference in the allocation of taxing powers between Member States.[1026] This means that the ascertainment of tax avoidance and profit shifting is simultaneously a risk to a balanced allocation of taxing powers between different jurisdictions. According to this mindset, the requirement of a need to combat tax avoidance would be in its entirety covered by the justification for a balanced allocation of the power to tax.

In effect, this implies that the need to combat tax avoidance has, until now, been somewhat contained within a different requirement. The determining distinction between the two would be based on the need for the design of the discriminatory national tax rule to be aimed at combating a wholly artificial arrangement whose purpose is to obtain a tax advantage. Otherwise, the need to combat tax avoidance as a justification ground would not be accepted vis-à-vis the ECJ. These

[1022] Or, at least to ensure the proportionality of such an anti-abuse measure, allow for the taxpayer to prove that the structure used does not constitute some sort of abuse. Refer to the discussion on the German license barrier on Chapter 3.2.2.2. and the adequate design of such a measure on Chapter 5.
[1023] See cases such as *Halifax* (C-255/02), para. 68f.; *Agip Petroli* (C-456/04), para. 19f. and specially *Cussens* (C-251/16), para. 30.
[1024] Refer to Kaul (2018): Der Nexus-Ansatz., P. 43ff.
[1025] Refer to Lazarov (2020): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 93ff.
[1026] Opinion of AG Kokott on *SGI* (C-311/08), para. 59. See also *Deister Holding* (Joined Cases C-504/16 and C-613/16), para. 96.

requirements are not present for a balanced allocation of taxing powers, which indicates that it is of a broader nature than the need to combat tax avoidance.[1027]

Considering the already existing difficulty of applying the prerequisites presented above, the more restrictive nature of this requirement makes its feasibility for the cases of withholding taxes and royalty deductibility barriers under discussion extremely difficult. For WHT in particular, the ECJ has demonstrated in cases like *Commission* v *Kingdom of Belgium* that a general presumption of tax avoidance or fraud is not sufficient to justify the elaboration of a national measure that compromises the fundamental freedoms.[1028] This in itself would already exclude the possibility of justifying a WHT as a general rule. However, even in the hypothesis of opting for the second approach, of withholding as a subject-to-tax clause, the barrier imposed by the Court's jurisprudence would still prevail in relation to the need for the targeting of purely artificial arrangements, that do not reflect any sort of economic reality, structured with the sole or main purpose of obtaining a tax advantage that would not be accessible in the absence of this scheme.[1029]

Therefore, for a justification through the need to combat tax avoidance to be viable, an eventual withholding tax as a subject-to-tax clause would have to be extremely restricted and reduced only to those cases without economic substance, which would kill the general purpose of the provision. Conditioning the activation of a WHT to taxation in another jurisdiction says nothing about the economic activity *per se*, and although such a provision has as its ultimate purpose to combat tax avoidance, it does not fulfill the requirements established for this justification from the ECJ's point of view. The result of such a rule justifiable by the need to combat tax avoidance would therefore be merely a watered down version of what is really needed to combat aggressive tax planning structures through a WHT, even if this kind of rule no longer had issues with European secondary law.

[1027] On this same opinion, refer to Tippelhofer (2016): Der Einfluss des Unionsrechts auf., P. 262.

[1028] C-433/04, para. 35. See also *Commission* v *France* (C-334/02), para. 27, and *Eqiom* (C-6/16), para. 31ff. This general presumption ultimately reverses the burden of proof of abuse from the tax administration to the taxpayer, which is in itself disproportionate and incompatible with EU primary law. For more on this discussion, see Kuzniacki, Blazej (2019): The ECJ as a Protector of Tax Optimization via Holding Companies. In *Intertax* 47 (3), P. 315f; and Ravelli, Fons; Franconi, Federico (2021): Numerous EU Member States are in Breach of EU Law by Requiring Taxpayers to Demonstrate Absence of Abuse. In *European Taxation* 61 (10), P. 440ff. This brings, furthermore, issues with the OECD GloBE proposal, that has a similar system. Refer to Brokelind, Cécile (2021): An Overview of Legal Issues Arising from the Implementation in the European Union of the OECD's Pillar One and Pillar Two Blueprint. In *Bulletin for International Taxation* 75 (5), P. 217f.

[1029] See the clear ECJ statement in *Aberdeen* (C- 303/07), para. 65.

A similar problem occurs with the royalty deductibility barrier, since provisions that restrict the deductibility of expenses affecting only those cases where transactions between related companies are entirely artificial in nature will also fall short on resolving the issue at hand. It is no coincidence that none of the royalty barriers implemented in Europe is restricted solely to wholly artificial arrangements, despite having different degrees of interference in the fundamental freedoms. This would be the same in the case of the undertaxed payments rule within the OECD GloBE and, possibly, the EU directive. Despite the partial substance carve-out foreseen, the rule will trigger for non-artificial arrangements – only an extensive carve-out for substantial activities would suffice, which however would be contrary to the common approach and undermine the effects of the GloBE proposal.[1030]

In the case of the German royalty barrier, for example, there is no reference to the structure of the company, but rather to the foreign design of the relevant preferential regime. An extremely marginal opinion holds that,[1031] in this specific case, a justification based on the need to combat tax avoidance would not be necessary, since there would be no violation of the fundamental freedoms, for the company's presence in the country with the non-nexus-conform IP-Box is to be regarded as a sufficient factual justification.[1032]

While it is feasible to argue that an IP-Box that follows the dictates of the nexus approach is opposed to the formation of structures of an entirely artificial nature; it is not feasible to assume *a contrario sensu*, if the country of residence involved fails to design a rule under the nexus-approach, that companies that take advantage of this regime will not have any economic substance.[1033] The Austrian rule, on the other hand, does not even mention requirements of substance or economic activity, being totally restricted to the level of taxation that royalty payments are subject to at the parent company level. Even in the remote hypothesis of arguing for

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[1030] Refer to the opinion of Englisch, Joachim (2021): Non-harmonized Implementation of a GloBE Minimum Tax: How EU Member States Could Proceed. In *EC Tax Review* 30 (5&6), P. 210ff.; confirmed previously in Englisch (2020): Diskriminierungs- und Beschränkungsverbote im direkten Steuerrech. In: Schaumburg/Englisch (Eds.) - Europäisches Steuerrecht., P. 185ff.
[1031] See the opinion of Brandt, Jürgen (2017): „Lizenzschranke" auf der Zielgeraden des Gesetzgebungsverfahrens. In *Der Betrieb* (19), M5.
[1032] Diverging opinion by Lüdicke, Jürgen (2017): Wogegen richtet sich die Lizenzschranke? In *Der Betrieb* 26, P. 1482f., and further response by Brandt, Jürgen (2017): Vereinbarkeit der sog. Lizenzschranke mit dem Grundsatz der Besteuerung nach der Leistungsfähigkeit und mit den unionsrechtlichen Grundfreiheiten. In *Der Betrieb* 26, P. 1483.
[1033] For further criticism on this imbalance, refer to Chapter 3.2.2.2. See also Herzig (2017): Wie kann die Regierung steuerliche., P. 74f.

the possibility of abstractly justifying a royalty barrier based on the risk of tax avoidance, it would be further necessary to prove the proportionality of this measure, which has by itself many issues, as will be demonstrated in the following subsection.

The ECJ furthermore requires for a justification according to the need to combat tax avoidance that the questioned national tax measures allows for a global assessment, that is, subjecting each particular case to a specific examination, and not only confined to applying predetermined general criteria.[1034] This means that rules with very abstract criteria for establishing which structures should be fought due to the risk of tax avoidance cannot be justified by this requirement, as is the case with general conditions such as corporate affiliation, low taxation and, in the German case, directed in an abstract manner to the preferential regime abroad.[1035] This reinforces the idea that, regardless of the justification through the need to combat tax avoidance, that an individualization of a royalty deductibility barrier is an important aspect of its fairness, for it to cover only those cases where there actual risks of profit shifting exist. It is thus not only advisable, but necessary for the taxpayer to have the possibility to defend himself and present evidence that base erosion and profit shifting does not occur in the development of their activities.

Thus, in the name of protecting the fundamental freedoms, the ECJ has created an extremely defensive and restricted jurisprudence, (partially) responsible for upholding cases of aggressive tax planning that use international structures with licensing agreements to reduce their overall tax burden within the EU. This is a quasi-catch-22 situation, in which a rule aiming at solving a problem can only do so in a way that is compatible with European primary law if it is structured in a manner that does not solve the problem altogether. While it is clear that neither the obtaining of a tax benefit nor a cross-border structuring constitute, in themselves, an abuse, it is noticeable that without a significant evolution of the Court jurisprudence, it would not be feasible to justify anti-avoidance measures of a minimally broad and satisfactory character for the resolution of this problem. This would also naturally apply to the UTPR within the context of the GloBE proposal, be it implemented directly by Member States[1036] or through a directive.

[1034] See the decisions in *Leur-Bloem* (C-28/95), para. 41; and in *Modehuis* (C-352/08), para. 44.
[1035] See Wimpissinger, Christian (2014): Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach §12 KStG unionsrechtswidrig? In *SWI*, P. 225.
[1036] On this same opinion, refer to Nogueira/Turina (2021): Pillar Two and EU Law. In: Perdelwitz/Turina (Eds.) - Global minimum taxation?, P. 299.

c.2) More recent developments and the urgency for case-law progress

This need for evolution of the case-law of the ECJ – specially from the one in *Cadbury Schweppes* – in order to be able to justify this type of measure had already been observed before,[1037] and interestingly enough, it may have come before these rules were actually put directly to the test before the Court. In the recent and extremely controversial decisions in the *Denmark*[1038] cases of February 2019, the Court reinforces the idea that national tax measures aimed at combating tax avoidance should be interpreted in a manner compatible with the directives. However – and herein comes the great surprise – even in the absence of internal regulation, Member States have an *obligation* to prevent the use of European Law by abusive structures.[1039] The Court's rationale for this assertion is to protect the European single market in order to avoid distortions in its internal competition, which occurs both in cases of excessive taxation and in cases of aggressive tax planning that gives a tax edge to internationally active companies. This is a relatively new concept in the field of direct taxes – since these are cases discussing withholding taxes on interests and dividends –, considering that the ECJ previously mainly had a direct application of such a principle of prohibition of abuse of rights in the field of value added tax, *i.e.* indirect taxation.[1040]

As previously discussed, the European Union has tended, through coordination and influence of the OECD BEPS Action Plans,[1041] as well as through the Anti Tax-Avoidance Directive,[1042] to undertake actions with Member States to introduce provisions with the aim of establishing a common concept of tax avoidance to combat cross-border structures established by multinational companies aimed at substantially reducing their tax burden. Apart from the methodological and constitutional issues of implementation – such as a legal basis, requisites for application and ranking – the substantive scope of this tax avoidance concept has been clearly

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[1037] As noted by Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), P. 210; and van Lück, Kolja (2017): Gesetzentwurf zur Einführung einer Lizenzschranke durch §4j EStG. Verfassungsrechtliche und europarechtliche Herausforderungen. In *IStR* (10), P. 391.

[1038] *N Luxembourg 1 and Others* v *Skatteministeriet* (C-115/16 to 119/16 and 299/16).

[1039] *Ibid*, para. 117ff.

[1040] As was the case in *Halifax* (C-255/02), para. 93; *Italmoda* (joint cases C-131/13, C-163/13 and C-164/13), para. 46; and *Cussens* (C-251/16), para. 31ff. See also Lampert, Steffen (2019): Zur Vereinbarkeit der Quellenbesteuerung von Zinsen und Dividenden mit dem Unionsrecht in den "Dänemark"-Urteilen des EuGH (Rs. C-115/16 bis C-119/16 und C-299/16). In *ISR* 19, P. 261f.

[1041] For example through Action 6, in order to prevent tax treaty abuses.

[1042] Obliging the tax legislator *e.g.* to introduce a GAAR, as discussed in Chapter 2.1.3.

extended over the years by the EU possibly due to public pressure and influence from the OECD,[1043] where instead of being recognized only in narrow cases of artificial arrangements, real arrangements which might also fulfill a commercial purpose are put to the test if they lead to competition distortions within the European single market. It is apparently in this wake that the ECJ recognized in recent decisions the need to combat tax avoidance not only as a justification for infringements on the fundamental freedoms, but as a general principle of EU law[1044] within the framework of direct taxation that leads to an *obligation* of MS to fight tax avoidance.[1045]

It is debatable whether this principle is interpretative, *i.e.* whether it merely aims to direct the interpretation of directives and national tax rules; or whether it is a principle of substantive law, producing effects independently. It seems that, through an analysis of these most recent ECJ decisions on the matter, the Court gave in to the pressures of a holistic approach to the fight against tax avoidance, deciding to bestow its own effects on the general anti-abuse principle, defined as a self-standing concept. This decision has been severely criticized by the doctrine,[1046] since it is not the fact that this principle has a ranking comparable to that of primary law that the *effects* produced by it should also have them, which otherwise could override the specific purposes of anti-abuse clauses contained within the directives. Moreover, this turns out to be a strong siege on the tax sovereignty of Member States to legislate and encourage tax competition on their own terms, since there would be an obligation to combat abuse without there necessarily being a specific rule on this matter decided by the EU itself.

This criticism makes sense to the extent that the design of specific anti-abuse clauses by the European Union in directives, if they were to be overridden by a general, broad principle of anti-abuse in EU law, in addition to hurting the tax sovereignty of Member States, would make the

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[1043] As noted by Schön, Wolfgang (2019): The Concept of Abuse of Law in European Taxation: A Methodological and Constitutional Perspective. In *Working Paper of the Max-Planck Institute for Tax Law and Public Finance* 18. Available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3490489, checked on 25.11.19, P. 2ff.
[1044] Interestingly very much in line with OECD standards, such as the PPT. See Danon, Robert J.; Gutmann, Daniel; Lukkien, Margriet; Maisto, Guglielmo; Jiménez, Adolfo Martin; Malek, Benjamin (2021): The Prohibition of Abuse of Rights After the ECJ Danish Cases. In *Intertax* 49 (6-7), P. 517f.
[1045] Even though these developments are seen with much skepticism by many when it comes to justifying measures such as license barriers. Refer to the opinion of Dürmeier (2021): Die Lizenzschranke aus verfassungs- und unionsrechtlicher., P. 276ff.
[1046] See, for example, Broe, Luc de; Gommers, Sam (2019): Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases. In *EC Tax Review* (6), P. 270ff., Larking, Barry (2019): CJEU Decisions on Tax Avoidance and Conduits: More Questions Than Answers. In *Tax Notes International* 95 (1), P. 25ff; and Zalasinski, Adam (2019): The ECJ's Decisions in the Danish "Beneficial Ownership" Cases: Impact on the Reaction to Tax Avoidance in the European Union. In *International Tax Studies* 2 (4), sec. 4.1ff.

drafting of such specific provisions utterly meaningless. In instances where there are no specific provision in directives or in national law, to allow a broad justification as this one would furthermore bring about legal certainty concerns similar to those related to the use of a GAAR. Therefore, it seems wise to observe these judicial developments with skepticism and great caution.

c.3) A light at the end of the tunnel: practical use for the need to combat tax avoidance

It is however arguable that it would be reasonable, with this new ECJ jurisprudence, that the Member States should be allowed to draft an anti-abuse rule outside the scope of the directives, and that this general principle should therefore operate either as a reduction of the scope of the fundamental freedoms or as a justification of a similar nature as the need to combat tax avoidance. This means that on the one hand, in cases of withholding taxes, for example, which fall within the scope of the Interest and Royalties Directive, MS anti-abuse measures could not override what is foreseen within this harmonized field of taxation. However, on the other hand, the objective of a royalty deductibility barrier is outside the scope of secondary EU legislation, and it would be fair to argue that this general anti-abuse principle could endorse such a measure – provided it is proportionately structured – rather than justify an interference in a supposedly abusive tax planning without any substratum in the corresponding national legal system.

If a Member State, by implementing a royalty deductibility barrier, can demonstrate that this restrictive – or rather discriminatory – national tax provision is necessary to counteract an aggressive tax planning structure used by the taxpayer to reduce his tax burden in a way that violates the objective of fundamental freedoms, it is possible that the ECJ, if it follows the direction taken in these latter decisions, will see this measure as justified by the need to combat tax avoidance.[1047] While it seems to have been a categorical error of the Court to allow for the production of effects of this general principle in the fight against tax avoidance even in the absence

[1047] Some authors, however, deny promptly this possibility, arguing that rules that limit deductibility do not really operate as anti-abuse rules, as they exclude the possibility of abuse by simply forbidding deductions. That is to say they operate at a previous level, by avoiding mismatches from the get-go, and would therefore not be proportional and justifiable by the need to fight tax avoidance in the first place. Refer to Dourado, Ana Paula (2015): Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6. In *Intertax* 43 (1), P. 49ff.

of a specific provision by the EU and/or by the national tax legislation alike,[1048] these decisions indicate a clear break with the historical case-law of the European Union regarding the primacy of fundamental freedoms in the fight against tax avoidance, which is traditionally bound by the restriction on wholly artificial arrangements. At the same time that these decisions established a general anti-abuse principle, they also diluted the strict requirements of earlier decisions, aligning the Court's jurisprudence with the BEPS Action Plans, which for some goes far beyond the limits established for judicial acts within the EU.[1049]

Fighting tax avoidance has become in the past few years the backbone of international taxation, which is directly reflected in the most recent ECJ decisions. Whether this trend will continue, however, only time will tell. It is, nevertheless, important that there be consistency in the use of the concept of abuse by the Court and by Member States that wish to justify the adoption of national measures according to these parameters. This is made difficult by the fact that, from *Cadbury Schweppes*[1050] to *Deister Holding*[1051] and now *Denmark*[1052], there has been a significant change in the Court's stance on this issue, especially when one considers that in *Deister Holding* a directive benefit is denied based on a statutory anti-abuse provision, whilst for the Denmark cases it is solely based on a nation- or EU-wide general principle with no corresponding provision on directives or national law.[1053]

In a way, this seems to be a relatively progressive evolution of jurisprudence, firstly because, as a general anti-abuse principle, it should not be restricted only to indirect taxation, but should be part of the European tax system as a whole. Moreover, almost every Member State has now some form of GAAR and/or SAARs, especially due to the ATAD, which reinforces the idea that this would be a general principle of European law. The greatest concern is with regards to the

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[1048] For more on this opinion, see Schön, Wolfgang (2019): The Concept of Abuse of Law in European Taxation: A Methodological and Constitutional Perspective. In *Working Paper of the Max-Planck Institute for Tax Law and Public Finance* 18. Available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3490489, checked on 25.11.19, P. 10ff.
[1049] As defended by Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 300ff.
[1050] C-196/04.
[1051] C-504/16.
[1052] Joined cases C-116/16 and C-117/16.
[1053] For more on this opinion, van Hulten, L. C.; Korving, J.J.A.M. (2019): Svig og Misbrug: The Danish Anti-Abuse Cases. In *Intertax* 47 (8&9), P. 793ff. What the ECJ held in *Deister Holding* remains, however, valid even after the Danish cases. See Danon, Robert J.; Gutmann, Daniel; Lukkien, Margriet; Maisto, Guglielmo; Jiménez, Adolfo Martin; Malek, Benjamin (2021): The Prohibition of Abuse of Rights After the ECJ Danish Cases. In *Intertax* 49 (6-7), P. 517.

autonomy of the MS, since the decision not to adopt anti-abuse measures, be they specific or general, can be seen as another way to promote tax competition with other states.

This is not, however, a problem for those countries that wish to implement a royalty deductibility barrier or similar rule to combat tax avoidance, rather quite on the contrary: the countries that decide to thread this path have an extra foothold in combating tax avoidance through the recognition of this principle, since EU law cannot be relied on for abusive or fraudulent ends. Considering that the requirements and scope of this principle are still unclear, leaving relatively open the meaning of fraud or abuse that could be used as a justification,[1054] the MS will have to do an imaginative and rational exercise to justify their national measures before the fundamental freedoms of the EU. Ideally, the European Union would find a harmonious balance for this problem, balancing the legitimate interests of tax base protection of Member States and the economic freedoms assured within the European single market. However, considering the multitude of opposing interests within the EU and the need for unanimity, this seems to be a distant reality. Therefore, it is up to governments of MS wishing to present a satisfactory unilateral answer through royalty barriers to do it in an orderly and proportional fashion.

4.2.2.1.3 Proportionality considerations

Even in the debatable hypothesis that it would be possible to conclude that a WHT or a royalty deductibility barrier could be justified by the above-mentioned requirements, a final proof, namely, of the proportionality of the restrictive national tax legislation, would still be necessary according to the ECJ. This unveils the principle of proportionality in European law as being a true limitation to the justifications under EU law.[1055] That is, if a certain measure goes beyond what is envisaged and could be replaced by a lesser interference in the fundamental freedoms and consequently in the taxpayer's sphere of protection, it will be considered disproportionate and therefore ultimately unjustified. It is therefore necessary that the member state regulations that are justified remain within a framework that is able to reflect fairness on a case-by-case basis.[1056]

[1054] For more information, refer to Larking, Barry (2019): CJEU Decisions on Tax Avoidance and Conduits: More Questions Than Answers. In *Tax Notes International* 95 (1), P. 27ff.
[1055] In the form of a so-called "limitation on limitations", or "*Schranken-Schranke*". For more on this definition, see Schnitger (2006): Die Grenzen der Einwirkung der., P. 398ff.
[1056] Refer to Seer, Roman (2005): Die gemeinschaftsrechtliche Beurteilung der erweiterten Mitwirkungspflicht bei Auslandssachverhalten. In *IWB* (5), P. 675ff.

The ECJ case-law recognizes the importance of the principle of proportionality insofar as it gives it a ranking of general principle of EU law,[1057] which requires that the restrictive or discriminatory measure to be of a nature likely to achieve the objective pursued by it, but without going beyond what is necessary to achieve that end.[1058] For this analysis, two main requirements are commonly evoked, namely, adequacy – a measure's ability to achieve its desired objective, based on a causal link between them – and necessity – the assessment of whether there is no other less intrusive measure capable of achieving the same objectives.[1059] Commonly indicated by the literature on the subject,[1060] but sometimes overlooked by the Court, in some cases a third requirement is still assessed in the form of a *stricto sensu* proportionality, in which a balance of the various interests involved is evaluated. In the case of national tax provisions aimed at combating aggressive tax planning structures that use royalty payments, the interests are certainly the protection of the fundamental freedoms and guarantees to the taxpayer *versus* the protection of the tax sovereignty and tax base of Member States, paired with the desire to combat tax avoidance.

Therefore, with regards to the proportionality of a withholding tax, it is relatively clear that there are no problems concerning its adequacy, since the absence of a withholding tax is nearly a prerequisite for developing an aggressive tax planning structure with IP.[1061] However, the distinction between a broad WHT and one structured as a subject-to-tax would be significant in the aspect of its necessity. When comparing them, it is evident that a provision with a more restricted design represents a minor interference in the fundamental freedoms, being more suited to allow for differentiated treatment in specific cases. Compared to a royalty barrier, for instance, a WHT also has reduced compliance burdens, since it is simple to implement and comply with for both tax administrations and taxpayers alike.[1062] Were it not for its restriction based on secondary law, there is no doubt about the proportionality of a withholding tax, especially as a subject-to-tax

[1057] As established in *Hermann Schräder* (C-265/87), para. 21; and *Commission* v *Hellenic Republic* (C-210/91), para. 19.
[1058] See cases *Kraus* (C-19/92), para. 32; *Bosman* (C-415/93), para. 104.; and *Futura Participations SA* and *Singer* (C-250/95), para. 26.
[1059] See the discussion by Englisch (2005): Dividendenbesteuerung, P. 284ff.
[1060] Refer to Schilcher (2010): Grenzen der Mitwirkungspflichten im Lichte., P. 154f.
[1061] EU studies show that if there was some form of WHT, the tax-saving structure would lose much of its functionality. See Chapter 3.1.1 for more information, as well as European Commission (2017): Aggressive tax planning indicators. Final Report. Institut für Höhere Studien und Wissenschaftliche Forschung. Luxembourg (Taxation papers, 71-2017)
[1062] This aspect of the administrative costs of implementing a measure was also discussed by the ECJ in cases such as *Pirkko Marjatta Turpeinen* (C-520/04), para. 34ff.; *Amurta* (C-379/05) and even by the Opinion of AG *Kokott* in *Truck Center* (C-282/07) para. 45ff. See also Simader (2010): Die Zulässigkeit der Erhebung von. In: Lang/Schuch/Staringer (Eds.) - Quellensteuern., P. 44f.

clause that allows individualized treatment of taxpayers. This is not surprising considering the wide acceptance WHT has had for many years in the international taxation scene.

With regards to the royalty deductibility barrier, however, the reality may be somewhat different. There are no manifest problems with the adequacy, since by restricting the possibility of deducting royalty payments as business expenses and thus guaranteeing taxation at the license holder level, a cross-border tax saving structure would lose its *raison d'être*. Therefore, this provision is, as a rule, adequate to achieve the objectives it sets out to achieve. The necessity aspect, however, begins to present problems, since it is debatable and likely that a WHT as a subject-to-tax clause will be considered a less intrusive measure regarding the impossibility of deducting royalties, especially considering the high compliance costs to adapt to a relatively new rule such as the royalty barriers. However, considering the current near impossibility of implementing a WHT with respect to royalties in European law, one could argue that there would be no less revolutionary alternative, since the inverted tax credit system requires a thorough reform of the national deductions system.

The biggest challenges, however, are in some way at the level of *stricto sensu* proportionality, especially when paired with the more traditional ECJ jurisprudence. If one opts for a rule such as the Austrian one, which completely forbids the possibility of deductions from a given threshold, it is clear that this goes beyond what is necessary for the provision to achieve its goals, and it is not possible to consider this rule proportional if not even the restriction on deductibility is proportional to the (effective) tax rate.[1063] Possible attempts to justify this "simplification" of the rule based on ease of employment by tax administrations would most likely also not be accepted, since the risks of unfair and burdensome treatment through royalty deductions barriers are too high when compared to the increase in complexity of a proportional deduction.

Furthermore, it must be borne in mind that a provision based solely on the establishment of a subsidiary company in another MS with a lower tax rate and/or preferential tax regimes does not justify an absolute presumption of tax avoidance.[1064] This goes far beyond what is necessary to achieve the goals of countering aggressive tax planning structures, as the taxpayer should at

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[1063] On this same opinion, see Wimpissinger, Christian (2014): Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach §12 KStG unionsrechtswidrig? In *SWI*, P. 226.
[1064] As seen in cases such as *ICI* (C-264/96), para. 26; and *Lankhorst-Hohorst* (C-324/00), para. 37.

least be allowed to prove that their activities are covered by economic reality and/or have not been structured with a (primary) tax saving intent. However, even in cases where this possibility exists, one cannot forget the restrictions of ECJ jurisprudence, which not only consider proportionate discriminations solely in relation to wholly artificial arrangements,[1065] but also that a tax adjustment should be able to occur exclusively in relation to the part that is not on arm's length terms, *i.e.*, is economically disproportionate.[1066]

Although the attempt to protect the arm's length principle is understandable, to confine the use of a corrective tax measure, in order not to be considered disproportionate, to the part which exceeds what would have been agreed under normal competitive conditions, completely runs contrary to the purpose of a royalty deductibility barrier. These problems would already be solved on their own through the arm's length principle by itself, and it is clear that the purpose of the royalty barriers is also to combat those structures that carry out transactions according to this principle if they serve an aggressive tax planning scheme.[1067] From this perspective of the Court, the royalty barriers would all have to be considered disproportionate.[1068] Only if one takes into account the most recent case-law regarding anti-abuse could it be feasible to acknowledge that the ECJ would accept a justification for cases where there is economic reality and for transactions that occur according to arm's length standards, which is essential for the royalty barriers to achieve their objective. It remains yet to be seen if this line of reasoning – which puts the fight against tax avoidance above the traditional jurisprudential requirements – will, especially after general acceptance of the OECD GloBE proposal, be accepted by the Court as proportional.

4.2.2.2 Compatibility with state aid law

A final aspect of European primary law that should be analyzed to ascertain the compatibility of specific measures to combat aggressive tax planning structures that use cross-border intra-group royalty payments is state aid law. In order to maintain a level playing field and ensure an efficient allocation of resources within the European single market, Art. 107 to 109

[1065] Drummer, Verena (2017): Lizenzschranke: Abzugsbeschränkung vs. Tax Credit aus EU-Rechtlicher Sicht. In *IStR* (15), P. 603f.
[1066] As stated in *SGI* (C-311/08), para. 72; and *SIAT* (C-318/10), para. 52.
[1067] For more information in the discussion on arm's length, refer to Chapters 2.1.1 and 3.2.1.
[1068] As defended by Hagemann, Tobias; Kahlenberg, Christian (2017): Die Lizenzschranke (§ 4j EStG) aus verfassungs- und unionsrechtlicher Sicht. In *FinanzRundschau* (24), P. 1129f., and Jerabek, Richard; Neubauer, Nikolaus (2014): Unionsrechtskonformität des §12 Abs. 1 Z 10 KStG? In *SWI*, P. 380.

TFEU establish some legal restrictions on Member States' interventions in the market-based economy of the EU. Accordingly, any aid granted by an MS or through public resources in any form whatsoever that has the potential to distort, directly or indirectly, specific activities or products through a (tax) advantage by an undertaking is heavily restricted or outright prohibited.

For Art. 107 TFEU to be applicable, the existence of some form of *aid* is required, a concept that, however, has no formal legal definition.[1069] It is clear that if a company receives a grant in the form of an economic advantage from a Member State that would normally be inaccessible to it, a form of aid will be constituted.[1070] In tax law, however, the dynamics is somewhat different, since the payment of taxes is a means of financing the State, and not the other way around.[1071] This means, therefore, that if one undertaking has to pay less taxes than another, it is possible to consider that it has an economic advantage in relation to the other, which may constitute a form of aid, given the broad interpretation this concept has by the ECJ.[1072]

The determining factor to identify a case of potential state aid in fiscal matters revolves around identifying a selective advantage as requires Art. 107 TFEU.[1073] In order to be able to identify an advantage, it is necessary to have a standard of comparison in the form of benchmarking, since an advantage will only be established when a certain tax treatment is compared with what a *normal* taxation would be.[1074] Unfortunately, neither the ECJ nor the Commission has determined, up to this moment, the precise contours of how to identify what should be considered a general rule and what would be an exception,[1075] it thus not being straightforward to identify the limits between a specific provision and a general system.[1076]

[1069] Refer to Marchgraber (2018): Double (non-)taxation and EU law., P. 169ff.

[1070] These more pronounced cases were identified by the ECJ at an early time in decisions such as *SFEI and others* v *Poste* (C-39/94), para. 60; *DMT* (C-256/97), para. 22; and *Spain* v *Commission* (C-342/96), para. 41.

[1071] See Schön (2021): State Aid in the Area. In: Hancher/Ottervanger et al. (Eds.) - EU state aids., Ch. 12.

[1072] See reitrated case-law in *Air Liquide Industries Belgium SA* and *Province of Liège* (C-393/04 and C-41/05), para. 30; *Banco Exterior de España* (C-387/92), para. 14, and *Cassa di Risparmio diFirenze and Others* (C-222/04), para. 132.

[1073] As in Miladinovic (2020): Chapter 4 - The State Aid. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 117ff.

[1074] *European Commission and Kingdom of Spain* v *Gibraltar* (C-106/09 and C-107/09), para. 90; and *Portuguese Republic* v *Commission* (C-88/03), para. 56.

[1075] See the Opinion of AG Jääskinen in *European Commission and Kingdom of Spain* v *Gibraltar* (C-106/09 and C-107/09), para. 184; as well as Schön, Wolfgang (1999): Taxation and State Aid Law in the European Union. In *Common Market Law Review* 36 (4), P. 925ff.

[1076] Refer to the comments of Lang (2009): Selectivity as a Criterion to. In: Pistone (Ed.) - Legal remedies in European tax., P. 269ff.

It is clear that state aid rules will be applied in cases where there is a treatment through national (tax) measures that will favor certain enterprises over others. In the case of royalty deductibility barriers, for example, despite only a minority of the companies being affected by the provision, they will be afflicted by a treatment *less favorable* in relation to other companies, which would ensure, from a teleological perspective, a favored – standard – treatment to most companies. In fact, the ECJ already has settled case-law in the sense that measures promoting any form of differentiation between undertakings will be *prima facie* selective, except in cases where this differentiation arises from the very nature or overall structure of the system of which they are part of.[1077] This methodology for a selectivity test resembles, in practice, the discrimination test and application of the principle of proportionality under the EU fundamental freedoms seen previously,[1078] and it might apply to anti-abuse measures insofar as they have derogation structures ensuring that the provisions will not apply to certain transactions or undertakings.[1079] If this non-applicability of the anti-abuse rules to a specific field cannot be justified through the underlying logic of these rules in question, there may be an infringement of state aid rules. It remains therefore to be seen whether this and the other specific rules are compatible with European law on a state aid law basis.

As a rule, evidence of selectivity and violation of state aid law is evaluated based in three main steps. First, it must be determined which taxation is considered as "standard", in order to then be able to assess in a second step whether there are hypotheses in which an undertaking in a similar legal and factual situation as another one may be treated differently. Finally, in a third step, a justification based on the overall structure and nature of the system as a whole is feasible.[1080]

While keeping in mind that there already are European secondary law restrictions, in the specific case of withholding taxes on royalty payments, it is interesting to evaluate whether, if

[1077] See decisions such as in *Adria-Wien Pipeline* and *Wietersdorfer & Peggauer Zementwerke* (C-143/99), para. 42; *Portuguese Republic* v *Commission* (C-88/03), para. 52; and *British Aggregates Association* v *Commission* (C-487/06), para. 83.

[1078] As confirmed by the ECJ itself, such as in *Commission* v *Lübeck* (C-524/14), para. 53. This is not surprising, insofar as both state aid provisions and the fundamental freedoms promote, as a means of negative integration, the implementation of the European single market.

[1079] See Commission Decision 2007/256/EC of 20 December 2006 on the aid scheme implemented by France under Article 39 CA of the General Tax Code (OJ L 112, 30.4.2007, p. 41), para. 81ff.; and Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01), para. 183.

[1080] For more information on the system and procedural nuances, refer to Blumenberg, Jens; Kring, Wulf (2011): Europäisches Beihilferecht und Besteuerung. In *IFSt-Schrift* (473), P. 7ff.

there were no such restriction, this measure could be considered compatible with European state aid law.[1081] Although WHT are widely accepted in the international taxation scene, the greatest concern with this rule to combat BEPS would be in relation to its variant of a *conditional* withholding. This occurs because, given its conditional nature, it could be considered that there is differentiated treatment for undertakings in a similar situation, constituting a form of state aid.

As the main evaluation criterion is selectivity, and with a broad-specter WHT out of the equation, it is possible to identify that a withholding tax as a subject-to-tax clause can promote differentiated treatment – albeit disadvantageous – for a specific group of undertakings making payments to low tax jurisdictions, which indirectly ensures "better treatment" for payments made to other areas. Nevertheless, a state aid analysis is not merely about determining whether there has been a deviation of the national measure in the form of an exception to a general standard,[1082] but about demonstrating whether there has been a derogation from the reference framework in order to differentiate between undertakings that are in a legally and factually similar situation.[1083]

Although it does not yet provide definite outlines, the Commission itself indicates that it is not sufficient to examine whether a particular measure derogates from the rules of the system used as a reference within the framework of the MS concerned. It is also necessary to assess whether the limits of this reference system have been consistently designed or, conversely, whether its structure is not in itself discriminatory and arbitrary, in order to favor specific undertakings which, according to the logic of this general system, should be treated in a similar manner.[1084]

If the WHT as a subject-to-tax clause is considered as the reference system and the underlying logic of this system is the objective of preventing BEPS, the differentiated treatment can readily be justified on the basis of the overall structure and nature of the system as a whole. Moreover, following the line of reasoning that the concept of selectivity is directly linked to that

[1081] State aid has, as a general rule, to be imputable to the Member State directly, that is to say that, if the rule stems from a directive, the State will not be responsible for the violation. As stated by Kofler, Georg (2022): The Shielding Effect of EU Secondary Law. Zoom Conference (OMG Transatlantic Tax Talks), 20.01.22.
[1082] Lyal, Richard (2015): Transfer Pricing Rules and State Aid. In *Fordham International Law Journal* 38 (4), P. 1017ff.
[1083] Refer to Marchgraber (2018): Double (non-)taxation and EU law., P. 181f.
[1084] European Commission (2016): Commission Notice on the Notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union. Official Journal of the European Union (C-262/1), para. 129.

of discrimination in relation to fundamental freedoms,[1085] if one considers that there is no violation of these freedoms by a WHT of this nature, there would be no unwarranted selectivity, and it therefore follows that a conditional withholding tax would not constitute state aid.[1086]

With respect to royalty deductibility barriers, one of the main problems is – as in many cases of state aid – the determination of what will be the criteria for determining standard taxation, which may lead to diametrically opposed results. If one decides on the rule being the deduction of business expenses, and a royalty deductibility barrier being the exception to this rule, there would be no concern regarding state aid law within the EU, as a *selective advantage* that could constitute a form of aid would not be granted from that point of view through a national tax measure.

However, if one considers the royalty deductibility barrier to be the standard, the whole picture is altered. Although it may be argued that one cannot directly compare purely domestic transactions with those carried out cross-border between related parties; there would still be a differentiation between cross-border transactions based on the activation of the rule for low-tax jurisdictions or those with a preferential tax regime in relation to those resident in other countries.[1087] In this case, undertakings that were excluded from the rule would be receiving preferential treatment and, therefore, a selective advantage outside the overall system of restrictions on deductions chosen as "standard".[1088] This would then constitute a prohibited state aid within the meaning of Art. 107 TFEU.[1089]

[1085] As advocated by Douma (2018): Chapter 3: An EU Free. In: Maisto (Ed.), Taxation of Intellectual Property under., P. 46f.
[1086] Also on this opinion see Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 19f.
[1087] This risk had already been manifested in the case of the German provision when discussing the drafting of the regulation. See Pinkernell, Reimar (2017): Öffentliche Anhörung zu dem Gesetzentwurf der Bundesregierung "Entwurf eines Gesetzes gegen schädliche Steuerpraktiken im Zusammenhang mit Rechteüberlassungen" (Drs. 18/11233). With assistance of Flick Gocke Schaumburg. Deutscher Bundestag. Available online at https://www.bundestag.de/ausschuesse/ausschuesse18/a07/anhoerungen/109--sitz-/497496, checked on 11.01.19, P. 12ff.
[1088] The same could occur in this hypothesis with the German rule based on its §4j para. 1 sentence 4 provision, that has a reverse exception for regimes in line with the OECD nexus-approach. This could thus produce a selective advantage for such cases. See the opinion of Hagemann/Kahlenberg (2011): §4j. In: Herrmann/Heuer et al. (Ed.) - Einkommensteuer- und Körperschaftsteuergesetz, para. 5.
[1089] On this opinion, see Max, Marcel; Thiede, Jesko (2017): Der Gesetzesentwurf zur Einführung einer Abzugsbeschränkung für Lizenzaufwendungen - "Lizenzschranke". In *StB* (6), P. 180 and Herzig (2017): Wie kann die Regierung steuerliche., P. 80.

Although it is feasible to argue that the standard to be assumed may be the non-deductibility through the royalty barrier, even if its activation occurs in the minority of cases,[1090] traditionally the deduction of expenses has always been seen as the rule, ensuring the net taxation of profits. Therefore, it seems more reasonable to assume that the standard taxation will be the deduction of expenses,[1091] while the deductibility barrier will be the exception, which would ensure its compatibility with European state aid law. Furthermore, European case law on the matter of royalties and state aid has been relatively shy, and the small deviations of treatment conferred by States to royalty transactions between companies of the same corporate group – for instance through diverging arm's length methods – was not deemed to be a violation of Art. 107 TFEU.[1092]

Finally, with respect to an inverted tax credit system, any possible issues with selectivity – since the granting of tax credit will be differentiated if the payment is made to a license holder residing in a country with different tax rates from the licensee's country of residence – will be justified based on the logic inherent to the tax credit system. The very core of this proposal is to subvert the current system of deductions and its consequent replacement by a new one, capable of better dealing with the problem of profit shifting through royalty payments. This differentiation of treatment, if it can be considered a differentiation at all, is based on the very nature and overall structure of the inverted tax credits system, being therefore a justification already widely accepted by the ECJ for the generation of distinct effects for undertakings.[1093] In the absence of selectivity, the requirements of Art. 107 TFEU to consider the existence of state aid are not fulfilled.

4.2.3 Interim results on the relation between specific anti-avoidance measures on royalty payments and European Law

As demonstrated in this section, even prior to taking into account any restrictions arising from a tax treaty network or the WTO, the attempt to adopt specific measures to combat profit shifting opportunities through royalty payments proves to be a tough and winding road for EU member countries.[1094] The balance between the tax sovereignty of the MS and the protection of

[1090] What is relevant for the ECJ is the production of distinct effects between undertakings in similar situations, and not the proportion of affected companies. See *Banco Exterior de España* (C-387/92), para. 14ff.
[1091] On this same opinion, see Müllmann (2021): Die Lizenzschranke als Abwehrmaßnahme im., P. 330f.
[1092] As was the case in the recent decision on *Luxembourg* v *Commission* (T-816/17).
[1093] *Op. cit.*, Fn. 1090.
[1094] For a general overview on the compatibility of specific measures against profit shifting in relation to higher-ranking law, refer to Appendix II.

the European single market is very delicate, and both European secondary legislation and traditional ECJ case-law regarding fundamental freedoms are extremely conservative in this sense. Each one restricts to a large extent how and to which degree a Member State can combat aggressive tax planning structures of a cross-border nature, all in the name of defending the commercial freedoms present within the EU.

This zeal for the fundamental freedoms and free competition in the European market is well-founded, as they have historically been very difficult to achieve. However, it is questionable to which point these precepts should remain intangible in view of the latest developments of the BEPS project and the clear usage of some European law mechanisms as essential gears in international tax avoidance systems. The Interest and Royalties Directive, for example, by restricting the possibility of withholding taxes in cross-border royalty payments without expressly providing for a single taxation principle or allowing the insertion of a WHT as a subject-to-tax clause, fostered many tax planning opportunities within – and sometimes even beyond – the EU.

Both forms of withholding discussed in the previous chapter are therefore most likely utterly unfeasible in a European context if there are no substantial reforms[1095] to secondary legislation – related or not to the OECD GloBE proposal – or through an enhanced cooperation system, and would still face issues with primary law even if WHT were not already virtually off limits. Even the most recent EU directive proposal wishing to implement a minimum tax based on the OECD GloBE has seen small adjustments trying to make the project more compliant with the fundamental freedoms, which might also bring about adverse consequences.

Alternatively, some MSs have decided to implement the royalty deductibility barriers, which circumvent the scope of the directive insofar as it has applicability in relation to the payee of royalty transactions, which can be taxed only in their country of residence, whilst not covering the taxation of the payer. Accordingly, a limitation on the possibility of the licensee deducting expenses is not contrary to European secondary law. However, this measure faces several challenges in relation to the fundamental freedoms, since a violation cannot be ruled out as its implementation may reduce the attractiveness of the internationalization of an undertaking, which would amount to discrimination prohibited by EU law. Even extending the applicability of a

[1095] Which are, by themselves, incredibly hard if not impossible to be implemented on the current European framework.

royalty barrier to domestic cases as well – much like the recent attempt at a EU directive to implement the OECD GloBE proposal – would most likely be insufficient, as an indirect discrimination would occur due to the measure affecting mainly, if not solely, cross-border cases, even though the international debate naturally influences the interpretation of the fundamental freedoms.

Despite the hypothesis that such discrimination could be justified, it is notable that this is extremely difficult considering the ECJ jurisprudence on the subject: (a) a balanced allocation of taxing rights is only examined, as a rule, in situations of double dipping, which is not the case with royalty barriers; (b) the cohesion of the tax system commonly requires that there be a direct link between obtaining a tax advantage and the tax levy, which also does not apply to this provision; and (c) the need to combat tax avoidance, which *prima facie* would be the best justification for this rule, is restricted only to wholly artificial arrangements, which essentially kills the purpose of the norm.

These European law requirements lead to almost paradoxal restrictions for royalty deductibility barriers and the OECD Pillar 2 proposal alike, where the design of a norm whose purpose is to ensure a minimum level of taxation in at least one of the countries involved, in order to combat aggressive tax planning structures and profit shifting, will be justifiable in the European context if, and only if, its design does not solve the problem at hand. This does not mean, however, that its implementation is entirely unfeasible within the EU. It should not be forgotten that these justifications do not have a fully defined outline and legal requirements, and that an evolution in these understandings over time is possible.

Moreover, there has never been an analysis by the ECJ of a rule directed at the deduction of royalties such as those under discussion, and although, considering the decisions handed down so far by the Court, the chances of rejection of this measure for violation of fundamental freedoms being high, the evolution of jurisprudence in recent years in favor of measures against base erosion and profit shifting, especially those of February 2019, is remarkable.[1096] This process might be accelerated if the GloBE proposal succeeds the unanimity barrier within the EU and is actually implemented as a directive. What remains for the Member States that seek the employment of such

[1096] Refer to the case-law discussed on Subsection 4.2.2.1.2, *lit*. “c”.

a rule is to structure it as fairly as possible, to ensure that, in addition to achieving its objectives, it has greater chances of being considered compatible with the precepts of European law by the ECJ.[1097]

In a sense, the implementation of a royalty deductibility barrier, while on the one hand possibly violating the fundamental freedoms, might on the other hand help in a dialectical way the promotion of the European single market. By virtue of Art. 3 para. 3 of the TEU, the functioning of the internal market would also be endangered if entrepreneurial decisions were primarily or exclusively paired with an aim of sparing taxes, taking the place of more rational decisions from an economic viewpoint.[1098] Moreover, distortions in competition caused by cross-border aggressive tax planning structures also directly impair the smooth functioning of the internal market. According to the Court, the prevention of tax avoidance is an objective recognized and encouraged by EU law in general, and there is a legitimate interest of the MS in taking *appropriate measures* in order to protect their financial interests and the functioning of the European market. This was already apparent for VAT in particular with *Halifax*, however this has shifted with the new ECJ decisions, expanding to direct taxation.[1099]

While the latest ECJ decisions, especially *T-Denmark* and *N-Luxembourg*, pose problems and new questions from a technical outlook, they also bring about opportunities. It can be argued that countries are, by implementing specific anti-avoidance measures against aggressive tax planning structures that abuse royalty payments, simply seeking to combat tax avoidance based on European principles, actually safeguarding the single market to a certain extent. Decisions such as the C-116/16 and C-117/16 joined cases[1100] show how a view linked to the OECD BEPS project has come to permeate the opinion of the ECJ and how it decides cases that are not resolved in a manner deemed satisfactory by current measures under European Law, embracing a wider concept of tax avoidance. While anti-avoidance measures such as royalty barriers with a sloppy design that simply assume abuse and do not grant the taxpayer an opportunity for exculpation will probably

[1097] As will be discussed further in Chapter 5.
[1098] For more on this discussion, see Fehling, Daniel; Schmid, Mareike (2015): BEPS und die EU: Was ist die "europäische Dimension" von BEPS? Das Beispiel grenzüberschreitender Lizenzzahlungen. In *IStR*, P. 496ff.
[1099] See Öner, Cihat (2018): Is Tax Avoidance the Theory of Everything in Tax Law? A Terminological Analysis of EU Legislation and Case Law. In *EC Tax Review* 2, P. 105ff.
[1100] Refer to Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 286f.

still be unacceptable,[1101] a window of opportunity has certainly opened up with the recent developments in the EU level, even if there still are – understandably – doubts concerning the compatibility of the royalty barriers implemented so far.[1102] This extends, of course, to the OECD GloBE proposal and Pillar 2 outcomes,[1103] especially the undertaxed payments rule, as even if implemented through EU legislation, it would have as of now theoretically to contain substance carve-outs in respect of genuine commercial operations[1104] so as to satisfy the ECJ requirements on a presumption of abuse, in effect devoiding it of effectiveness. It is highly questionable whether the proposed carve-outs for payrolls and tangible assets will suffice.

The only measure that is nearly immune to problems with European law – also due to its not entirely developed theoretical character – is the inverted tax credit system of *Lodin*. Since it represents a complete revolution in a country's system of deductions, it would be difficult to speak of a violation of European law with the alteration of a purely national system. Even if indirect discriminatory treatment were to be determined, for affecting cross-border transactions in a different way from those occurring nationally,[1105] a justification based on the cohesion of the tax system or even on a balanced allocation of taxing rights does not seem to be troublesome. The issues that this proposal raises are of a different, economic nature, and have been discussed in Chapter 3.3. From the moment that more concrete proposals for the implementation of this measure arise, it is possible to state with more certainty what are or possibly would be the possible shortcomings of this rule with respect to European law.

[1101] See, for instance, Rothe, Sarah; Schade, Filip (2020): Unionsrechtliche Legitimation unilateraler Missbrauchsbekämpfung am Beispiel des deutschen §50d Abs 3 EStG. In *SWI* 30 (12), P. 687.

[1102] Especially after the *Lexel* decision discussed previously. Refer to Schnitger, Arne (2021): Verbot des Zinsabzugs für Zahlungen an ausländische Gruppengesellschaften und die Frage nach Zinsschranke und GloBE. In *IStR* (4), P. 147f.

[1103] While there are differences between the rules evaluated by the ECJ so far and pillar two, none of these mechanisms are targeted exclusively at artificial arrangements, which might prove to be a problem regarding the TFEU, despite of the political pressure this agreement currently exerts within the EU. See Goulder, Robert (2021): The Lexel Decision: Does Pillar 2 Have a TFEU Problem? In *Tax Notes International* 102 (6), P. 846f. and Gebhardt, Leon (2020): Einführung einer Mindestbesteuerung nach den Plänen der OECD. In *IWB* 23 (19), P. 967f.

[1104] Refer to Brokelind, Cécile (2021): An Overview of Legal Issues Arising from the Implementation in the European Union of the OECD's Pillar One and Pillar Two Blueprint. In *Bulletin for International Taxation* 75 (5), P. 219.

[1105] As observed by Evers (2015): Intellectual property (IP) box regimes., P. 228f.

4.3 Treaty law

The second point of interest that should be examined to determine whether the specific measures able to combat aggressive tax planning structures with royalties are compatible with higher-ranking law is the tax treaty network operating on the international scene. Considering the importance of standardizing, clarifying and promoting security to the tax status of taxpayers who are engaged in commercial, industrial or financial activities of a cross-border character, many countries decide, through bilateral – and in some less recurring cases, multilateral – agreements to promote a standardization of cross-border treatment.

This is usually promoted through double taxation agreements, whose tax treaty network currently encompasses more than 3000 conventions in force,[1106] but also bilateral investment treaties (BIT), with more than 2300 operational agreements signed.[1107] These two types of treaties have, of course, distinct functionalities, in which a double tax treaty has as its main purpose to eliminate double taxation (and non-taxation) that may eventually arise as a result of international economic activities, while a BIT aims to protect foreign investors from discriminatory treatment, arbitrary practices such as uncompensated expropriation, etc. Although they are designed for different reasons – on one side to prevent the harmful effects of double taxation and on the other to ensure legal security in international investments – both share the common goal of promoting cross-border investment and, consequently, economic growth.[1108]

As these are agreements under public international law, *i.e.* bi- or multilateral legal acts of an international nature in which subjects of international law – in this case, States – are involved,[1109] it is possible that their provisions restrict or modify the way in which measures such

[1106] Refer to the IBFD Tax Treaty Database for statistical information on the subject, as well as Quak, Evert-Jan; Timmis, Hannah (2018): Double Taxation Agreements and Developing Countries. Institute of Development Studies - K4D Desk. Available online at https://assets.publishing.service.gov.uk/ media/5b3b610040f0b645fd592202/ Double-Taxation-Treaties_and_Developing_Countries.pdf, checked on 12.04.20

[1107] See United Nations Conference on Trade and Development (2020): International Investment Agreements Navigator. Bilateral Investment Treaties (BITs). Available online at https://investmentpolicy.unctad.org/international-investment-agreements, checked on 19.01.21.

[1108] As stated by Pistone (2017): Chapter 1: General Report. In: Lang/Owens et al. (Eds.) - The impact of bilateral investment., P. 1f.

[1109] For more information on this definition, refer to Schaumburg/Häck (2017): Bilaterale Maßnahmen zur Vermeidung der. In: Schaumburg (Ed.) 2017 – Internationales Steuerrecht.

as WHT and royalty deductibility barriers may be implemented at the national level in order to comply with the provisions agreed in an international framework.

4.3.1 Effects of Double Taxation Agreements on tax planning with royalty payments

As treaties under public international law, double taxation agreements bind the contracting States. However, they might also create rights and obligations for the persons covered by the treaty in accordance with its provisions,[1110] which may directly impact the applicability of national anti-avoidance rules.

Of course, the results may differ to the extent that the provisions agreed upon by the states involved are different. However, there are model conventions, such as the OECD one, that have gained such relevance in the international taxation arena that they can be considered a firm basis for assessing the compliance of national rules. The main objective of these model conventions is precisely to ensure that there is a concrete possibility of uniform application of standards in relation to the most common problems that arise within an international taxation perspective.[1111]

Thus, models such as those of the OECD, UN and even the US are used as a basis for negotiations involving double taxation agreements, and it is possible to evaluate on the basis of these models and their respective comments any impacts that these treaties might have on the anti-avoidance provisions currently under evaluation. The most widely adopted model is the one implemented and updated by the OECD, being used as a basis not only by the members of this international organization, but all around the globe and in particular by those countries that do not see the need to adopt their own model, as is the case with the USA.

4.3.1.1 OECD model tax convention as a foundation

Considering the influence that the OECD model convention has had since 1963[1112] in the negotiation, implementation, application and interpretation of tax treaties, the effects it has in the treatment of royalties – and in any measures that impact this treatment – cannot be set aside. The first point to note is clearly Art. 12 OECD-MC, since it deals directly with the income arising from royalties and the allocation of taxing rights between the contracting parties in relation to them.

[1110] See Lehner (2015): Grundlagen. In: Vogel/Lehner (Eds.) - DBA., P. 128f.
[1111] Refer to Vogel/Rust (2015): Introduction. In: Reimer/Rust (Eds.) - Klaus Vogel on double taxation., P. 1ff.
[1112] *Ibid.*, P. 7f.

However, given that the nature of the norms being currently evaluated pursues an anti-avoidance objective and can simultaneously promote distinct treatment among taxpayers based on specific criteria to combat aggressive tax planning structures, as occurred with European law, it may be imagined that a potential risk is that of discriminatory treatment between taxpayers, which would activate the scope of Art. 24 OECD-MC.

Both provisions must be studied in more detail to determine their possible influence on the treatment of withholding taxes, royalty deduction barriers and even the inverted tax credit system.[1113] Of course, these observations are restricted to the relationship between the (numerous) countries that have double taxation agreements in force within the OECD framework, and it is possible that different requirements and clauses may have been provided for on the basis of bi- or multilateral negotiations between the contracting states involved.

For those states that are part of the European Union, the restrictions presented in the previous subsection regarding anti-avoidance measures are valid in addition to any impacts that the double taxation agreements may have on them. This is because, in principle, Member States of the EU retain their competence to conclude international (tax) treaties by virtue of their sovereignty under public international law.[1114] The negotiation of this type of treaty remains, therefore, under the competence of each individual MS.

4.3.1.1.1 Art. 12 OECD-MC

a) Scope of application and royalty payments

Article 12 OECD-MC stands as a rule that determines the allocation of taxing rights between the contracting states, *i.e.* it does not in itself establish the right to tax, but rather how this right established by national law is to be divided among the states involved in order to avoid double taxation. While Art. 12 para. 2 contains a definition of what is deemed to be royalties for the purposes of the treaty,[1115] paragraph 1 indicates that the taxation of royalties arising in one of the contracting states will occur *only* at the residence State of the beneficial owner[1116] receiving the

[1113] For more information on this methodological cut, refer to Subsection 4.1.
[1114] See the observations on this matter by Lehner (2015): Grundlagen. In: Vogel/Lehner (Eds.) - DBA., P. 265f.
[1115] For discussions regarding the definition of royalties on a tax treaty framework, refer to Chapter 1.2.2.
[1116] Concerning the definition and problems involving the contours of beneficial ownership, refer to Chapters 1.4.1.1 and 3.2.2.1.

royalties. Therefore, there is no doubt that the OECD model has opted for an exclusive taxation right of the residence state, with no interpretative margin due to the use of the word “only”. This is not surprising since the OECD has always had, by representing the interests of its members, which are commonly stronger economies, a trend directed towards a residence-based taxation at the expense of source taxation.[1117] Another commonly used justification for this decision is that it would be economically logical for the source state to waive the taxation of royalties in favor of the residence state since it is the latter, where the beneficial owner resides, that suffers the tax consequences of the development costs of intangible asset.[1118]

In this sense, the provisions of the Interest and Royalties Directive examined previously are in accordance with the allocation provided for by the model convention,[1119] which also explains the fact that the definition in Art. 2 *lit*. “b” of the Directive is interpreted in the light of Art. 12 OECD-MC,[1120] revealing a certain level of coordination between these instruments. This emphasizes the need for concepts such as royalties and the allocation of their taxing rights to be interpreted in a relatively harmonized manner in the international scenario, in order to avoid dissent.[1121] Thus, many of the issues that anti-avoidance rules have within European secondary law are also present in the analysis of treaty law through double tax treaties. This is reinforced to the extent that the only exceptions to this allocation rule, provided for in paragraphs 3 and 4 of Art. 12, are highly strict, being applied, respectively, only in the hypothesis (a) of the beneficial owner of the royalties carrying businesses in the other contracting state through a permanent establishment that effectively has the right or property over the intangible asset for which the royalty is paid; and (b) to the amount of payment that is eventually not compatible with the arm's length standard between the related parties.

Of direct relevance to the interpretation of these provisions is not only the national case-law regarding the application of treaties in the field of royalty payments, but also the comments issued by the OECD itself for the purpose of clarifying the provisions of the model convention. It

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[1117] This is precisely why alternative proposals, such as the UN-Model, have been developed in the first place. Refer to the observations of Brauner, Yariv (2014): What the BEPS. In *UF Law Faculty Publications*. Available online at https://scholarship.law.ufl.edu/facultypub/642, P. 63ff.
[1118] Refer to Pöllath/Lohbeck (2015): Art. 12. In: Vogel/Lehner (Eds.) - DBA., P. 1372f.
[1119] See Tippelhofer (2016): Der Einfluss des Unionsrechts auf., P. 128f.
[1120] As in Arginelli (2018): Chapter 4: Open Issues of. In: Maisto (Ed.), Taxation of Intellectual Property under., P.62f.
[1121] See Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) - 100 Jahre Steuerrechtsprechung in Deutschland., P. 926.

should not be forgotten, however, that this interpretation is commonly accepted only on the basis of the comments existing at the time the agreement was signed.[1122] That is, in the case of a subsequent update of these remarks, innovative interpretations based on the new observations will not be accepted, rejecting a dynamic interpretation of the treaties.[1123] Only those comments that are presented in a clarifying manner, and that could already be inferred at the time of signing the contract, may be taken into consideration.

It is clear that these generic restrictions linked to the arm's length principle do not cover all situations of aggressive tax planning targeted by anti-avoidance rules involving royalty payments,[1124] and actually merely seek to preserve minimum parameters linked to transfer pricing rules. In order to allow a withholding of taxes by the source state, for example, it would be necessary to have a specific provision in the treaty, considering that the rule in Art. 12 leaves little doubt regarding where the right to tax lies. This provision occurs in some cases, however, especially in agreements with developing countries,[1125] and, as they have the purpose of fighting double taxation and promote economic development without restrictions, these treaties tend to avoid allowing the implementation of WHT with respect to royalties. These are not, however, the only restrictions that these treaty provisions offer.

b) Restrictions on the implementation of anti-avoidance rules

It is apparent that, in relation to withholding taxes, the intention of Art. 12 OECD-MC is to eliminate them altogether, which does not mean, however, that there is no prospect of levying WHT despite the existence of a double tax treaty. This is because, since the OECD model convention is a non-binding *suggestion* of how to structure such an agreement, one must always rely on the exact wording established by the parties in the relevant bilateral tax treaties to precisely

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[1122] See, for example, Vogel (2005): Soft Law und Doppelbesteuerungsabkommen. In: Lang (Ed.) - Soft Law in der Praxis., P. 145ff. and Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) - 100 Jahre Steuerrechtsprechung in Deutschland., P. 929ff., on the decisions of the German BFH.

[1123] While jurisdictions deal with this issue differently, there is a notable tendency in rejecting a dynamic interpretation, as is the case as of 2015 with the German *Bundesfinanzhof* in the decisions of 10.06.2015 - I R 79/13, BFHE 250, 110, BStBl II 2016, 326; and 25.11.2015 - I R 50/14, BFHE 253, 52, BStBl II 2017, 247; and as was done recently by the Spanish *Tribunal Supremo*. See practical discussions in Martín-Luengo, Enrique Sánchez de Castro (2021): Spanish Supreme Court Limits the Use of Dynamic Interpretation of Tax Treaties. In *Bulletin for International Taxation* 75 (1), P. 2ff.

[1124] Concerning the insufficiency of TP rules to solve the problem under discussion, refer back to Chapter 2.1.1.

[1125] Refer to Groß/Strunk (2015): Lizenzgebühren., P. 594f.

define how the allocation of taxing rights of royalties will be determined.[1126] In practice, this means that the relationship between two countries will always have to be assessed individually, which practically ensures that in order to implement a broad-specter or even a conditional withholding tax (as well as the OECD subject-to-tax-rule acting as a withholding tax),[1127] the article regarding the royalties of the available DTTs will have to be modified from the OECD model – just like the Interest and Royalties Directive in the European case.

If one decided for a conditional withholding tax that had restricted applicability only to international affairs where there was no double tax treaty, the effectiveness of this anti-avoidance measure would fall apart, in addition to making its application extremely complex and fostering treaty shopping strategies. Ideally, as the conditionality of a withholding tax may be provided not necessarily in national legislation, but in tax treaties themselves,[1128] these provisions should be negotiated so as to grant a tax exemption or reduction of WHT provided that the royalties are effectively taxed in the state of residence of the payee at a given rate.[1129] Thus, the state of residence would still hold the right to tax, but would allow for an ordinary credit of the withholding tax. Since credits granted for withholding are commonly limited to the same level of taxation as the country granting them, this would ensure that the taxpayer would be subject to a minimum level of tax whilst avoiding double taxation. This assumes, of course, that both parties would agree to these terms, which turns out to be the major problem with this proposal.[1130]

While there are other models currently in use that are more likely to allow this type of conditionality with withholding taxes,[1131] the archetype proposed by the OECD, while not

[1126] There are many countries, within and outside of the OECD, that have reservations concerning Art. 12 para. 1 OECD-MC, reserving their right to tax royalties at source. In the German case, for example, there are several differences with respect to Art. 12 of the OECD-MC, and the levying of WHT in a way so that it is later compensated by the other party, as mentioned by Reimer, Ekkehart (2021) Überdehnung der beschränkten Steuerpflicht? Lizenzgebühren als „inländische Einkünfte" nach §§ 49, 50a EStG, as part of the Max-Planck Online Colloquium. Refer to Becker, Florian (2020): Steuerliche Berücksichtigung ausländischer Quellensteuern auf Lizenzerlöse. In *Der Betrieb* 25, P. 1311ff.
[1127] For this parallel, see Jirousek, Heinz (2021): Pillar Two - Die Subject to tax rule (STTR). In *ÖStZ* (1-2), P. 57.
[1128] As could be the case with the introduction of a principle purpose test (PPT) rule, being currently negotiated in multiple treaties by Germany, for example, since the MLI initiative failed to reach many of its objectives. Refer to Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 12f.
[1129] For example, at least equal to the withholding tax rate. This is similar to the concept behind the OECD GloBE proposal.
[1130] For the possibility of a unilateral treaty override, refer to section 4.3.1.1.3. On the difficulties of bilateral negotiations with countries that promote harmful tax practices, refer to Chapters 5.2.1 and 1.4.2.
[1131] Refer to Chapter 4.3.1.2.

precluding the possibility of negotiating *e.g.* reservations, makes it more difficult to adapt this article to provide an anti-avoidance measure in the form of a WHT by forcing the parties to have to negotiate these terms from scratch.[1132] Furthermore, for those countries that already have an established tax treaty network, a renegotiation of all treaties that do not provide for this clause would be necessary in each bilateral relationship,[1133] which could take years or even decades to be concluded – without necessarily ensuring success.

Another alternative would be the one adopted by many countries that wish to unilaterally "update" the provisions of their bilateral treaties, namely, treaty overriding. Unfortunately, this relatively simple solution wears down diplomatic and trust relations between countries, reducing the legal certainty provided by the treaties for tax administrations and taxpayers alike.[1134] It is noticeable that withholding taxes are also relatively undesirable in treaty law due to their nature potentially linked to double taxation, which may undermine international trade. Their unrestricted implementation without comprehensive reforms to the current tax treaty network, for example depending on the definitive results of the OECD GloBE implementation, is therefore not a legally feasible solution.

With regard to the possibility of implementing a royalty deductibility barrier, however, the provisions of this rule of allocation of taxing rights seems unaffected. This is because the restriction on the possibility of deducting business expenses applies only to the payer, while the taxation of the amount paid due to the license remains untouched.[1135] As is the case with the framework of application of the Interest and Royalties Directive within EU law, a royalty deductibility barrier does not represent a violation of provisions concerning the taxation of the amounts paid to the

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[1132] It is not specified whether or not the exemption in the state of source should be conditional to taxation of the royalties in the state of residence, which must be settled through bilateral negotiations. Refer to Nr. 6 OECD-MC Commentary.

[1133] For instance, the UK and Germany recently renegotiated their DTT with the introduction of a PPT rule in order to deny treaty benefits – *e.g.* those contained in Art. 12 OECD-MC – in cases of arrangements with a tax-saving purpose. The aim is to eliminate double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, as stated in the new preamble. This type of solution would work as a GAAR for the treaties, although it has a rather difficult broad implementation considering the challenges and difficulties faced by the multilateral instrument (MLI) so far. Refer to Chapter 2.1.3.2 for more information.

[1134] For an in-depth discussion on this topic, refer to Chapter 4.3.1.1.3.

[1135] See, for instance, Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), P. 211; and Kraft (2022): §4j EStG. In: Kanzler/Kraft - Einkommensteuergesetz, P. 583.

license holder.[1136] Therefore, there is no violation and no need to resort to treaty overriding in this case, since it is imperative to differentiate between a restriction on the possibility to deduct expenses and a refusal to grant a tax exemption to a royalty payment.[1137]

Finally, with respect to the *Lodin* model of an inverted tax credit system, once again there are no problems with respect to higher-ranking law.[1138] In this specific case for a similar reason to the royalty deductibility barrier: the modification of the deductions system and the granting of credits to offset these expenses does not concern the allocation of taxing rights between source and residence state, which removes this rule from the scope of Art. 12 OECD-MC. Nevertheless, considering the similarities this measure has with royalty deductibility barriers, it is possible that it might present similar concerns in the cases of non-discrimination covered below, related to Art. 24 OECD-MC.

4.3.1.1.2 Art. 24 OECD-MC

a) Scope of application and royalty payments

While rules for the allocation of taxing rights in double tax treaties such as Art. 12 OECD-MC have the primary purpose of restricting the access of contracting states to specific tax sources – in this case, royalty payments – they do not set requirements for a particular design of national tax law. This competence belongs and remains with each of the parties, who through their (tax) sovereignty can decide how to best structure their national rules within the framework of the allocation provisions. Art. 24 OECD-MC, however, is an exception to this rule as it entails a non-discrimination principle that will consequently directly impact the structuring of national tax provisions.[1139]

[1136] There have been discussions at OECD level for an implementation of changes to the OECD-MC Commentary that acknowledges countries' right to restrict deductibility of payments through national law. Even though this is at first meant only for Art. 9 OECD-MC and interest payments in relation to TP rules, it argues that it is for the domestic law of each contracting state to determine whether and how profits should be taxed, which would, in turn, also apply for royalty payments on Art. 12 OECD-MC. See Finley, Ryan (2021): OECD Proposes Amending Treaty Commentary on Interest Deductions. In *Tax Notes International* 102 (1), P. 92f.
[1137] This unfortunately does not mean, however, that this solution is certainly perfectly compatible with treaty law. For further discussion, refer to the next Subsection.
[1138] As in Hummel, Roland; Knebel, Andreas; Born, Alexander (2014): Doppelbesteuerung und BEPS. In *IStR*, P. 838ff.
[1139] See Rust (2015): Art. 24. In: Vogel/Lehner (Eds.) - DBA, P. 2175f.

Paragraphs 1 to 5 of this article provide for prohibitions on discrimination with different ranges of application and legal consequences, directed at the residence state of a given taxpayer, forbidding discrimination of nationals of the other contracting state in relation to its own nationals. This application is, however, commonly restricted to *inbound* cases, and does not provide for restrictions on unfavorable treatment of a country of their own nationals with investments abroad in relation to domestic investments.[1140] Interestingly, para. 6 of this article extends its applicability to any tax type or designation – much broader than the usual scope of DTTs –, which ensures that it will be applied to any of the anti-avoidance measures under analysis. Furthermore, there is no foreseen justification for discrimination whatsoever, which – unlike in European law – ensures that once a provision falls within the scope of application of Art. 24 OECD-MC, it will constitute a violation of the provisions of the treaty.

This means that at the same time a contracting state has to observe the allocation rules present *e.g.* in Art. 12, that it may not incur in any of the forms of discrimination indicated in Art. 24. Of special relevance for this analysis are, in particular, the para. 4 and 5, which deal directly with cross-border royalty payments and with companies of the same business group, respectively.

Of a more explicit applicability, Art. 24 para. 4 OECD-MC restricts the leeway of a contracting state to lay down national rules regarding the deductibility of royalties. This is because any royalties paid to residents of the other contracting state – for which the arm's length standard has been met[1141] – must be allowed for deductions as business expenses for the payor in the same way as if such payments were made to domestic persons.[1142] While this rule establishes that the place of residence of the recipient of a (royalty) payment may not be used as a reference point for providing a tax disadvantage to the taxpayer, Art. 24 para. 5 OECD-MC prohibits a company from being accorded a worse economic position because of the domicile of the shareholders and/or those who exercise control over it. That is to say that this article prohibits a more burdensome taxation that is caused by the fact that the shareholders of a company are residents of the other contracting state. This therefore protects, for example, a parent company from discrimination in the form of

[1140] Except maybe para. 4, where payments made to persons resident in another contracting state are also affected. Refer to van Raad (1986): Nondiscrimination in international tax law., P. 257ff.
[1141] Otherwise Art. 12 para. 4 would be activated, which would set a restriction on the applicability of Art. 24 para. 4 OECD-MC.
[1142] See Rust (2015): Art. 24. In: Reimer/Rust (Eds.) - Klaus Vogel on double taxation., P. 1720f.

the denial of a benefit due to it being a non-resident with control or ownership over the paying company.

Art. 24 para. 5 OECD-MC can be applied simultaneously with Art. 24 para. 4, as the latter is not to be regarded as *lex specialis* in relation to the former, considering both have a relatively different scope.[1143] Whilst para. 4 deals mainly with cases in which the deduction of a payment is disallowed when made to a non-resident company, although this deduction would occur if the same payment was made to a resident recipient; para. 5 could also trigger on the deduction of payments if they were disallowed in case of foreign shareholders of the non-resident company receiving the payment, while those same payments would be deductible if the controlling shareholders were residents in the same country as the payor.

In fact, one of the major functions Art. 12 para. 4 OECD-MC has in relation to Art. 24 OECD-MC in general is in determining whether domestic rules restricting deductions for payments to persons resident in the other contracting state conform with the prohibition of discrimination in Art. 24 para. 4, and possibly Art. 24 para. 5 as well.[1144] It is relatively easy to understand that the goal of these latter regulations does not correspond to the traditional purpose of a double tax treaty, that is to simply determine the allocation of taxing rights between states. These rules create, in a way, duties for the national legislator and rights for the taxpayer with respect to, among others, royalties, in the form of this non-discrimination principle, and hence their relevance to the anti-avoidance measures under discussion.

b) Restrictions on the implementation of anti-avoidance rules

The non-discrimination mechanisms provided for in Art. 24 para. 4 and 5 OECD-MC offer some issues in relation to the anti-avoidance rules under review, especially for the royalty deductibility barriers. This is due to the fact that the possibility of withholding taxes of any nature

[1143] *Ibid*., P. 1724f.

[1144] Refer to para. 74 of the OECD-MC Commentary on Art. 24 on this relation and saving clauses, as well as in Kofler, Georg; Verlinden, Isabel (2020): Unlimited Adjustments: Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the "Saving Clause". In *Bulletin for International Taxation* 74 (4), P. 274f. On a side note, some consider the UTPR of the GloBE proposal to not be covered by the saving clause, which would make the UTPR in this case incompatible with tax treaties, if one were to follow this line of reasoning. For more information, refer to Li, Jinyan (2022): The Pillar 2 Undertaxed Payments Rule Departs From International Consensus and Tax Treaties. In *Tax Notes International* 105 (12), P. 1405f.

is already restricted by the allocation rule contained in Art. 12, as demonstrated earlier,[1145] which implies a need for explicit negotiation and reform of this article if one opts for a WHT implementation that does not entail treaty overriding. Therefore, royalty barriers have to be taken into consideration to the extent that, according to Art. 24 para. 4 OECD-MC, payments made by an enterprise of one of the contracting states to a resident of the other state are to be allowed as deductions when determining the taxable profits of that enterprise under the same conditions as payments made to a resident of the first-mentioned state. Despite the connection with Art. 24 para. 5 not being as immediately perceptible as the one present in the previous paragraph, the protection that this provision confers on the shareholder residing abroad against tax discrimination may also apply, through this safeguard for parent companies, to royalty barriers.

Since the primary purpose of a restriction on deductions is to promote differentiated treatment between transactions subject to what is considered an "appropriate" level of taxation and those made with the intention of base erosion and shifting of profits, discrimination – even if indirect – between national and cross-border payments is almost inevitable. This arises because, despite the royalty deductibility barriers commonly being drafted in a broad and *prima facie* fair manner,[1146] ensuring an applicability to domestic and international cases alike, in practice their activation will occur only in cross-border transactions, since the level of taxation adopted internally will always be considered sufficient for the full deduction of the payment.

However, the interpretation most commonly accepted for Art. 24 is that only open and direct discrimination based on one of the features set forth in this provision is in fact prohibited.[1147] This means that, unlike European law, covert or indirect discrimination tied to criteria different than the ones foreseen in the DTT is not prohibited.[1148] This restriction is possibly linked to the non-justifiability of discrimination once it is covered within the framework of Art. 24 OECD-MC, and as such a narrower scope would ensure a better balance to the provision.

[1145] Refer to Subsection 4.3.1.1.
[1146] For more information on the practical application of royalty deductibility barriers, refer to Chapter 3.2.
[1147] See Wassermeyer (2015): Art. 24 OECD-MA. In: Wassermeyer (Ed.) – Doppelbesteuerung, para. 16 and 86; and Rust (2015): Art. 24. In: Vogel/Lehner (Eds.) - DBA., P. 2174.
[1148] Opposing opinion in Benz, Sebastian; Böhmer, Julian (2017): Der RegE eines § 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke). In *Der Betrieb* (05), P. 211; and Kraft (2022): §4j EStG. In: Kanzler/Kraft - Einkommensteuergesetz, P. 583.

Art. 24 para. 4 prohibits every discrimination that has as a base the residence in the other contracting state. However, the taxing state is allowed to differentiate on the basis of characteristics other than domicile, which means that it is the payee's *residence* that must be the triggering circumstance for the tax disadvantage of non-deductibility of the payment. In the case of royalty deductibility barriers, unless a black- or white-listing system is chosen,[1149] the most common standard is broadly linked to the level of taxation of payments, and not to the residence *per se*.

Thus, in theory, it is arguable that as long as the deductibility barrier provided nationally has no requirement linked directly to the country of residence of the payee, that there will be no violation of the device even if the *de facto* effects are restricted to cross-border cases.[1150] The decisive element for a well structured royalty deductibility barrier is the occurrence of low-taxation in the jurisdiction that receives the payment, and not the absence of residence of the payee in the payor's source state or of its shareholders.[1151] As such, when it comes only to a possible indirect discrimination, in which an insufficient taxation is the cause for the non-deductibility, there would be no violation of the provisions of Art. 24 para. 4 and 5 OECD-MC.[1152]

The only possibility of applying one of these provisions due to discrimination on the basis of other aspects would be if the discrimination on the basis of the other characteristic would also cease to exist if the person were assumed to be resident in the same country as the payor.[1153] This would indicate a direct relationship between the employed criterion and the residence requirement. Such a scenario would occur, for example, for thin capitalization rules that act beyond the arm's length principle,[1154] which are very similar rules to royalty deductibility barriers, and might be

[1149] Which would ultimately be a criterion linked to residence, much like the more recent German proposal of a law of protection against tax-havens (StAbwG) based on the EU Code of Conduct Group (2019): Report to the Council of 25 November 2019 (14114/19 FISC 445 ECOFIN 1006, Annex4). See, for instance, the discussion in Werthebach, Felix (2021): Erste Anmerkungen zum Entwurf eines Steueroasen-Abwehrgesetzes (StAbwG). Neue Details zur Undertaxed Payments Rule und zur Subject-to-tax-Klausel. In *IStR* (9), P. 338ff.
[1150] Refer to Bruns (2019): Artikel 24. In: Schönfeld/Ditz (Eds.) - Doppelbesteuerungsabkommen., P. 1438ff.
[1151] See van Lück, Kolja (2017): Gesetzentwurf zur Einführung einer Lizenzschranke durch §4j EStG. Verfassungsrechtliche und europarechtliche Herausforderungen. In *IStR* (10), P. 392.
[1152] On this opinion, Hummel, Roland; Knebel, Andreas; Born, Alexander (2014): Doppelbesteuerung und BEPS. In *IStR*, P. 837ff; regarding Art. 24 para. 5 OECD-MC refer also to the opinion of Rust (2015): Art. 24. In: Reimer/Rust (Eds.) - Klaus Vogel on double taxation., P. 1726. Opposing opinion in relation to the UTPR, see Li, Jinyan (2022): The Pillar 2 Undertaxed Payments Rule Departs From International Consensus and Tax Treaties. In *Tax Notes International* 105 (12), P. 1407.
[1153] This is based on a decision of the German Federal Tax Court, naturally linked to German law. For more information, refer to Kaul (2018): Der Nexus-Ansatz., P. 45f.
[1154] For this would lead to the activation of exceptions to Art. 24 to. 4 OECD-MC. Refer to Rust (2015): Art. 24. In: Vogel/Lehner (Eds.) – DBA, P. 2222f.

considered discriminatory especially if there is no opportunity for the taxpayer to present evidence that it fulfills the requirements for obtaining a tax advantage.

Thus, in spite of the fact that, according to the prevailing view, there is no violation of Art. 24 in the case of indirect discrimination, it is possible that the other contracting state or even the taxpayer might question national tax anti-avoidance rules that exclusively affect cross-border cases. It is with such considerations in mind that it was decided by the lawmaker of some of the most recent rules to implement an explicit treaty override in the body of these provisions, with the intention of resolving any future conflicts with the tax treaty network in force for that country. In the German case, for instance, the legislator set out in §4j para. 3 EStG that the restriction on royalty deductions will occur independently of an existing double taxation agreement,[1155] which was drafted with a view to settling future disputes with Art. 24 OECD-MC in accordance with the official justifications for the drafting of the law by the German federal government.[1156] Accordingly, even if a court's understanding were to be for a violation of Art. 24 OECD-MC due to a royalty deductibility barrier, the manifest legislative will to override the treaty provisions agreed upon with the other contracting state would render the application of the model convention void for this particular case. Adoption of this stance certainly has its advantages and disadvantages, which will be further analyzed in the following subsection.

Finally, with regards to the inverted tax credit system, there are actually no identifiable problems of significance with either of the two paragraphs, namely 4 and 5, to the subject in Art. 24 OECD-MC. This is because the granting of a tax credit, instead of the traditional deductions system, is completely independent of the taxpayer's place of residence, occurring equally in purely national and cross-border situations.[1157] As there is no specific modification in the way of taxing royalty payments or the occurrence of unfavorable treatment discriminating against the parent company, but only a broad reformulation of the deductions system, there is no violation of the non-discrimination principle contained in the DTT.

[1155] Refer to Subsection 3.2.2.2.6.

[1156] Bundesregierung (2017): Regierungsentwurf eines Gesetzes gegen schädliche Steuerpraktiken im Zusammenhang mit Rechteüberlassungen. BR-Drucks 59/17. Deutscher Bundestag. Available online at http://dipbt.bundestag.de/extrakt/ba/WP18/795/79562.html, updated on 11/16/2018, checked on 08.01.19.

[1157] Refer to Lodin, Sven-Olof (2011): Intragroup Lending in Sweden - A Vehicle for International Tax Arbitrage. In *Tax Notes International* (62), P. 179f.

4.3.1.1.3 Treaty override as a (viable) solution?

The concept of treaty overriding (TO) describes the conflicting situation in which a provision of a DTT that is applicable in domestic law finds itself if there is a supersession of this norm by subsequent acts of the respective national tax legislator.[1158] More importantly, the subsequent domestic law will then constitute a conflict of norms with one or more DTT regulations, which results in a violation of public international law between the contracting states. Such measures are advantageous in the sense that unilateral effects on DTAs through domestic legislation ultimately circumvent the protracted progress of a possible revision or termination of the treaty.[1159]

On the other hand, adopting a treaty override without first providing sufficient margins for dialogue with the affected contracting states weakens confidence in the violating country and causes issues with legal certainty for taxpayers and tax administrations alike, not to mention a possible increase in administrative and judicial conflicts. One might even try to justify legislation that contradicts a DTT by claiming that this legislation, by combating non- or low-taxation,[1160] simply prevents possibilities of treaty abuse and therefore would not violate the basic core of the treaty. However, the fact is that treaty overriding has international and constitutional consequences, incorporating a violation of the principle of "*pacta sunt servanda*" and is, ergo, an action contrary to public international law that brings about practical ramifications.[1161]

Consequently, the sanctions under public international law for a treaty override or treaty breach must be considered. Those are provided for in Art. 60 of the Vienna Convention on the Law of Treaties, namely either the suspension or the termination of the treaty, if no other amicable solution can be found, such as through the mutual agreement procedure of Art. 25 OECD-MC. Since for the application of Art. 60 VCLT a *significant violation* of the essential provisions of the treaty is in principle a prerequisite, it could be argued that one of the "base" provisions of the treaty, such as Art. 12 OECD-MC, would represent a more fundamental character of the treaty,

[1158] See Schönfeld/Häck/Ellenrieder (2019): Systematik der Doppelbesteuerungsabkommen. In: Schönfeld/Ditz (Eds.) - Doppelbesteuerungsabkommen., para. 148ff.

[1159] Lehner (2015): Grundlagen. In: Vogel/Lehner (Eds.) - DBA., P. 248f.

[1160] See Gosch, Dietmar (2008): Über das Treaty Overriding - Bestandaufnahme - Verfassungsrecht - Europarecht. In *IStR*, P. 414ff.; and Gebhardt, Ronald (2019): Seminar H: Unilateral Treaty Overrides. In *IStR* 16, P. 653ff.

[1161] Although it is not contraty to EU law. For more information, refer to Musil, Andreas (2006): Spielräume des deutschen Gesetzgebers bei der Verhütung grenzüberschreitender Steuerumgehung. In *RIW* (4), P. 287ff.

while the provisions of Art. 24 OECD-MC and its non-discrimination rule would be an accessory rule and therefore more prone to being sidestepped or indirectly reformed by a treaty override. Ultimately, though, it remains for the contracting states to determine the cost-benefit of carrying out a treaty override, as well as the cost-benefit of *reacting* to such a breach through legally enforceable measures.

Whether tacitly or explicitly – as is the case with the German §4j EStG, that overwrites a consensus reached at OECD-level – many countries resort to treaty overriding as a shortcut in the form of prompt answers against issues of international taxation. Although its admissibility differs from country to country due to varying relationships between domestic and (public) internal law, many countries use TO as a recurrent resource for "updating" the provisions of a treaty. It is not only allowed, but has widespread use in countries such as the USA,[1162] Austria[1163] and Germany,[1164] not even being prohibited by EU law.[1165]

The main concern is how useful and effective it would be to adopt a treaty override approach to implement rules aimed at combating tax avoiding arrangements with royalty payments by using the provisions of DTTs. On the one hand, it would be possible with a treaty override to implement withholding taxes despite the allocation rule in Art. 12 OECD-MC, which would lead not only to a violation of this provision, but also of the arm's length principle, which is considered the only exception in the article to this allocation of taxing rights. The importance of the absence of WHT for these aggressive tax planning structures is evident, which would perhaps justify the use of a treaty override without hurting the core goals of the treaty.

However, the OECD model convention comments already provide for the possibility for contracting states to negotiate the implementation of separate rules for withholding taxes in order

[1162] The legal situation in the United States of America shows, through frequent treaty overriding with different objectives, that treaty override by later federal law is not only permissible, but is used in practice as an economic and political tool. Regarding more information on this matter, see Girolamo, Giuseppe (2013): Tax Treaties: Ratification and Relationship with Domestic Law in the Italian and US Legal Systems. In *Bulletin for International Taxation* 67 (3).

[1163] See Peyerl, Hermann (2014): Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern. In *ÖStZ* 314, P. 225f.

[1164] Decision of the German Federal Constitucional Court nº 141, 1 - 56 of 15.12.2015, 2 BvL 1/12. See, however, in particular the dissenting opinion of Judge *König*, who issued a special opinion on the decision. A balancing would then be required in each individual case.

[1165] Refer to the *Levy* and *Sebbag* (C-540/11) decision of the ECJ. Legislation in violation of a DTT is not in violation of European law, but is actually to be regarded as a violation of an international obligation derived from public international law.

to condition the tax benefit to the proper taxation of royalties.[1166] Overriding this rule through a treaty override, ignoring the possibilities of negotiation, especially on an issue of such importance to DTTs and to the functioning of the international market, which is the allocation of taxing rights, seems a somewhat drastic measure, even if theoretically feasible. This would, furthermore, not solve the issue in its entirety in an European context without a proper reform of the Interest and Royalties Directive.

On the other hand, in the specific case of royalty barriers, the implementation with an explicit treaty override might even be unnecessary, as the impact that this rule possibly has on Art. 24 OECD-MC – since such a provision is outside of the scope of Art. 12 OECD-MC – is relatively low, and it is not to be assumed that it would represent a "significant violation of the essential provisions of the treaty".[1167] This was, as mentioned above, the decision of the German legislator, for example, when implementing an explicit treaty override in its deduction rule, in order to immediately solve any clashes that the provision restricting the deductibility of royalty payments might have with the double tax treaties agreed so far.[1168] Such an application of treaty overriding specifically against the prohibition of discrimination under treaty law is actually unparalleled,[1169] but the wording of the provision "regardless of an existing double taxation agreement" ensures application of the TO even if the scope of other treaty provisions were to be debated.

Considering the strong political and economic role played by Germany – characteristic present in most of the source states leading this *momentum* against the unrestricted deductibility of royalties – the chances of some form of retaliation due to a possible violation of the DTT provisions seem to be low. Even if a treaty override is not explicitly provided for, the mere fact that new tax legislation is implemented, subsequent to the treaties in force, would generally override existing treaty provisions.[1170] The outcome of this conflict is then left to national law.

[1166] Refer to Nr. 6 OECD-MC Commentary on this article.

[1167] See Herzig (2017): Wie kann die Regierung steuerliche., P. 67f.

[1168] Refer to, for instance, Holle, Florian; Weiss, Martin (2017): Einschränkung des Abzugs für Aufwendungen aus einer Rechteüberlassung. In *FR Finanz-Rundschau Ertragssteuerrecht* (5), P. 219f.; and Kahlenberg, Christian (2020): Das neue BMF-Schreiben zu §4j EStG als Arbeits- und Entscheidungshilfe. In *Praxis Internationale Steuerberatung* (05), P. 128f.

[1169] Schnitger, Arne (2017): Weitere Maßnahmen zur BEPS-Gesetzgebung in Deutschland. In *IStR* (6), P. 221.

[1170] See Bush, John N. (2019): A Roadmap for a Tax on Base-Eroding Payments. In *Tax Notes International* 96 (7), P. 605.

Thus, only new treaties[1171] would need to be negotiated in terms that encompassed the rule against the deductibility of royalties.

Accordingly, through the implementation initiative of some relevant countries – possibly encouraging other jurisdictions to do the same – as well as recognizing the anti-avoidance intent of the royalty barrier, it is to be expected that a treaty override would not be retaliated against internationally. However, its explicit stipulation may be relevant in order to leave no doubt of the applicability of the measure despite the existence of Art. 24 OECD-MC, which would possibly reduce protracted legal disputes on the issue. While the renegotiation of DTTs may be considered as the ideal measure, treaty overriding remains a commonly feasible, fast and efficient way out for the implementation of a new standard.

4.3.1.2 UN- and US-model conventions as alternatives

Alongside the OECD model convention, which is applied far beyond the OECD itself, there are several other models that are used by countries as a basis for negotiating double tax treaties. Whilst all these models serve only as a starting point for facilitating and shaping the general contours of the desired end result of the treaty, these model conventions often have *nudges* in certain directions that may increase or decrease the chances of implementing a specific measure or approach. Bearing in mind that, ultimately, it is what is agreed upon between the parties that will have validity, it is necessary to determine whether models such as the UN-MC and the US-MC[1172] have any specificities that might lead to different results than the ones obtained by the model proposed by the OECD.

While the influence of the OECD-MC is clear in the basic elaboration of these conventions, where it was used for example as a foundation in the original drafting and future revisions of the United Nations Model Double Taxation Convention between Developed and Developing

[1171] Opposing opinion by the German *Bundesfinanzhof*, which indicates that a treaty override can occur even in cases where the treaty is newer than the overriding law. Refer to BFHE from 25.05.2016 - I R 64/13.
[1172] These two model conventions were selected based on some of their specific features that have relevance to the discussion at hand. The so-called "German negotiation basis" is left out because of the express treaty override provided for in German law with regard to the royalty deductibility barrier, which makes the features of this particular model irrelevant.

Countries, only part of the provisions and comments of the OECD Model Convention are reproduced,[1173] while others have some unique properties.

As the very name of the UN-model indicates, there is a greater focus on protecting the interests of developing countries, often harmed by the source-residence logic traditionally applied by the OECD in double tax treaties. With respect to Art. 12 UN-MC, there is a substantial distinction with respect to the OECD-MC and even the US-MC, since the latters provide for an allocation right to the residence state of the payee, while the former is the only one to allow for source taxation, by not granting the residence state of the beneficial owner exclusive taxing rights. This interpretation follows from the use of the term "*may* be taxed in that other state" used in Art. 12 para. 1 UN-MC, being further clarified in the subsequent paragraphs 2 and 5, including source rules as a necessary addition to paragraph 1.[1174]

With this provision, the UN model ensures that the starting point for discussions concerning the allocation of taxing rights for royalties is that, despite a preference for residence taxation, there is no express prohibition of the source state from taxing, at least in part, cross-border royalty payments. Therefore, no reservations are necessary with regard to Art. 12 para. 1 UN-MC, which occurs relatively often in the OECD model. This approach would allow withholding taxes to be used more effectively and without treaty overriding in cases of aggressive tax planning structures with royalty payments.[1175]

A differentiation with respect to Art. 12 of these model conventions, however, does not solve the problem with royalty deductibility barriers, since the article most affected is, in fact, the one regarding discriminatory treatment. However, the OECD, United Nations and US model tax conventions all contain the same overall structure and language in their Arts. 24 para. 4 and 5, which will lead to similar results with respect to the (indirect) discrimination problem discussed

[1173] See, for instance, Jiménez (2018): Chapter 6: Article 12 OECD. In: Maisto (Ed.), Taxation of intellectual property under., P. 138ff.

[1174] For more information, refer to Valta (2015): Art. 12. In: Reimer/Rust (Eds.) - Klaus Vogel on double taxation. P. 981.

[1175] A balance, however, is certainly needed, as allowing the unbridled reintroduction of WHT goes against not only market development, but also the rationale behind double tax treaties in the first place. For more on this discussion, refer to Chapter 3.1.1.

in the previous subsection.[1176] While this level of standardization of the proposals presented in the respective model conventions is to be welcomed, it seems that the restrictions observed above with respect to royalty barriers in the OECD model apply also to other design examples of relevance. Only Art. 12 UN-MC has different alternatives that could have an impact on the treatment of royalty payments.

4.3.2 The Bilateral Investment Treaty network and its impact on transactions between licensor and licensee

While the part of treaty law commonly referred to for tax issues is undoubtedly the one related to double tax treaties, there is yet another extremely widespread form of bilateral agreements that can, directly or indirectly, have an impact on the taxation of royalty payments and, therefore, on anti-avoidance measures related to these transactions. Bilateral investment treaties – or simply BITs – although originally signed primarily between developed and developing countries in order to make foreign direct investment (FDI) more attractive and secure due to the economic and political instabilities of the postwar period of the last century, have become a common feature of the FDI panorama over the last 30 years.[1177]

Much like with the popularity of DTTs, there are almost 2400 BITs currently in force,[1178] signed among the most different countries, but with the same intent: to create an environment of legal guarantees for international investors and investments alike.[1179] Nonetheless, it is important to note that, differently from the main problems faced in the 1970s and 1980s, such as the fear of expropriation and problems with transfer pricing of multinational enterprises, today the economic role of the State has shifted from direct intervention to a more indirect one. As developing countries

[1176] The discussion of discrimination with respect to the American model is, however, relatively unique, since the rule implemented nationally by the USA in the form of the BEAT provision is not equivalent to a denial of deductions. For more information, refer to the observations in Chapter 3.2.2.3, as well as Avi-Yonah, Reuven (2018): Beat It: Tax Reform and Tax Treaties. In *University of Michigan Law & Economics Working Papers* (Research Paper nº 587), P. 2ff.; and Kysar, Rebecca (2018): Will Tax Treaties and WTO Rules 'beat' the BEAT? In *Columbia Journal of Tax Law* 10 (Tax Matters 1), P. 1ff.

[1177] In that regard, one could consider 1986 to be the beginning of the BITs era, with an exponential increase in their elaboration – and renegotiation – in the past few years. Refer to Leal-Arcas (2010): International trade and investment law., P. 188f.

[1178] For more information, refer to the database in United Nations Conference on Trade and Development (2021): Investment Policy Hub. Available online at https://investmentpolicy.unctad.org/international-investment-agreements, checked on 23.02.21.

[1179] For a list of countries with BITs and their recent renegotiations, see Sachs/Sauvant (2009): BITs, DTTs, and FDI flows. In: Sauvant/Sachs (Eds.) - The effect of treaties on., P. XXXVff.

present, in general, less risky and volatile business environments than in the last century, the main problems faced by FDI are no longer those of direct ownership exercised by public authorities, but market manipulations and indirect intervention in the economy through regulatory mechanisms that generate incentives and disincentives for the carrying out of certain activities and transactions.[1180] This occurs, among others, through tax rules, which are quintessential instruments for influencing the economic environment.

Therefore, the use of tax measures such as the anti-avoidance rules under discussion may be considered an implication of the regulatory powers of the State that, in a certain way, may adversely affect the economic interests of foreign investors and investments. This problem is, in the present-day, one of the main reasons for investment disputes on the international scenario, and although, to the best of my knowledge, there is no discussion in the academic literature about the relationship between the anti-avoidance measures in question and the BITs, this does not mean that one can immediately assume that there may not be any conflicts. It is, therefore, necessary to determine to what extent these rules contained in the BITs apply or rather restrict the possibility of implementing, at the national level, anti-avoidance measures against aggressive tax planning structures that use royalty payments.

4.3.3.1 Framework of application and guarantees within taxation

4.3.3.1.1 Applicability in the context of royalties

The first step is to determine whether cross-border intragroup royalty payments – the type of transaction responsible for aggressive tax planning structures – fall within the scope of bilateral investment treaties in order for their guarantees to have applicability. Considering the commonly accepted international definition of investment provided by the OECD,[1181] since BITs frequently do not provide for a strict definition of their own, direct investment would be a special category of cross-border investment that is undertaken by an investor resident in one economy with the ultimate objective of establishing a *lasting interest* in an enterprise resident in another economy. The idea of lasting interest is what differentiates a direct investment from mere portfolio

[1180] See, for instance, Wälde/Kolo (2008): Coverage of Taxation under Modern. In: Muchlinski/Ortino et al. (Eds.) - The Oxford handbook of international., P. 306ff.
[1181] OECD (2008): OECD Benchmark Definition of Foreign Direct Investment. Fourth Edition. Available online at https://www.oecd.org/daf/inv/investmentstatisticsandanalysis/40193734.pdf, checked on 23.02.21, P. 17ff.

investments, which are made through debt or equity instruments.[1182] This is a relevant differentiating factor between tax planning structures that use, for example, interest payments and debt instruments versus those that use royalty payments and rights to use intangible assets.

Despite the fact that a more precise definition of what an investment would be commonly comes from other sources, BITs have, especially in more recent years, a strong tendency to present a broad scope of application towards investments in general. More often than not, such treaties refer to every kind of asset that an investor of a contracting State owns, controls or invests in the other contracting State,[1183] followed by a non-exhaustive list of specific assets that should be included in this broad definition.

Among these listed assets, one can generally find intellectual property rights extensively considered[1184] as one of the forms of investment expressly included in the scope of the treaty.[1185] The term investment is hence dealt with in a comprehensive fashion, including rights to intangible assets and also protection to indirectly controlled structures, as is the case with the creation of a branch office in another jurisdiction.[1186] As was the case with the development of the role of intellectual property in recent years, foreign direct investment flows have also experienced exponential growth in the last decades, being multiplied by a factor of 14 only between 1973 and 1996.[1187] However, even with the growth in the internationalization of small and medium-sized enterprises, this increase in the international investment arena is mostly attributable to large multinational corporations, as is the case with transactions involving IP.[1188]

Therefore, considering the relatively common express inclusion of intellectual property rights in the list of investments within the scope of the treaty, as well as the protection of any investors[1189] that decide to invest in the territory of the host contracting country and who possess

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[1182] For more on this definition, refer to Shihata (1993): Legal treatment of foreign investment, P. 2.
[1183] See, for example, Art. 1 of the 2012 US Model BIT, and Art. 1 para. 1 of the 2008 German Model BIT.
[1184] For more on a (broad) definition of intellectual property rights, refer to Chapter 1.1.
[1185] For instance in the UK Model BIT, Art. 1 para. 1 (iv); US Model BIT, Art. 1 *lit.* “f”; German Model BIT, Art. 1 para. 1 (d).
[1186] See Basener (2017): Investment Protection in the European., P. 56f.
[1187] Refer to the study of Leal-Arcas (2010): International trade and investment law., P. 168f.
[1188] *Ibid*. As was also discussed in Chapter 1.4.
[1189] Also broadly considered, such as companies and nationals of a given contracting State. Refer to Vandevelde (2010): Bilateral investment treaties., P. 157ff. Whilst there are some discussions considering these definitions, such debates are outside the scope of this thesis.

a link of residence and/or nationality with the home contracting country,[1190] it would *prima facie* seem that royalty payment transactions are also to be included within the scope of BITs. This is furthermore supported to a certain extent by the case-law on the matter, where decisions of the International Centre for Settlement of Investment Disputes (ICSID) such as *Enron* v *Argentina*[1191] confirm a strong tendency to interpret the concept of investment in the most comprehensive way possible. Moreover, oftentimes these investments manifests themselves in the form of a local branch or subsidiary,[1192] which is explicitly included within the definition of investment and leads to the application of the provisions of the treaty, as confirmed in decisions such as *Plama* v *Bulgaria*[1193] and *Siemens* v *Argentina*.[1194] Whilst there is a known and not uncommon carve-out for tax matters sometimes provided for in order to limit the substantive scope of the treaty – which will be dealt with in the next subsection – as long as there is no such a provision, this raises concerns regarding the compatibility of anti-avoidance rules with a potentially discriminatory character and these treaty guarantees.

4.3.3.1.2 Relevance of treaty guarantees

The next step is thus to determine the framework of the treaty provisions that might be of use for the discussion at hand. Of particular note within BITs are, as a rule, fair and equitable treatment clauses, national treatment standards and the most-favored nation (MFN) rule, manifesting themselves as non-discrimination principles. To some extent, one can perceive similarities with the norms present in WTO law, which is naturally no mere coincidence, considering that the General Agreement on Tariffs and Trade is also a by-product of (multilateral) efforts in the post-World War II period aimed at protecting international trade and transactions.[1195] Then, it will be possible to determine if and which treaty provisions are applicable to the anti-avoidance rules under discussion, namely, withholding taxes, royalty deductibility barriers and the inverted tax credit system of *Lodin*.[1196]

[1190] Muchlinski (2009): The Framework of Investments Protection. In: Sauvant/Sachs (Eds.) - The effect of treaties on., P. 42ff.
[1191] ICSID Case nº ARB/01/3.
[1192] Which in turn will be used as a catalyst for royalty payment transactions.
[1193] ICSID Case nº ARB/03/24.
[1194] ICSID Case nº ARB/02/8.
[1195] For a deeper analysis of WTO law and anti-avoidance measures, refer to Chapter 4.4.
[1196] To be further discussed on Subsection 4.3.3.2.2.

First of all, it is important to note that, although BITs have their genesis in commercial relations between developed and developing countries, today this type of treaty is signed bilaterally between a multitude of countries. This ensures that the guarantees contained in the body of the treaty apply to both parties, regardless of whether a contracting state is predominantly a capital exporting or capital importing country. This means that it is irrelevant which country decides to introduce an anti-avoidance measure related to royalty payments, since if a bilateral investment treaty exists, its provisions will apply to all contracting parties involved.

a) Fair and equitable treatment clauses: a general idea of non-discrimination

One of the main investment/investor protection mechanisms contained in BITs are the so-called fair and equitable treatment (FET) clauses, which function as a blanket rule in the form of a more general provision, to be applied in cases or situations that are not covered by other, more specific provisions of the treaty.[1197] There is, however, no standard definition of what fair and equitable treatment would be, since it usually merely requires States to maintain stable and predictable investment environments consistent with reasonable investor expectations.[1198] This may lead, of course, to diametrically opposed results when dealing with these clauses in disputes regarding investments depending on the arbitration tribunal,[1199] which is not to say, however, that there is no approximate outline of what FET means.

Fundamentally, it amounts to an idea of proportionality,[1200] protecting legitimate and reasonable investor expectations, where the contracting state is expected to act in a transparent and non-discriminatory manner, avoiding arbitrariness and unjustifiable discrepancies. This would essentially be the same as considering the FET clause to be equivalent to the minimum standard of treatment of aliens, a position defended by some authors[1201] and confirmed by the ICSID in a few cases.[1202] It has thus become one of the provisions most frequently invoked by foreign investors wishing to challenge an alleged violation of the BIT by the contracting State acting as a

[1197] See, for instance, Vandevelde (2017): The first bilateral investment treaties., P. 403ff.
[1198] Qureshi (2016): Bilateral investment treaty claims., P. 20ff.
[1199] As occurred, for example, with *CME* v *Czech Republic*, Partial Award dated 13 September 2001 (UNCITRAL) and *Lauder* v *Czech Republic*, Award dated 3 September 2001 (UNCITRAL).
[1200] As decided in *Occidental Petroleum* v *Ecuador* (ICSID Case nº ARB/06/11).
[1201] As in Valenti (2014): The protection of general interest. In: Luca/Sacerdoti et al. (Eds.) - General interests of host states., P. 30.
[1202] For instance, *Deutsche Bank* v *Sri Lanka* (ICSID Case nº ARB/09/2).

host,[1203] due to its broad character of application. In the area of taxation, this provision has its use acknowledged to the extent that it could be applied to cases in which a government, for example, imposes an excessive corporation tax through rules that are based on a restricted classification linked to assets or income that, in practice, covers and negatively impacts only foreign corporations.[1204]

Precisely because of this broad character, fair and equitable treatment is commonly linked to the general idea of non-discrimination or, at least, *unreasonable* non-discrimination. In the way the FET clause is interpreted, an extra prohibition against discriminatory measures actually adds little or nothing to the rights of investors.[1205] Since an interpretation restricting all kinds of discrimination seems unreasonable – given that tax measures often affect taxpayers differently –, the concept of non-discrimination should be interpreted so as to restrict only those measures that are unreasonably and/or unjustifiably discriminatory, *i.e.* linked to arbitrariness.

Nonetheless, unlike the interpretation of non-discrimination clauses in Art. 24 OECD-MC, the provisions of the BITs do not seem to be restricted to discrimination based solely on nationality criteria. Any and all discrimination that – if unreasonable – puts international investors at a competitive disadvantage would be contrary to the objectives of the treaty, even though case-law on this issue by arbitration tribunals has been inconsistent.[1206] An analogy can actually be made between the guarantees conferred on investments by BITs and the free movement of capital within the European Union, albeit with important nuances regarding the possibilities of justifying such discrimination.[1207]

b) National treatment and MFN clauses

Alongside this general prohibition of discrimination are the ideas of national treatment and most-favored nation,[1208] protecting investors from discriminatory treatment through more specific rules. Of special interest for anti-avoidance rules involving royalty transactions is the standard of

[1203] Valenti, *op. cit.*, Fn. 1201. P. 54f.
[1204] Vandevelde (2017): The first bilateral investment treaties., P. 403.
[1205] Vandevelde (2010): Bilateral investment treaties., P. 212ff.
[1206] See, for instance, *LG&E* v *Argentina* (ICSID Case nº ARB/02/1). The vast majority of the decisions, nevertheless, do not mention a limitation based on nationality.
[1207] To be discussed further in Subsection 4.3.3.2.2. See also Basener (2017): Investment Protection in the European., P. 430ff.
[1208] Also further dealt with in Chapter 4.4.

national treatment, since it imposes on the host State an obligation to accord the foreign investor a treatment that is not any less favorable than that accorded to its own nationals. It is, hence, a comparative relative principle, in which there is no determination of a specific action or omission, but rather the emergence of an obligation arising from the comparison between the treatment related to national and foreign investors.[1209]

While this definition is relatively clear, the difficulties in applying a national treatment standard are of a different nature, namely, in the *way* in which it is determined whether there has been a discrimination, which commonly has a three-step-test for analysis. The investor, in order to invoke a violation of the national treatment standard, must establish (a) the similarity between the situations of national and foreign investors; (b) *de jure* or *de facto* discrimination in relation to the national rule; and (c) the measure cannot be backed up by any justification ground.[1210] While proving that there is disparate treatment between national and international investors is not difficult – much like with a general non-discrimination provision –, indicating that the circumstances applicable to each of the investors are similar is extremely difficult, considering that the latters are, by definition, quite distinct from one another.[1211]

This rule, hence, aims to ensure that national and international investments and investors in like circumstances are treated at least equally. As the language commonly used suggests a "no less favorable" treatment, this means that there would be no breach of treaty obligations in the event of discrimination against national investments in favor of international ones.[1212] Although this hypothesis is unusual, it may occur in scenarios in which a country is very keen on attracting foreign direct investment. The likeness of circumstances, on the other hand, is determined and commonly interpreted based on similarities that do not need to represent exactly identical

[1209] Refer to Reinisch (2015): §8 Internationales Investitionsschutzrecht. In: Tietje/Götting (Eds.) - Internationales Wirtschaftsrecht., P. 411ff.
[1210] More information on this three-step-test can be found on the decision *Methanex* v *USA*, Final Award of the Tribunal on Jurisdiction and Merits dated 3 August 2005 (UNCITRAL).
[1211] This is, next to the possible justification grounds, rich ground for debates with diametrically opposed conclusions. See, for instance, Basener (2017): Investment Protection in the European., P. 84f.
[1212] See Muchlinski (2009): The Framework of Investments Protection. In: Sauvant/Sachs (Eds.) - The effect of treaties on., P. 52.

situations, under penalty of voiding this guarantee of meaning, but rather a genuine likeness, such as acting in the same economic sector or being subject to similar market rules.[1213]

Moreover, in contrast to the prohibitions of discrimination in European law, the BITs commonly do not expressly provide for justification grounds[1214] in the case it occurs under national treatment or, as a matter of fact, under the most-favored nation standard as well. Thus, mainly the justification grounds discussed in the arbitration awards can be taken into consideration, which, however, is not particularly helpful since these awards apply only to the specific individual cases to which they are attached.

The justifications to which national treatment may be subject may have a more general character, as is the case with reasons linked to national security, public health or morality – all hardly applicable in the field of tax law and anti-avoidance measures –; or subject-specific justifications, linked to distinguished sectors of the economy or specific business structures.[1215] Ultimately, justifiable discriminations must be analyzed on a case-by-case basis, and it is difficult or maybe even impossible to determine beforehand in an abstract manner the acceptable contours of a justification, especially considering the role of arbitration in resolving conflicts involving this rule. Not surprisingly, many countries consider the concept of national treatment closely linked to that of FET,[1216] where fair and equitable considerations have to be made to reach an inference based on the national standard.

Finally, the standard of national treatment can be either negotiated and implemented as a stand alone provision or, in order to complement it, be introduced alongside the so-called most-favored nation (MFN) principle. The basic effect this provision has is to extend the guarantees provided by a national treatment – *i.e.* no less favorable treatment between national and international investors and investments – to horizontal relations between foreign investors. This would ensure that equal treatment by the host country among all foreign investors would be

[1213] See, for instance, the award in Occidental v. Ecuador (I) (London Court of International Arbitration Case nº UN 3467).
[1214] Although there are often exceptions for application with regard to free trade areas, customs unions or even for tax matters. More on this discussion on the following Subsection.
[1215] United Nations Conference on Trade and Development (2004): International Investment Agreements., P. 177ff.
[1216] See Vandevelde (2017): The first bilateral investment treaties., P. 409ff.

warranted, bringing equal conditions of competition in the host state's internal market between investors and investments of different nationalities.

It is in this sense that the concept of national treatment and MFN can be seen as complementary,[1217] since the latter brings similar guarantees as the former, but in relation to foreign investors among themselves. Thus, the observations and problems involving one of them will generally also apply to the other, considering that MFN can also be introduced as a stand alone clause and often has exceptions linked to regional economic integration commitments[1218] promoted by the contracting parties in other treaties; or with respect to taxation matters due to the protection of the tax sovereignty of the states involved.

The main distinction between the two guarantees is that the MFN principle is primarily employed to bring provisions from *other*, more favorable treaties into the relation and conflict resolution of a foreign investor and the host country. This does not mean, however, that the MFN clause allows an investor to cherry-pick with respect to the provisions of other BITs to which it is not directly subject, but rather has to rely on the whole scheme of a given treaty,[1219] for example dispute settlement provisions. In being able to apply the national treatment or the most-favored nation standard simultaneously, the most common perception is that preference will be given to the rule that is more beneficial to the investor,[1220] despite the fact that the national treatment is identified as representing the stronger standard of protection.[1221]

Whereas it is relatively common to find in the initial articles of BITs definitions of key terms that indicate the intention of the contracting parties[1222] with respect to the application and interpretation of the substantive rights provided in the treaty, there is to the best of our knowledge no definition of *tax* or *taxing rights*. This could, as with the other definitions, assist the courts in their process of resolving conflicts involving guarantees such as national treatment and MFN. Since the treaties that deal with taxation are primarily double taxation treaties, one seems to

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[1217] And usually seen as less problematic, although this isn’t necessarily true in the case of anti-avoidance measures. See Kampermann (2009): Steuersouveränität und internationales Investitionsschutzrecht., P. 240f.
[1218] As discussed in Muchlinski (2009): The Framework of Investments Protection. In: Sauvant/Sachs (Eds.) - The effect of treaties on., P. 52ff.
[1219] Decided, for example, in *Hochtief* v *Argentina* (ICSID Case nº ARB/07/31).
[1220] Vandevelde (2017): The first bilateral investment treaties., P. 449f.
[1221] Refer to the work of Hawkings (1951): Commercial treaties & agreements: principles & practice., P. 12ff.
[1222] For example, whether to adopt a broad or restrictive concept of terms such as “investment”, “investor”, “dispute” etc.

overlook the need to address tax issues with respect to BITs regardless of whether there is a provision for a tax carve-out or not.

Although the applicability to tax law of such guarantees is not immediately apparent even in the absence of a tax carve-out, a norm granting unfavorable treatment to foreign investors residing in specific jurisdictions could trigger a most-favored nation clause insofar as this treatment would not be extended to all non-national investors or investments. The objective of this clause at a higher level of generality – alongside national treatment – is, as for any non-discrimination provision,[1223] to ensure a level playing field and equal conditions in the competition between different investors for the same market. This is precisely why it is necessary to assess to what extent tax carve-outs are relevant and necessary so that BITs do not restrict the possibilities of implementing the anti-avoidance measures under scrutiny.

4.3.3.2 Significance of a BIT tax carve-out for transactions involving royalty payments

As mentioned previously, it is relatively common for countries negotiating a bilateral investment treaty to consider the possibility of implementing a tax carve-out. The purpose of this exception is to protect the tax sovereignty of the contracting states by restricting the scope of applicability of the treaty guarantees, excluding tax matters from the framework of standards such as national treatment and most-favored nation. However, a *de facto* implementation of a tax carve-out occurs less frequently than expected, being present only in roughly 10% of all negotiated BITs so far.[1224] This means that, although it is a possibility that must be evaluated in each individual case, the presence of a tax carve-out is indeed not so widespread, and while the UNCTAD has outlined in recent years a few reform options to tackle this issue,[1225] one of the most important

[1223] Stated by Vandevelde (2010): Bilateral investment treaties., P. 342.
[1224] Precisely speaking, on 274 out of 2575 treaties, according to the UNCTAD investment policy hub on the mapping of IIA content. Available online at: https://investmentpolicy.unctad.org/international-investment-agreements/iia-mapping, checked on 02.03.2021.
[1225] See United Nations Conference on Trade and Development (2018): UNCTAD's Reform Package for the International Investment Regime. United Nations.

phases of reform involves renegotiating and modernizing the existing stock of old-generation treaties, which is not only time-consuming, but also does not ensure harmonization.[1226]

Questionable is to what extent such a carve-out would impact the possibility of applying treaty guarantees to situations that arise due to the implementation of anti-tax-avoidance rules such as a royalty deductibility barrier. In the absence of any form of tax exception expressly provided for by the investment treaty, it can be assumed that it will have application to matters of taxation.[1227] However, due to the lack of more detailed definitions on tax issues within the treaty, typically it will fall to an arbitration tribunal to determine what can be considered a tax and whether or not there will be any enforceability with respect to BIT guarantees. Thus, in the event of a taxation exception clause, and considering the underlying rationale for its implementation, it is clear that the general objective of such a provision is to isolate the complexity present in tax matters that might render them unsuitable to be dealt with under general rules such as those of national treatment and most-favored nation.[1228]

Moreover, tax issues already are, in theory, addressed by subject-specific treaties in the form of DTTs, which even have their own non-discrimination provisions within *e.g.* Art. 24 OECD-MC. Therefore, a tax carve-out also aims at avoiding conflicts between the different international treaties signed by the contracting state, besides promoting a protection of the tax sovereignty of the involved jurisdictions, which understandably might be unwilling to surrender their right to taxation or subject them to review through arbitral tribunals.[1229]

The most common version of this type of exception provides that the MFN treatment will not be extended to advantages granted through an international agreement relating wholly or mainly to taxation,[1230] but there is also the possibility of excluding “tax matters” altogether from the scope of the treaty and its provisions. This exception could also apply to the national treatment obligation if it were extended to benefits granted through national rules relating wholly or mainly

[1226] See the discussion for instance in Jalan, Nupur (2020): Bilateral Investment Treaties: India and Beyond. In *Tax Notes International* 100 (11), P. 1436f.
[1227] Refer to Gildemeister (2015): Investment Law and Taxation. In: Bungenberg/Griebel et al. (Eds.) - International investment law., P. 1682f.
[1228] See the opinion of Vandevelde (2010): Bilateral investment treaties., P. 346ff.
[1229] As indicated by Wälde/Kolo (2008): Coverage of Taxation under Modern. In: Muchlinski/Ortino et al. (Eds.) - The Oxford handbook of international., P. 322f.
[1230] As is the case in treaties such as the UK-Bosnia BIT (Art. 7); Germany-Timor East BIT (Art. 3 para. 4); and Austria-Armenia (Art. 3 para. 4 *lit.* “b”)

to taxation, as is the case with subsidies,[1231] or even the possibility of deducting business expenses. Due to these distinctions that are dependent on the particular design conferred to the carve-out, the next subsection is concerned with the different outlines that these rules can have, as well as the different results that these choices bring to the world of taxation and anti-avoidance measures concerning royalty payments.

4.3.3.2.1 Possibility of different outcomes based on carve-out design

Regarding the different design possibilities involving tax carve-outs within BITs, one can divide them roughly into two main categories, namely full (broad) and partial (strict) carve-out clauses. As the name implies, while the former features a general exclusion of tax issues from the framework of the investment treaties, a partial carve-out is a more targeted solution, being applied to only one or some of the provisions and guarantees present in the BIT. Broad exceptions are relatively uncommon, being more frequently found in treaties concluded by countries such as the USA, Japan, Canada and Singapore,[1232] but not within EU Members.[1233]

When implementing a partial carve-out, the parties are naturally free to determine the scope of such a clause, yet its design has a definite inclination to exclude *direct* taxes from its scope, relegating its regulation to double tax treaties. As a consequence, if the exclusion of direct taxes from the BITs framework is interpreted *a contrario sensu*, investment treaty obligations may apply to those taxes regarded as indirect.[1234] Partial provisions that exclude the applicability of national treatment and/or MFN standards to a specific set of taxes suggest that the treaty guarantees will apply to all taxes other than those expressly mentioned in the tax carve-out.[1235]

This interpretation seems to be the most coherent, considering the main purpose of the (modern) investment treaties to create a predictable, secure and non-discriminatory investment environment. Since taxes significantly affect business decisions, controversial issues regarding

[1231] For more information, refer to Vandevelde (2010): Bilateral investment treaties., P. 347.

[1232] See Gildemeister (2015): Investment Law and Taxation. In: Bungenberg/Griebel et al. (Eds.) - International investment law., P. 1683.

[1233] As in Belgium and France. Refer to Traversa/Richelle (2017): Belgium. In: Lang/Owens et al. (Eds.) - The impact of bilateral investment.; and Dubut/Randriamanalina (2017): France. In: Lang/Owens et al. (Eds.) - The impact of bilateral investment.

[1234] Although this differentiation is not always clear, as stated by Larking (2005): IBFD international tax glossary, on the definition of direct and indirect taxes.

[1235] Refer to Wälde/Kolo (2008): Coverage of Taxation under Modern. In: Muchlinski/Ortino et al. (Eds.) - The Oxford handbook of international., P. 320ff.

taxation that were not expressly excluded from the scope of validity of the treaty should be taken into consideration. If the ultimate purpose of a BIT is to promote effective legal protection for foreign investments, a holistic approach,[1236] covering situations across the board in which a contracting state may affect non-national investments or investors that have not been expressly excluded, conveys the impression of being reasonable.

Therefore, if a broad tax carve-out clause is decided upon, the guarantees contained in the investment treaty will *prima facie* not apply to any taxation measures implemented nationally or internationally by the countries involved. This is, however, a conscious choice based on the negotiations developed at the international bi- or multilateral level. On the other hand, if this choice is the adoption of a partial carve-out clause – or, as a matter of fact, of no exclusion provision at all – it is wise to assume that there is the possibility of the investor challenging tax measures that may eventually violate provisions such as the fair and equitable treatment, national treatment or most-favored nation, depending on the structure employed in the respective BIT.

Even in cases where a broad exclusion of tax matters is adopted, the possibility of implementing a limitation on the effects of tax carve-outs cannot be overlooked. The so-called clawback clauses may constitute specific counter-exceptions, the most common of which is for expropriation issues – one of the most important protections conferred by BITs. However, these clawback provisions are rarely foreseen for the most relevant treaty guarantees, in the name of safeguarding the tax sovereignty of the contracting states.[1237]

It is important, nevertheless, to observe all the features surrounding a far-reaching carve-out, especially in cases involving abuse. Due to general rules of treaty interpretation such as the principle of good faith,[1238] the contracting states must abstain from abusing treaty provisions, and if a discriminatory measure disguised as a tax measure to be protected by the exception is implemented, the carve-out may be disregarded. All these factors should be taken into consideration when assessing the compatibility of national tax measures with treaty provisions,

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[1236] Also on this opinion, see Pistone (2017): Chapter 1: General Report. In: Lang/Owens et al. (Eds.) - The impact of bilateral investment., P. 20f.
[1237] See Gildemeister (2015): Investment Law and Taxation. In: Bungenberg/Griebel et al. (Eds.) - International investment law., P. 1685ff.
[1238] In Art. 26 VCLT and as a general principle.

which explains the relevance of discussing these features and the importance of carve-outs in shaping the scope of application of investment treaties in tax matters.

4.3.3.2.2 Overall compatibility with specific anti-avoidance measures relating to royalty payments

While the ideal scenario would be to have a certain homogeneity in the treatment of tax carve-outs within BITs, so that one can more accurately evaluate their possible impacts on anti-avoidance rules against aggressive tax planning structures that use cross-border intragroup royalty transactions, there are many nuances that especially partial carve-outs have in the different investment treaties. This prevents the adoption of a one-size-fits-all approach, which, however, does not mean that it is not possible to indicate in general terms the expected results in cases where (a) there is a broad tax carve-out; and (b) there is no tax carve-out at all *or* that this exception is not applicable to the relevant guarantees for the measures under analysis.

If a BIT has a broad tax carve-out, regardless of the existence of clawback clauses for expropriation or abuse cases, it is safe to say that there will be no negative impacts either for withholding taxes, royalty deductibility barriers or for *Lodin's* inverted tax credit system. If the contracting parties decide to completely exclude the subjection of tax matters to an investment treaty, where only extreme cases of abuse will be covered, there is no fear that anti-avoidance rules pondered for a legitimate purpose would fall within the scope of this specific treaty or would be considered abusive. While the considerations regarding double tax treaties and EU law – if applicable – remain valid, there would be one less layer of complexity in the event of such a far-reaching tax exception.

Although this is the simplest scenario, it will not only be uncommon, but also perhaps relatively incompatible with the general objectives of a modern BIT. After all, the weight that tax considerations have in the decision-making process of multinational companies is enormous, directly impacting foreign investments and investors. Therefore, in cases where there are no tax carve-outs or where the existing exception is not applicable to (either) FET, NT or MFN, it is necessary that the anti-avoidance rule be considered compatible with the treaty.

a) The issue of coordinating anti-avoidance measures with BITs without a tax carve-out

When it comes to withholding taxes as a way to ensure a minimum level of taxation when international royalty payments occur, ironically the form that would present the fewest problems is a broad WHT.[1239] This is because the possibility of levying this type of tax is considered legitimate and in principle accepted under BIT repatriation rules,[1240] and as long as it does not occur in such conditions and at a level that, in practice, prevents or makes exceedingly unattractive options for repatriating earnings, it will not be problematic.

Furthermore, a broad-specter withholding tax would ensure that its treatment would not be discriminatory or affect distinct foreign investors differently, as it targets every transaction equally. However, if there were a double tax treaty between the country wishing to withhold taxes and a third country, due to the likes of Art. 12 OECD-MC, which as an allocation rule virtually prevents the withholding of taxes by the source state,[1241] investors from the contracting state of the BIT could, in the absence of a tax carve-out, try to invoke the MFN clause in order to extend to themselves the preferential treatment conferred by the DTT.

In the case of a targeted withholding tax, similar problems arise not only because there will be, regardless of the existence of DTTs, different treatment between foreign investors of different jurisdictions; but also because this differentiation may arise directly by means of a national provision, which requires that, in order to fall within the scope of a carve-out, it be redacted as to exclude not only the "privileges granted to investors of a third state by virtue of a tax treaty or arrangement relating to taxation",[1242] but also those privileges arising from domestic legislation.[1243]

This means that while the fair and equitable treatment standard, as it is more of a blanket rule, deals with the most blatant cases of discrimination and will hardly be applicable to a WHT as an anti-avoidance rule, withholding advantages arising from DTTs or even other BITs may have to be extended to transactions involving royalties due to the most-favored nation principle in the

[1239] For all the other issues with this option, refer to Chapter 3.1.2.1.
[1240] See Wälde/Kolo (2008): Coverage of Taxation under Modern. In: Muchlinski/Ortino et al. (Eds.) - The Oxford handbook of international., P. 333ff. Opposing opinion on Pistone (2017): Chapter 1: General Report. In: Lang/Owens et al. (Eds.) - The impact of bilateral investment., P. 27ff. For the author, the national treatment standard may prevent the levying of WHT on outbound payments of passive income.
[1241] For more information, refer to Chapter 4.3.1.1.1.
[1242] As is the case, for example, with the German Model Bit (Art. 3 para. 4) and Netherlands Model BIT (Art. 10 para. 1 *lit.* "a").
[1243] As is the case, *e.g.*, with the UK Model BIT (Art. 7 para. 1 *lit.* "b").

absence of a specific tax carve-out.[1244] However, at least with respect to the national treatment, there are usually no problems involving withholding if it does not occur nationally, as it is a widely accepted and legitimate practice also in the investment world, albeit undesirable for representing a trade barrier.

Similar problems are faced by a royalty deductibility barrier, which despite being most likely outside the protective scope of a FET clause,[1245] protecting predominantly against arbitrariness,[1246] may present several problems with respect to national treatment and MFN. While the "importation" of benefits from DTTs is not the main concern, since only the non-discrimination clause in Art. 24 OECD-MC – which works similarly to the national treatment contained in the BITs – has relevance for royalty barriers,[1247] the fact that the deductibility of royalty payments is assured only for (i) national investors, since they will hardly fulfill the requirements for activating the rule; and (ii) those foreign investors that meet the requirements such as minimum tax thresholds and the nexus-approach; may characterize a less favorable or discriminatory treatment against foreign investors that are subject to the rule.

This involves, however, difficult comparisons between possibly very different situations: on the one hand, between the domestic comparator and a foreign investor subject to a tax rate deemed insufficient; and on the other hand, between two foreign investors from home countries with contrasting tax opportunities. Considering that there are no objective criteria determined by the BITs on what would be "like situations" or a relevant difference in actual treatment,[1248] one cannot state with precision the outcome of this analysis, which will vary not only according to the specific design of the royalty barrier, but also according to the assessment of the responsible arbitral tribunal.

[1244] There is a discussion concerning the limitation of impacts of the MFN obligation regarding withholding taxes within DTTs, since the combination of a WHT imposed on royalties by the source state offset by a tax credit by the residence state (through Art. 23B OECD-MC, for instance) would constitute a neutral allocation of taxing rights, and not a discrimination in relation to third parties. See the decision in *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* (C-336/96) by the ECJ. If there is no (full) tax credit, however, the discrimination would be ensured.

[1245] It will have applicability if the tax carve-out is restricted to the NT and MFN clauses, but is unlikely to see practical use with regard to anti-avoidance measures related to royalties.

[1246] Refer to Vandevelde (2017): The first bilateral investment treaties., P. 416ff.

[1247] For more information, see Chapter 4.3.1.1.2.

[1248] See Reinisch (2015): National Treatment. In: Bungenberg/Griebel et al. (Eds.) - International investment law., P. 846ff.; and Wälde/Kolo (2008): Coverage of Taxation under Modern. In: Muchlinski/Ortino et al. (Eds.) - The Oxford handbook of international., P. 326f.

It can of course be argued that the situation between a domestic and a foreign investor with respect to the deductibility of business expenses is different to the extent that the taxation of the foreign investor is much lower than the taxation of the domestic one. Therefore, the total and especially the partial restriction of the deductibility of royalty payments could actually play a role in equalizing the competitive opportunities between them. The same reasoning could be applied to foreign investors from different countries, since they would not be in a *like situation* if one of them is a resident of a country with a much more "generous" tax system, creating an advantageous situation through a tax edge.

However, arguing that, due to these anti-avoidance rules, discriminatory treatment that violates the NT and MFN clauses can occur is not an unfounded argument either. If one considers that these are (a) at least similar circumstances[1249] that (b) lead foreign investors to be discriminated towards national ones, the three-step-test[1250] requires that these rules be (c) justifiable in order to be exceptionally permitted. While some BITs provide for explicit exceptions to the applicability of national treatment and most-favored nation clauses, such as reasons of public order and security,[1251] or even public health and morality, these general justifications are unlikely to be applicable to tax anti-avoidance rules. The primary purpose of these measures is to protect the tax base of the host country, avoiding or at least making less attractive the shifting of profits to low-tax jurisdictions.[1252] Furthermore, since these are treaties that traditionally do not deal with matters of taxation, there is a lack of foreseen justifications that touch upon the *raison d'être* of such tax rules.

b) Attempting to justify a possible violation of the BIT on tax matters

However, even if there is no express provision for valid reasons for a discriminatory measure in the area of taxation, it cannot be forgotten that some restrictions by the host state are already accepted, as long as they are not arbitrary or abusive, as is the case with withholding taxes in relation to the repatriation rules of BITs. Thus, even if there is no tailor made justification for

[1249] Irrespective of the difference in tax treatment by each State, since this is a corollary of the tax sovereignty of these States.
[1250] As discussed on Chapter 4.3.3.1.
[1251] As is the case with the German Model BIT, Art. 3 para. 2.
[1252] For more information on the goal of specific anti-avoidance measures relating to royalties, refer to Chapter 3.

tax matters, arbitral tribunals regularly take the host state's possibility of justification into consideration when dealing with possible differential treatment.[1253]

These justifications can either be analyzed individually, *i.e.* independently of the other criteria of the three-step-test, or discussed in conjunction with the other requirements, such as when arguing that there is no "like situation" between domestic and foreign investors concerning the tax aspects of royalty payments. Both of these approaches can be found in arbitration awards in recent years to deny a breach of the national treatment or MFN provisions, as was the case for justifications linked to the concept of like circumstances in *inter alia Pope & Talbot* v. *Canada*;[1254] or for independently assessed justifications as in *Parkerings* v. *Lithuania*.[1255]

The crux of these decisions is that for there to be a violation of a BIT, the discrimination must be unreasonable or disproportionate, unrelated to a legitimate aim of the host state. If there is an objective justification for the implementation of a *prima facie* discriminatory rule, even if there are similar circumstances among those affected, it is possible that, in the concrete case,[1256] this measure will be considered compatible with the investment treaty. Unlike what occurs under European law, where the European Court of Justice already has a relatively conservative jurisprudence on the subject,[1257] the issues surrounding BITs are more open and subject to the assessment of each individual case by an arbitration tribunal. This means that justifications that have little to no chance of being accepted at the European level regarding, for example, the free movement of capital,[1258] can be independently assessed under BITs to combat tax avoidance with much higher chances of success for the contracting State, given the awards reached so far.

Once again, criteria such as the proportionality[1259] of the measure become subject to discussion, which ensures the upper hand for specific measures of a more targeted nature, as is the

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[1253] See Reinisch (2015): §8 Internationales Investitionsschutzrecht. In: Tietje/Götting (Eds.) - Internationales Wirtschaftsrecht., P. 863ff.
[1254] Specifically on the UNCITRAL Award on the Merits of Phase 2 of 10.04.2001, para. 77ff.
[1255] ICSID Case nº ARB/05/8, Award from 11.09.2008, para. 368.
[1256] See for instance the decision on *Toto* v. *Lebanon* (ICSID Case nº ARB/07/12), Award dated 07.06.2012, in which a modification of the level of taxation for foreign investors was not considered incompatible with the treaty.
[1257] Refer back to Chapter 4.2.2.
[1258] For a parallel between investment rules and EU law, refer to Leal-Arcas (2010): International trade and investment law., P. 219ff.; and Basener (2017): Investment Protection in the European., P. 430ff.
[1259] In fact, this proportionality test in order to justify the measure is also regarded to be similar to the European treatment on the subject, as indicated by Kriebaum (2015): Standards of Protection. In: Bungenberg/Griebel et al. (Eds.) - International investment law., P. 804ff.

case of a royalty barrier that allows for a proportional deduction of payments, according to the amount taxed in the payee's jurisdiction.[1260] It seems reasonable to assume that, in the case of a well-structured rule aimed at combating base erosion and profit shifting – also detrimental to a natural flow of FDI between countries – that a possible unfavorable treatment may be considered justified.

For the proportionality of both withholding taxes and royalty deductibility barriers, it is expected not only that the scope of the rule is as narrow as possible, so that activation occurs only in cases where there is BEPS, but also that there is the possibility for the taxpayer to prove in its particular case that it meets the necessary requirements to take advantage of the benefits traditionally granted to this type of transaction.[1261] At least with regard to *Lodin's* inverted tax credit system, the results seem to be, once again, the same:[1262] as this is a comprehensive reform of a country's national tax system, arising from the exercise of its tax sovereignty, identical treatment is ensured to nationals and foreign investors and investments alike with regard to the deductibility of payments. Even if, in practice, this system eliminates the possibility of tax competition by ensuring the same level of taxation for all investors and investments within the jurisdiction of the host state, it is most likely not a decision that violates the guarantees present in the BITs. If the conditions for implementing this system are clear, and considering that the deductions are disallowed for all payments on all entities,[1263] there are no objections to be made from the point of view of investment treaties.

Although this line of argument concerning the justification of tax anti-avoidance rules is sound, there is actually no certainty that it will be accepted before an arbitration tribunal, even though the tendency has been, especially with the OECD GloBE proposal, for such initiatives to be acknowledged. There is a balance to be struck between protecting the interests of foreign investors and protecting the national tax base and combating profit shifting by the host state. The

[1260] As with the German model of a sliding scale. Refer to Chapter 3.2.2.2.
[1261] Design issues will be further discussed on Chapter 5.
[1262] Even though this issue is not dealt with directly by his proposal, the logic is similar to the one applied to the discrimination contained within the OECD-MC.
[1263] There is an argument to be made regarding the concession of the tax credit, that is dependable on the resident jurisdiction's effective tax rate and might be disputed as an indirect discrimination between different international investors and/or their national counterparts. However, considering that the disallowance of the deduction in a broad and unrestricted manner is the base treatment, and the concession of the tax credit is always equally dependable on the tax rate of the residence jurisdiction, this line of reasoning seems rather unlikely to be accepted. More on this discussion, see Chapter 4.4.2.1.

safest alternative is to (re)negotiate tax carve-outs at least for the national treatment and most-favored nation clauses,[1264] which are already the most popular targets of this type of exception precisely due to their ease of application in tax matters.[1265] There seems to be no need, however, to also include the FET clause within this carve-out. Since it has a more general aspect,[1266] it would confer a minimum of protection (also) to tax issues within the investment treaty, considering the importance of dealing, to a minimum degree, with issues involving taxation, which are likewise highly relevant in the investment decision-making process.

Another option would be to expressly include in the treaties the possibility of justifying apparently discriminatory measures based on the need to combat tax avoidance. This solution, however, might be a pitfall insofar as, despite formally guaranteeing the possibility of justification, it would not necessarily solve the need to weigh the opposing interests in each specific case, which almost ensures that the matter would still have to be resolved before a tribunal. Moreover, this could open the way for the host state to implement measures that, cloaked in an apparent intention to fight off base erosion and profit shifting, aims to achieve an objective equivalent to an otherwise prohibited restriction of investor rights.

Therefore, it seems reasonable that the most complex tax issues be solved by specific treaties, namely, double tax treaties, and that the function relegated to BITs in relation to tax be primarily a general backstop in the form of the FET clause for the protection of investors' interests. Thus, a partial tax carve-out linked to the other guarantees is not only appropriate, but advisable to the extent that it avoids conflicts and doubts with respect to the application of these treaties in tax matters.[1267] This brings more legal certainty not only for the contracting states involved that wish to protect their tax sovereignty, but to a certain extent also for the investors, who will know

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[1264] Which are undoubtedly the most controversial provisions, oftentimes leading to conflicting decisions. Refer for instance to the cases *Garanti Koza* v. *Turkmenistan* (ICSID Case nº ARB/11/20) and *Kılıç* v. *Turkmenistan* (ICSID Case nº ARB/10/1) on the most-favored nation clause.

[1265] See Wälde/Kolo (2008): Coverage of Taxation under Modern. In: Muchlinski/Ortino et al. (Eds.) - The Oxford handbook of international., P. 328.

[1266] Oftentimes considered to not be materially different from the standard of treatment in customary international law. Refer to *Deutsche Bank* v. *Sri Lanka* (ICSID Case nº ARB/09/2), Award dated 31.10.2012.

[1267] On this same opinion, see Pistone (2017): Chapter 1: General Report. In: Lang/Owens et al. (Eds.) - The impact of bilateral investment., P. 20ff; and Kampermann (2009): Steuersouveränität und internationales Investitionsschutzrecht., P. 306f.

in advance the scope of applicability of the BIT and will at least be secure against clearly arbitrary tax treatment through the FET clause.[1268]

However, should the contracting states decide not to implement a carve-out, they should be ready to face challenges of a similar nature as those derived from Art. 24 OECD-MC with respect to double taxation treaties.[1269] While there are already decisions that allow the host state to justify even tax measures that prevent the deductibility of some expenses by foreign investors,[1270] each case will have to be analyzed individually to determine whether or not there has been a violation of the BIT.[1271] While it seems that the chances are good that the anti-avoidance measures under review would be found to be compatible with BITs – depending on their design –, the security that at least a partial tax carve-out clause would bring is to be welcomed and highly recommended.

4.3.3 Interim results on the relation between specific anti-avoidance measures on royalty payments and Treaty Law

While it is true that the impact that treaty law has on the national application of tax anti-avoidance measures may vary greatly on a case-by-case basis, given that every aspect of a treaty is negotiated bi- or multilaterally between the contracting parties involved, the vast existing network of tax and investment treaties, as well as the general lines that the model conventions present, paint a relatively defined scenario for the measures under analysis.

As might be expected, the DTTs in particular impose limits in different ways on the fight against the shifting of profits by means of national tax measures. Although Art. 12 OECD-MC is primarily a mere allocation rule, it by itself already restricts the possibility of introducing withholding taxes in their various forms as a way to ensure a minimum level of taxation on cross-border royalty payments. Even though this does not mean that the use of this remedy is impossible

[1268] For example discriminatory ways of interpreting tax rules, tax auditing or tax prosecution etc.
[1269] Similar to the WTO law guarantees, discussed in Chapter 4.4.
[1270] See for example the case of *Ryan and others* v. *Poland* (ICSID Case nº ARB(AF)/11/3).
[1271] It is, however, a high threshold to be met by the investor. Only a handful of cases of discrimination on tax issues have been decided in favor of the claimant, as for instance in *ADM* v. *Mexico* (ICSID Case nº ARB(AF)/04/5), Award dated 21.11.2007; and *Feldman* v. *Mexico* (ICSID Case nº ARB(AF)/99/1), Award dated 16.12.2002.

altogether,[1272] there might be objections from the other contracting state leading to disputes that could either be solved by mutual negotiations,[1273] or even the termination of the treaty altogether – although that is unlikely given the overall impact of a termination. Thus, withholding taxes as anti-avoidance rules in line with double tax treaties are, in the absence of specific provisions, difficult to implement.

Problems of a different nature, however, are faced by rules providing for a restriction on the deductibility of royalties in cross-border transactions, in particular with regard to the non-discrimination rule of Art. 24 OECD-MC. The question is whether indirect discrimination, *i.e.* a rule that is formally equitable, but in practice only affects cross-border cases involving low-tax jurisdictions, would violate the provisions of the (model) tax convention. Although the general understanding is that indirect discrimination, not being linked to a criterion of the taxpayer's nationality, would be outside the scope of double tax treaties, the safest option is certainly to expressly provide, if constitutionally possible, for a treaty override – at the cost of wearing down diplomatic and trust relations between the parties – to ensure that the anti-avoidance objective of a royalty barrier will be achieved without further treaty law impediments.

Moreover, considering the recent changes in the rationale behind treaties, especially DTT models, which indicate after a reform in their preamble a desire to combat double taxation, but without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, the prospects that an anti-avoidance measure will be considered compatible with the treaty increases, regardless of the need to implement a treaty override. The adoption of a measure that is deemed compatible with double tax treaties may, in addition, produce effects far beyond treaty law itself. This is because, in the context of EU law, the ECJ has a clear tendency of regarding the MS's compliance with the OECD model regarding national tax legislation as a strong signal of an adequate and well-designed solution,[1274] which would solve two debatable compatibility issues at once.

[1272] For instance, if a PPT rule is foreseen to restrict treaty benefits, as is the case with Art. 12 para. 5 of the UK-Germany DTT, recently renegotiated to include a broad PPT for the entirety of the treaty. This, however, presupposes fairly equal footing in the negotiation position of both countries.
[1273] For more on this option, refer to Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) - 100 Jahre Steuerrechtsprechung in Deutschland., P. 943ff.
[1274] Especially when referring to primary law. See Dubut, Thomas (2012): The Court of Justice and the OECD Model Tax Conventions or the Uncertainties of the Distinction between Hard Law, Soft Law, and No Law in the European Case Law. In *Intertax* 40 (1), P. 4ff.

Similar issues are raised with regard to the non-discrimination provisions contained in bilateral investment treaties, such as the most-favored nation and national treatment. While the idea of fair and equitable treatment, being more general and directed against arbitrariness, would hardly present problems for well-designed and well-founded tax anti-avoidance measures, the absence of a tax carve-out for the other treaty guarantees could represent a dangerous path for national measures. While WHT are generally accepted as a valid, albeit undesirable, mechanism within the scope of investment treaties, royalty barriers can easily be deemed discriminatory by impacting differently national and foreign investors; or even treating a foreign investor less favorably from another based on their effective tax rate.

While the objectives of national treatment and non-discrimination rules of investment treaties and those of Art. 24 OECD-MC are largely the same – having the same underlying purpose –, unlike what has been observed with regard to the justification grounds of European law, there is often no specific provision or consistency as to the reasoning that may be accepted concerning cases of discrimination within these treaties. Therefore, it will always ultimately be up to an arbitral tribunal to determine, in each concrete case, whether this possible discrimination is *justifiable*, for instance on the basis of the need to fight off tax avoidance. Precisely because of this, at least in the case of BITs, there would be a substantial reduction in the layer of complexity in this analysis if a tax carve-out were to be implemented.

While states rely modernly mainly on more specific investment protection standards in the form of BITs, there are other mechanisms developed in particular in the post-World War II period and at the end of the last century which also have applicability and relevance to the measures under discussion. Alongside investment treaties, World Trade Organization law in the form of the GATT, GATS and TRIPS constitute the core of contemporary investment protection mechanisms, which will be discussed hereinafter.

4.4 WTO law

Despite having its origins connected to the international investment regime and bilateral investment treaties, world trade law has been developed in a distinct and parallel way for most of the time. This is especially clear insofar as, despite the start of the WTO's activities on January 1st, 1995, countries continued – and even further increased the intensity – of BIT negotiations among

themselves,[1275] even if, in many cases, there is a degree of overlap between the rules envisaged for the international organization and on other investment treaties.

These similarities may, however, notwithstanding the distinct development of these two areas, be useful to the extent that arbitrators involved in conflicts between investors and States refer back to the case-law established by the WTO in disputes involving different States,[1276] and vice versa. This means that many of the conflicts, problems and observations applicable to investment law will also be valid when discussing the relevance of WTO law. Especially since the beginning of this century, the relevance of the WTO as an organization has increased dramatically, which has naturally also led to an increase in its impact on tax issues.

While indirect taxation is originally the main (tax) target of the rules developed within the WTO framework, there are also several relevant applications for direct taxation. Strangely enough, the compatibility of tax rules with WTO law is oftentimes simply taken for granted, possibly due to the multiple exceptions and tax carve-outs present in the treaties.[1277] However, this debate remains important to the extent one envisions the real possibility of instituting anti-avoidance rules in a manner compatible with all sorts of higher-ranking law, and the broader role of the WTO in fostering international trade.

4.4.1 Relevance and scope of application

First, it is essential to determine what impact WTO rules impose on policymakers' freedom to formulate tax policies, in this particular case that of anti-avoidance rules targeting aggressive tax planning structures with royalty payments. Naturally, Members States will wish to avoid that measures developed as a means of protecting its tax base are (successfully) challenged at an

[1275] See Ziegler (2015): Investment Law in Conflict with. In: Bungenberg/Griebel et al. (Eds.) - International investment law., P. 1785ff.

[1276] For more on this discussion, refer to Kurtz, Jürgen (2009): The Use and Abuse of WTO Law in Investor-State Arbitration: Competition and its Discontents. A Rejoinder to Robert Howse and Efraim Chalamish. In *The European Journal of International Law* 20 (4), P. 1095ff.

[1277] What interestingly also happens in other fields of taxation, as seen in Falcão, Tatiana (2021): Ensuring an EU Carbon Tax Complies With WTO Rules. In *Tax Notes International* 101 (1), P. 42ff.

international level within the WTO,[1278] and it is therefore desirable that they be designed *prima facie* in a manner compatible with the treaties.

Since one of the ultimate goals of the World Trade Organization is to promote free trade between the contracting states, which presupposes undistorted competition and determination of price,[1279] the imposition of payment obligations that do not have a corresponding direct counterpart by the State – in the form of taxes[1280] – may naturally represent a hindrance to this objective.

Therefore, since its founding in 1995, about 10% of all disputes brought by Member States before the WTO Dispute Settlement Body deal with tax issues.[1281] Moreover, it has been made explicitly clear from decisions such as *Indonesia – Certain Measures Affecting the Automobile Industry*[1282] and *United States – Tax Treatment for "Foreign Sales Corporations"*[1283] that both indirect as well as direct taxes may be subject to dispute settlement procedures under WTO rules, as, despite the efforts that the parties have had to secure specific exemptions for certain tax measures in the treaties, many of them are still subject to WTO law.

Questionable is, first of all, whether there is a specific autonomous definition of taxes within WTO law; so that one can determine, in parallel, which of the various agreements that make up the organization will have applicability and relevance for the provisions under analysis. While the World Trade Organization rests on three main pillars – in the form of the *General Agreement on Tariffs and Trade*, GATT, the *General Agreement on Trade in Services*, GATS, and *Trade-Related Aspects of Intellectual Property Rights*, TRIPS – and multiple secondary agreements, there are few passages that deal explicitly with taxes.

A general stand-alone definition, and only of direct taxes, can be found in Art. XXVIII, *lit*. "o" of the GATS. Interestingly, a broader definition, also involving other forms of taxation, can be found solely in one of the many secondary agreements, "hidden", namely on footnote 58 of

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[1278] As observed by Daly, Michael John (2016): Is the WTO a world tax organization? A primer on WTO rules for tax policymakers (Technical notes and manuals). Available online at http://www.imf.org/external/pubs/ft/tnm/2016/tnm1602.pdf, checked on 28.09.20, P. 1ff.
[1279] Refer to Schön, Wolfgang (2004): WTO und Steuerrecht. In *RIW* (1), P. 50ff.
[1280] Even though some authors indicate a shortfall in the coverage of taxation issues by WTO rules. See Schoueri, Pedro Guilherme Lindenberg; Owens, Jeffrey (2020): In Pursuit of Fair Tax Competition: The Linkage Between PTA, WTO Subsidies and EU State Aid Rules. In *Intertax* 48 (6&7), P. 583f.
[1281] Which is around 40 disputes out of a bit more than 500. Refer to Daly, *op. cit.*, Fn. 1278, P. 2ff.
[1282] WT/DS64/R of 2nd July 1998.
[1283] WT/DS108/36 of 17th March 2006.

Annex I of the Agreement on Subsidies and Countervailing Measures (or SCM Agreement). In this provision, taxes on royalties are expressly included in the list of possible direct taxes, and it is to be assumed that, although it is an ancillary agreement, that this definition will also apply to other fields of WTO law.[1284]

It follows, therefore, that the practical applicability of the main pillars of the WTO to the problem under discussion must be determined. At first, one immediately thinks of the possibility of applying TRIPS, since it is the only treaty that deals specifically with intellectual property and provides guarantees such as those of most-favored nation[1285] and national treatment[1286], as do both the GATT and GATS. However, the relevance of taxes in general and in particular of direct taxation for TRIPS is extremely restricted, not only because there is no mention of taxation whatsoever within the whole agreement, but also due to the lack of jurisprudence of the organization dealing with this issue.[1287]

In general, TRIPS deals with matters related to the economic protection of intellectual property rights, such as patents, copyrights, etc,[1288] and not with taxation of their transfer due to licensing between related parties. However, in the field of taxation, its use is argued by some authors to be feasible in cases where there would be a discriminatory taxation of IP,[1289] as it would be theoretically possible to contend that according to Art. 3 of the TRIPS and its national treatment rule, interpreted alongside footnote 3, that a favorable taxation for national IP *vis-à-vis* those of an international origin could constitute a violation of the treaty. Although there is, to date, no dispute within the WTO on this topic, one can imagine that the invocation of MFNs or NTs as non-discrimination provisions could occur, for example, with respect to the granting of preferential tax regimes in the form of IP-Boxes. However, discussions of issues directly related to royalty payments between related parties would hardly be disputed.

[1284] As defended by Ecker, Thomas; Koppensteiner, Franz (2009): Anwendbarkeit der WTO-Abkommen auf direkte und indirekte Steuern. In *SWI* (3), P. 142.
[1285] Art. 4 TRIPS agreement.
[1286] Art. 3 TRIPS agreement.
[1287] Out of 42 cases that directly cite this agreement in the request for consultations, none has directly dealt with taxation so far. Data available online at https://www.wto.org/english/tratop_e/dispu_e/dispu_agreements_index_e.htm?id=A26, checked on 08.04.2021.
[1288] For more information about this classification and definitions, refer to Chapter 1.2.2.
[1289] As indicated by Brauner (2005): The United States. In: Lang/Herdin/Hofbauer (Eds.) - WTO and Direct Taxation., P. 747f.

On the other hand, the GATT would also be unlikely to find application within the scope of licensing agreements, as it deals directly with the trade involving *products*. This means that tariff barriers and in particular indirect taxation – as is the case with value added taxes – are the core and main focus of this treaty.[1290] The traditional literature on this specific agreement even indicated that direct taxes would not even fall within the scope of Arts. I or III of the GATT, since these provisions would only concern product-related taxes.[1291] However, the most recent discussions on the subject accept that direct taxation can also be questioned within the framework of the GATT, since Art. III para. 2 GATT would apply to "internal taxes or other internal charges", which may, for instance, affect the final price of a given product[1292] and, accordingly, have a product-related impact.

Nevertheless, when dealing with intangible assets and intellectual property, even if these may, in some cases, simultaneously be accompanied by physical products, it would be unrealistic to speak of a trade involving products as far as cross-border licensing is concerned. The transfer of the right to use IP is much closer to a service provision, since it is a transaction in which no physical goods are transferred from the licensee to the licensor, but rather a right to use a given intangible asset in exchange for a fee in the form of royalties.[1293] In this sense, everything points to a greater possibility of application of the GATS for cases of anti-avoidance rules that impact the execution of cross-border licensing agreements between related parties. This treaty even makes direct reference to direct taxation, not only in its definitions, but also by allowing exceptions and creating rules for the application of its non-discrimination rules within this context, which indicates that the Member States recognize – despite the limitations imposed – the importance that this agreement has for the direct taxation of income and, consequently, of royalties.

4.4.2 (Direct) Taxation in the context of the GATS and overall significance for royalties

[1290] There is extensive case law relating GATT to indirect taxes. See cases like *Japan – Taxes on Alcoholic Beverages* (WT/DS11/AB/R, from 4th of June 1996) and *Chile – Taxes on Alcoholic Beverages* (WT/DS87/AB/R. from 12th of December 1999)

[1291] As stated, for instance, by Dam (1977): The GATT: Law and international., P. 124ff. On a similar opinion, see Hofbauer, Ines (2005): Die Anwendbarkeit des Art. I GATT auf direkte Steuern. In *ecolex*, P. 467ff.

[1292] Refer, for instance, to Avi-Yonah, Reuven; Slemrod, Joel (2002): (How) Should Trade Agreements Deal with Income Tax Issues? In *Tax Law Review* 55 (4), P. 536ff.; and Ecker, Thomas; Koppensteiner, Franz (2009): Anwendbarkeit der WTO-Abkommen auf direkte und indirekte Steuern. In *SWI* (3), P. 143f.

[1293] For more on the types of intangible assets and their characteristics in a licensing agreement, refer to Chapter 1.

Unlike its brother GATT linked to the trade of products, which has existed in a comparable way since 1947, the GATS is a relatively young agreement that does not have this all-encompassing nature that the rules linked to tariffs and trade have. This occurs because the GATS has several exceptions and reservations with respect to the applicability of its non-discrimination rules, discretionary individual commitments by Member States and tax carve-outs that restrict the impact that this agreement has for taxation measures. Nonetheless, this is compensated by the broadness of the scope of the treaty itself insofar as it uses the comprehensive term "measures" affecting trade in services [1294] to define its framework of application. Furthermore, this applicability is not only restricted to services *per se*, but is also extended to *service providers*,[1295] which ensures that, despite the multiple exceptions and carve-outs, that several tax implications are still contained within the GATS. Since the levying of customs duties is ruled out in the case of services anyhow, the discussion around the agreement is centered exclusively in matters of domestic direct and/or indirect tax burdens.[1296]

As mentioned previously, there is even a definition of what direct taxes would be considered to be within the context of this treaty in Art. XXVIII *lit*. "o", which is in fact extremely similar to the one found in the OECD-MC when defining taxes imposed on income and capital.[1297] While there is no precise definition of what would be regarded as a service provider,[1298] identifying the scope of application of the different "modes" of supply through Art. I para. 2 is a good indication of the forms of supply that fall under the agreement. There are basically four main modes supported by the GATS, namely (1) cross-border supply of a service; (2) consumption of a service abroad; (3) commercial presence; and (4) the presence of natural persons.

The GATS will therefore cover for example FDI and IP licenses insofar as it involves a commercial presence for the supply of the services, that is, the creation of a branch office abroad that will, in this case, undergo a licensing agreement with the parent company. This corresponds to mode 3 indicated in the agreement, which is estimated to include around 56% of total world

[1294] Art. I para. 1 of the GATS.
[1295] Through the modes indicated in Art. I para. 2 of the GATS.
[1296] As indicated by Schön, Wolfgang (2004): WTO und Steuerrecht. In *RIW* (1), P. 51.
[1297] Art. 2 para. 2 OECD-MC.
[1298] On Art. XXVIII *lit*. "g" of the GATS, broadly and circularly defined as "any person who supplies a service".

trade in services.[1299] Similarly to the freedom of establishment within EU law, this specific area of protection within the GATS aims at ensuring that the service provider will be free to establish a commercial presence[1300] without discriminatory burdens in another jurisdictions, whilst mode 1, allowing for the cross-border supply of any kind of service, relates directly to the freedom to provide services.[1301]

One must not forget, of course, that ultimately the GATS is rather a contract in the making than a completed work,[1302] since it aims to achieve ever higher levels of liberalization through successive rounds of negotiation. This is clearly stated in Art. XIX para. 1 of the agreement, which of course does not in itself reduce its importance in tax matters. Even though it works as a framework agreement, the GATS contains a number of definitions and basic obligations of the Member States, such as those arising from most-favored nation – potentially much broader than the one present in the GATT[1303] –, to readily enable a broadening of the market with respect to trade in services. Furthermore, through the schedule of commitments of each individual Member, the concept of national treatment also gains prominence, especially due to the understanding that the scope of application of the GATS disciplines is extremely broad,[1304] where Article I para. 3 *lit*. "b" of the GATS provides that the term "services" includes *any* service in *any* sector.

It is therefore important to keep these features in mind in order to understand, interpret and analyze the importance of this treaty and its non-discrimination rules regarding provisions dealing with royalty payments. Considering the impacts on trade that the anti-avoidance measures under discussion have presented so far, in particular due to their potentially discriminatory character by differentiating between jurisdictions with a higher or lower effective tax rate, it is certain that their implementation has at least an indirect effect on the trade in services, which is more than enough to open up the application of the GATS on this tax issue. This is because there are only two key legal issues that must be examined to determine whether a measure is one "affecting trade in

[1299] Refer to Daly, Michael John (2016): Is the WTO a world tax organization? A primer on WTO rules for tax policymakers (Technical notes and manuals). Available online at http://www.imf.org/external/pubs/ft/tnm/2016/tnm1602.pdf, checked on 28.09.20, P. 26.
[1300] The different degrees of control are specified in Art. XXVIII *lit*. "n" GATS.
[1301] See Prokesch-Schachner (2006): Freedom of Establishment and Freedom. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 461ff.
[1302] On this same opinion, see Senti/Hilpold (2017): WTO, P. 422ff.
[1303] As in van Thiel (2005): General Report. In: Lang/Herdin/Hofbauer (Eds.) - WTO and Direct Taxation., P. 35.
[1304] See the decision on European Communities – Regime for the Importation, Sale and Distribution of Bananas (AB Report WT/DS27/AB/R, from the 25th of September 1997), para. 220f.

services", namely, (a) whether there is "trade in services" in the sense of Article I para. 2 and its modes; and (b) whether the measure in issue "affects" such trade in services within the meaning of Article I para. 1.[1305]

In view of the extensive effects that income taxation has on private sector economic behavior; and as the anti-avoidance measures involving royalty payments certainly affect taxes imposed on the income earned by the establishment set up in a given host state as a service supplier and subject to a licensing agreement; the legal requirements for the applicability of the GATS to these measures are fulfilled.

4.4.2.1 Applicability of non-discrimination rules and legal framework on royalty provisions

Non-discrimination provisions have a special significance within the framework of the World Trade Organization, which is evidenced by the explicit mention of this type of provision already in the preamble of the Marrakesh Agreement, responsible for the definitive establishment of the WTO as an international organization. Functioning on the one hand as an economic mechanism instrumental to trade liberalization and inefficiency prevention; and on the other as a political mechanism in order to avoid tensions in the international relations among Member States,[1306] those provisions constitute the core of the GATS – and of international trade law as a whole.

Therefore, as previously discussed, non-deductibility and withholding tax measures related to the cross-border payment of royalties have discriminatory elements that seem to conflict with this trade and investment framework.[1307] This type of questioning is not new, as ever since the OECD adopted a vanguard stance in the fight against base erosion and profit shifting – long before the BEPS project, to be traced back *e.g.* to the OECD 2000 report[1308] – it has been discussed

[1305] See the decision on Canada – Certain Measures Affecting the Automotive Industry (WT/DS139/AB/R and WT/DS142/AB/R, from the 31st of May 2000), para. 155.
[1306] See Diebold (2010): Non-discrimination in international trade in., P. 15ff.
[1307] As was discussed in Chapter 4.3.2. For more on this opinion, see also the review by Zagaris, Bruce (2020): Book Highlights the Interplay of Harmful Tax Competition Policies With Trade and Investments Law. In *Tax Notes International* 99 (6), P. 781ff.
[1308] OECD (2000): Towards Global Tax Co-operation. Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs. Available online at https://www.oecd.org/ctp/harmful/2090192.pdf, checked on 13.04.21.

whether defensive measures in the form of anti-tax avoidance rules would be inconsistent with the GATS non-discrimination principles.[1309]

Ultimately, this question cannot be comprehensively and unreservedly answered on its own, but must be analyzed for each provision in the concrete case. This requires, moreover, a closer look at the particular tax carve-outs in both regimes, as well as at the specific exceptions provided for each one[1310] and the respective possibilities for justifying these measures.

Differently from what occurs in BITs and even in the GATT itself, the national treatment rule under the GATS cannot be considered a general commitment by the Member States, as it will apply only to the sectors expressly specified in the schedules, being also subject to the limitations listed therein. Conversely, the most-favored nation provision is a general obligation that applies to all measures affecting trade in services, with few exceptions, being even broader than the provision found in other agreements of similar nature. These rules are ultimately intended to protect not only services, but also the suppliers of said services, against discrimination that has origin at its base.[1311]

Considering the broad range that a provision such as the MFN has in the GATS, it is most likely the one to be triggered when dealing with tax anti-avoidance rules. Nevertheless, the measures under discussion must undergo proof regarding both provisions in order to eventually be considered compatible with WTO law.

4.4.2.1.1 Anti tax-avoidance rules in the context of the most-favored nation concept

The MFN provision, provided for in Art. II para. 1 of the GATS, is certainly one of the most essential principles that form the foundation upon which this agreement is built. Moreover, this was also the first time that such a non-discrimination provision was introduced in a multilateral agreement governing the international trade in services.[1312] This was done in a broad and almost unrestricted manner, ensuring an *immediate* and *unconditional* no *less favorable* treatment to *any*

[1309] Refer to Hofbauer, Ines (2004): To what extent does the OECD harmful tax competition project violate the most-favoured-nation obligations under WTO law? In *European Taxation* 44 (9), P. 402f.
[1310] To be discussed in Subsection 4.4.2.2.
[1311] See Daly, Michael John (2016): Is the WTO a world tax organization? A primer on WTO rules for tax policymakers (Technical notes and manuals). Available online at http://www.imf.org/external/pubs/ft/tnm/2016/tnm1602.pdf, checked on 28.09.20, P. 26f.
[1312] Wang, Yi (1996): Most-Favoured-Nation Treatment under the General Agreement on Trade in Services - And its Application in Financial Services. In *Journal of World Trade* 30 (1), P. 96ff.

measures[1313] applicable to services *or* service suppliers than it is accorded to *like* services and service suppliers of *any* other country.

This comprehensive definition ensures that its beneficiary can claim the most favorable treatment immediately from the moment it is granted to any third party, and there is no need for any form of compensation, due to its unconditional nature.[1314] However, it is certainly the idea of less favorable treatment linked to the likeness between services or service suppliers that is the precondition that carries out the effects of the whole provision. Member States are therefore obliged to extend more favorable treatment – for example, the absence of withholding taxes on cross-border payments – if it is granted to a third state in transactions involving service or service suppliers in like situations.[1315]

It is worth noting, however, that the concept of what would be likeness in the scope of services is much more complex than in the context of trade with goods, since services involve intangible processes that make it difficult to determine their exact content – much like intangibles in general –, not having clear physical characteristics like their counterpart.[1316] Hardly two services or service suppliers will have "likeness" in all of their aspects, even if they are from the same sector. In particular when dealing with services involving licensing agreements and intellectual property, the uniqueness of each asset makes it so that it is very difficult to determine likeness, which should be evaluated on a case-by-case basis.[1317]

However, the MFN principle ensures that benefits granted to one member must be extended to all members,[1318] which includes the treatment conferred to internal taxes or other internal

[1313] It covers any measure unless explicitly exempt (negative list approach).
[1314] Refer to Falzon (2006): Most-Favored-Nation Treatment in the GATS. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 127f.
[1315] It is worth noting that an MFN clause in (tax) treaties in general is seen as unproblematic between developed countries, but much more troublesome when involving developing countries, especially the source country. Refer to Paez, Sarah (2021): Most Favored Nation Clauses Problematic for Developing Countries. In *Tax Notes International* 103 (5), P. 632.
[1316] See Abu-Akeel, Aly (1999): The MFN as it Applies to Service Trade. New Problems for an Old Concept. In *Journal of World Trade* 33 (4), P. 109ff.
[1317] The last case in which the WTO discussed the term "likeness" in a more comprehensive fashion was in *European Communities - Measures Affecting Asbestos and Products Containing Asbestos* (WT/DS135/12, from 11th of April 2001). However, this decision was based on the likeness of products, and even though some scholars argue that the GATT case law should be used to interpret GATS as well, this does little to no good when dealing with the likeness in services. On the cross-reference usage of case law, see Olsen (2006): GATS - National Treatment and Taxation. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 115.
[1318] With a few exceptions, to be discussed in Subsection 4.4.2.2.

charges of any kind.[1319] If these taxes discriminate in any way – be it *de jure* or *de facto* discrimination[1320] – between different trading partners, there may be a violation of MFN.

a) Evaluation of anti-avoidance rules within the MFN principle

This brings us to a specific analysis of the anti-avoidance rules under discussion, starting with withholding taxes, whether designed as a subject-to-tax clause or broadly considered. Much like what happens with bilateral investment treaties, a broad-specter withholding tax presents fewer problems with respect to the MFN principle precisely because it harmonizes the tax treatment accorded to all trade partners. If there is no differentiation in the withholding rate between the different countries, there will be no possibility to claim discrimination that would eventually violate the MFN treatment.

This harmonized scenario is, however, rather unlikely, since this extensive application of the MFN principle within a multilateral agreement such as the GATS would effectively subvert the bilateral nature of a country's tax treaty network.[1321] If, within a DTT, one country gives another country a more beneficial treatment with respect to withholding taxes on cross-border royalty payments than with respect to a third country, the latter could find a remedy under the GATS MFN obligation, by establishing that its treatment is not equal to the most-favorable one offered by the first country to its trading partners. It was precisely with this problem in mind that exceptions were created (Art. XIV *lit*. "e" GATS) for tax treaties and general exemptions from the MFN (Art. II para. 2 GATS), to be discussed in further depth on Subsection 4.4.2.2.

Nonetheless, the problems linked to WHT are not only restricted to a possible preferential treatment conferred through a tax treaty, since, if a more targeted answer in the form of a WHT as a subject-to-tax clause is decided upon, which may arise from national tax law provisions alone, this provision would hardly escape the MFN framework. One of the most recent cases decided by the WTO in this context was *Argentina – Measures Relating to Trade in Goods and Services*[1322], in which one of the main measures under discussion was a withholding tax on payments of interest

[1319] As stated by Falcão, Tatiana (2021): Ensuring an EU Carbon Tax Complies With WTO Rules. In *Tax Notes International* 101 (1), P. 44.
[1320] Refer to Diebold (2010): Non-discrimination in international trade in., P. 35ff. and 53.
[1321] As indicated by Farrell (2013): The Interface of International Trade., P. 81ff.
[1322] WT/DS453/12, from the 11th of May 2016.

or remuneration that was applied to services and service suppliers of non-cooperative jurisdictions trading with the country. This WHT would not allow for any evidence to the contrary.

Initially, the Panel decided that such a WHT is inconsistent with Art. II para. 1 of the GATS, since Argentina accorded less favorable treatment to services and service suppliers located in non-cooperative jurisdictions than the one it accorded to like services and service suppliers of cooperative jurisdictions.[1323] The focal point of this interpretation is that these withholding taxes affected *like* services and suppliers *exclusively* due to their origin, which indicates the basic requirements for a measure to be considered incompatible with MFN within the GATS.

This understanding was, however, reversed by the Appellate Body at a later decision, as it asserted that in its analysis under Art. II para. 1 of the GATS, the Panel did not make a finding that the distinction between cooperative and non cooperative countries in the measures at issue was based exclusively on origin. In this case, it would be necessary for the Panel to undertake an analysis of likeness on the basis of different criteria linked to the competitive relationship of the service suppliers and services between cooperative and non-cooperative jurisdictions.[1324] This increases the complexity of proving likeness significantly, since precisely the characteristic that allows the elaboration of aggressive tax planning structures using IP in the first place[1325] – it's uniqueness – might represent its demise when looking for coverage within the GATS MFN principle.

This arises because, unlike the likeness requirements contained within BITs, which deal with like *circumstances* between investments and investors, the MFN provision of the GATS requires that the treatment be accorded to like *services and service suppliers*. This apparently harmless nuance may, in fact, cause the requirements foreseen by the GATS not to be met when it comes to a unique service provided by a given supplier through its intangible assets, since there will hardly be a comparable service or supplier in the market. The (scarce) jurisprudence of the Panel considers, in general, that suppliers are alike if they supply for "like" services, but there is little information about which are the characteristics of a supplier that should be taken into

[1323] See para. 7.293 of the WT/DS453/R.
[1324] See para. 6.1.6.1ff. of the WT/DS453/AB/R.
[1325] Discussed in Chapter 1.4.

consideration in this analysis,[1326] besides a possible competitive relationship between service providers.

In other words, aside from it being more difficult to prove likeness within the GATS when compared to provisions contained in BITs due to the use of different terminology, distinctions with respect to taxation may also represent within the WTO agreements a barrier to the comparability required by the MFN principle, since it directly affects the competitiveness among service providers. Therefore, in addition to *e.g.* company size, sales volume and type of services provided, the presence of entirely different tax treatments depending on the jurisdiction could represent a distinctive feature between services and service suppliers for MFN purposes.

On the other hand, the Appellate Body has made it crystal clear in past decisions that, even if a measure pursues entirely legitimate policies – such as anti-tax avoidance – and does not have design features that make it inherently discriminatory – such as an apparently equal application to national and cross-border cases alike –, the aims and effects of a measure are not relevant in any form when determining whether that measure is inconsistent with GATS provisions.[1327] This means that not only for WHT, but also for royalty deductibility barriers the main criterion that will determine whether or not these measures are compatible with the MFN treatment will be the determination of "likeness".

The objectives pursued by the rule are relevant only insofar as they indicate that less favorable treatment does not occur exclusively on the basis of national origin, but rather other criteria, in this case in the form of anti-avoidance provisions linked to the respective effective tax rates of the Member States.[1328] Subject-to-tax provisions such as a specific WHT or a royalty barrier therefore have concerns regarding their compatibility with MFN inasmuch as the likeness between services (on mode 1) or service providers (on mode 3) is confirmed by the Panel. This test is challenging to the extent that the uniqueness of the services tied to intangible assets, combined with the competitive differences promoted by preferential tax treatments within some

[1326] See Diebold (2010): Non-discrimination in international trade in., P. 253ff.
[1327] See, for instance, European Communities – Regime for the Importation, Sale and Distribution of Bananas (WT/DS27/AB/R), paras. 240ff.
[1328] As was argues by the US in United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services (WT/DS285/R), paras. 6.422f.

jurisdictions and the consequent creation of a tax edge will most likely lead to the *unlikeness* of services.

However, this analysis must be made in each specific case, and from the moment on that likeness is established,[1329] the differentiated treatment[1330] regarding *e.g.* the deductibility of cross-border royalty payments will constitute a less favorable treatment for one of the countries involved and, therefore, violate the GATS MFN provision. This occurs because, by differentiating the treatment given to subsidiaries within the national territory based on the tax treatment to which the parent company is subject to, less favorable treatment will occur among the cases in which there is a partial or total restriction on the possibility of deducting business expenses in relation to the other Member States that do not lead to the activation of such a restriction.

Finally, similar to what occurs in the treatment of the MFN provision within BITs, the proposal of an inverted tax credit system would hardly be considered incompatible with the GATS – even though not directly addressed by *Lodin* himself[1331] –, since even if there is likeness between services or service providers, the requirement of a less favorable treatment will not be met. As royalty payments cannot be deducted as business expenses for any of the companies, regardless of their origin, there would be no discriminatory or "less favorable" treatment arising from this rule.

However, there may be some concerns regarding the criteria for granting the tax credit in lieu of deductibility which, although the same for all countries, are based on the tax rate of the entity receiving the payment. While this is a sole responsibility and competence of the jurisdiction of residence of this entity, it is possible to imagine that, for some, this would constitute an indirect discrimination that would lead to less favorable treatment as defined by Art. XVII para. 3 GATS, that is, a different treatment that modifies the conditions of competition. Since the tax credit will be different in each international case based on the ETR of the jurisdiction, this might indirectly distort the competition between corporate groups.

[1329] It is however still unclear, despite the usage of allegedly objective methods, whether the concept of likeness mandates for services in another State to be entirely equal or comparable, or if a general resemblance would be enough.
[1330] Here it is spoken of a *de facto* differentiated treatment, as the provision itself does not draw distinctions.
[1331] See Lodin, Sven-Olof (2011): Intragroup Lending in Sweden - A Vehicle for International Tax Arbitrage. In *Tax Notes International* (62), P. 177ff.; and Lodin, Sven-Olof (2013): Intragroup Royalties as Vehicles for International Tax Arbitrage. In *Tax Notes International* (71), P. 1317ff.

In the way it is structured, nevertheless, the rule proposed by *Lodin* would seem to ensure an equitable treatment on a larger scale when compared to the other alternatives discussed by simply preventing the deductibility of all entities involved, this being the baseline treatment, that does not in any way differentiate between national and/or international taxpayers. The tax credit to be granted will always be a compensation[1332] equal in magnitude to the tax to which the payment was ultimately subject to, which, intuitively, would ensure that this would not lead to a less favorable treatment, as the tax results within the corporate group will always be neutral in nature, not leading to a competitive disadvantage.

Finally, it should not be forgotten, of course, that even if the requirements for a given case to be covered by the MFN provision within the GATS such as likeness and less favorable treatment are met, there are many exceptions to this application within the treaty itself. In the event that one of these exceptions is applicable, there will naturally be no incidence of the MFN and, therefore, no violation of WTO law. This will be further discussed in Chapter 4.4.2.2.

4.4.2.1.2 Anti tax-avoidance rules in the context of the national treatment provisions

Regulated in a special way within the GATS framework is also the national treatment provision in Art. XVII, which functions differently from its GATT version, which obliges all parties to grant no less favorable treatment to products and suppliers than is accorded to their national counterparts. The path chosen for the protection of services in the context of the GATS leaves much to be desired, since, in principle, national treatment will *not* be applied within the agreement *unless* a Member State has individually assumed this obligation – in a horizontal and sector-specific manner – in a positive list in the form of a schedule of commitments.[1333]

From the point of view of protecting the cross-border supply of services, the need for such a list is highly detrimental, since not only does it reduce the scope of protection of the standard to a handful of sectors, but it also prevents it from being possible, without new negotiations, to cover innovative branches of service supply that are relatively common when dealing with IP. This means that new forms of service are not automatically included in the scope of the national

[1332] It is open to discussion whether it is reasonable to expect this kind of compensation in a WTO law context. However, at least considering the structure of *Lodin's* rule, it will ensure compensation as it is provided by the very country that introduced the general rule for the purpose of anti-avoidance.
[1333] See, for instance, Senti/Hilpold (2017): WTO., P. 423.

treatment provision, and those that have already been included are still subject to any conditions and qualifications set out therein.

Although it is thereby not a general commitment, the national treatment obligation, as long as it is provided for in the schedules of a Member State, will apply to any and all tax measures, including tax incentives, which adversely affect the trade in services.[1334] This means that, while the *scope* of application of the national treatment is (very) limited within the GATS as to the type of service to which it applies, that from the moment it is relevant, both services and service providers will be protected against (a) all measures affecting trade with (b) a less favorable treatment that impacts, directly or indirectly, the conditions of competition with respect to their (c) "like" national counterparts.

As with the MFN provision, one of the most complex aspects to demonstrate on an alleged violation of the national treatment standard is the likeness of services and service providers.[1335] This is the case since "all measures" certainly also includes national anti tax-avoidance provisions, which in turn end up incurring, as a rule, in some form of less favorable treatment to services or service providers that are subject to a lower effective tax rate in connection with aggressive tax planning structures. Thus, all that remains is the proof of likeness between the comparable services – if, of course, (a) the service sector or subsector is present in the schedule of commitments; (b) the particular mode of supply of this service is also subject to national treatment; and (c) there are no specific or horizontal limitations excluding the applicability of tax treatment to NT.[1336]

Art. XVII GATS and the sparse jurisprudence of the Appellate Body shed a little light on the interpretation of this notion of likeness, since para. 3 of this article, as well as the decision in *EC – Bananas III*[1337] indicate that the national treatment standard was devised to ensure equal competition conditions between domestic and foreign services and suppliers. Logically, such

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[1334] Unless, of course, some of the other exceptions to this principle apply, to be discussed in Subsection 4.4.2.2.2. See also Daly, Michael John (2016): Is the WTO a world tax organization? A primer on WTO rules for tax policymakers (Technical notes and manuals). Available online at http://www.imf.org/external/pubs/ft/tnm/2016/tnm 1602.pdf, checked on 28.09.20, P. 27ff.
[1335] See the previous Subsection.
[1336] Refer to Farrell (2013): The Interface of International Trade., P. 189f.
[1337] *European Communities – Regime for the Importation, Sale and Distribution of Bananas* (WT/DS27/AB/R), paras. 244ff. It is also generally accepted for GATT NT jurisprudence to be used, where applicable, to the GATS NT provision. Refer to Olsen (2006): GATS - National Treatment and Taxation. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 115f.

conditions of competition that indicate a less favorable treatment may only be modified in a discriminatory manner in the hypotheses in which distinct services or service suppliers are in a competitive relationship in the first place.

Thus, the concept of likeness is intrinsically linked to the possibility of competition between services or suppliers in a specific market, which indicates an economic interpretation of the term with respect to national treatment.[1338] This market-based standard approach indicates that merely objective distinctions between services and providers – unlike the one for products within the GATT – will hardly be of relevance when determining likeness.[1339]

Furthermore, while proof of likeness will inevitably only occur in each concrete case just as for the MFN principle, a further specific hurdle is imposed for the NT through the schedule of commitment itself. Unlike the GATT schedules, which usually consist of little more than a list with the numbers of different products and possible import duties acceptable for each one, GATS schedules are much more complex and individualized, varying greatly from one Member State to another.

Assuming that the analysis of compatibility with the national treatment provision is based on a service whose sector and mode of supply has been included without exception in the schedule of commitments, one can assess whether or not there is a violation of the GATS agreement. Starting as usual with withholding taxes, if there is likeness between services and/or suppliers, only a broad-spectrum WHT that is applied to cross-border and national cases alike would be compatible with the national treatment standard. However, even in these cases, if a withholding is imposed on the gross amount of source income while the national taxpayer is taxed at a normal rate on net income, there would potentially be a violation of the national treatment requirement of Art. XVII GATS.[1340] In general, gross-basis measures are considered a poor proxy for net-basis direct taxation,[1341] but specifically in this case there are still noticeable complications with WTO law.

[1338] As defended by Englisch (2012): Wettbewerbsgleichheit im grenzüberschreitenden Handel, P. 408ff.
[1339] Diebold (2010): Non-discrimination in international trade in., P. 124ff.
[1340] Much like with the violation of the freedom to provide services decided within the EU for interests in *Brisal* and *KBC* v *Fazenda Pública* (C-18/15).
[1341] See Goulder, Robert (2019): BEPS and Withholding: Unlikely Bedfellows. In *Tax Notes International* 94 (7), P. 678ff.

A WHT as a subject-to-tax clause, therefore, could even more hardly be considered to be readily compatible with the NT provision, since there would be no need to withhold taxes on purely domestic transactions, whilst this requirement would be triggered in some of the cross-border cases. These more targeted anti-avoidance measures aimed at the protection of a country's tax base that already possibly had problems with the MFN principle also have the potential to breach the GATS national treatment obligation if they are not simultaneously applicable to national cases, something that is contained within the very nature of these anti-avoidance provisions.

Following this line of reasoning, royalty deduction barriers would also be at first sight incompatible with the NT obligation, since their applicability would be not formally, but materially restricted only to those cases of a cross-border nature. Thus, there would be a *de facto* less favorable treatment when dealing with like services or service suppliers, prohibited by Art. XVII GATS. As the difficulties faced by these rules are similar to those related to MFN, the "safest" measure is once more the inverted tax credit system, in which the standardization of the deduction system – which disappears completely – ensures that the treatment between national and foreign services or providers will be exactly the same, with the exception of the amount paid as credit.

Furthermore, the argument that granting a different tax credit instead of the deduction due to different ETRs is a violation of the NT obligation, despite the basic rule being the same for every taxpayer, is weakened by the official footnote nº 10 of the GATS on Article XVII. It clearly states that the commitments made under the NT obligation will not be construed so as to require a Member to compensate for *inherent competitive disadvantages* resulting from the foreign character of the service or service supplier. In a way, the granting of a tax credit for international providers below the amount granted nationally is a consequence *inherent* to the foreign character of this service or service supplier, since it is in its jurisdiction of residence where it will naturally be subject to (lower) taxation. Thus, not only will there not be a competitive disadvantage due to the neutral aspect provided by this system, but possibly the NT provision might have no application altogether.

It can be seen that the national treatment obligation contained in the GATS could be highly litigious within the WTO law framework, as is the freedom of establishment and freedom to provide services in the European context. With this in mind, the Member States, in their negotiations, fiercely restricted its applicability not only by the need to draw up individual

schedules of commitments, but directly through exceptions provided for in the main body of the agreement. These exemptions will now be in the forefront of the analysis, to determine to what extent the scope of the NT and MFN provisions are limited by them.

4.4.2.2 Exception provisions

In addition to determining whether the anti-avoidance rules under discussion fall within the scope of the MFN and NT provisions in the first place, it is necessary to assess to what extent the exceptions to these provisions – whether in the form of general exceptions, tax carve-outs or presence in schedules of commitments – exempt these anti-avoidance provisions from a violation of the GATS. The part of the GATS with general obligations and duties has, at first glance, four main fields of exception, with different scopes. Arts. XII and XIII regulate the possibility of imposing restrictions to safeguard the balance of payments and rules on government procurement, respectively. Arts. XIV and XIVbis correspond roughly to Arts. XX and XXI of the GATT, dealing with general exceptions and with the protection of a Member States' national security.

These are not, however, the only exceptions within the GATS, as there are some specific provisions within the MFN and NT principles themselves. While these broader exceptions are often of less relevance to the issue of anti tax-avoidance measures, some of the general exceptions in Art. XIV have direct applicability to tax matters. As the MFN and NT standards differ significantly not only in their general scope but also in their limitations, both provisions ought to be studied carefully to determine whether and to what extent they are actually applicable to anti-avoidance measures addressing royalty transactions.

4.4.2.2.1 Influence of MFN GATS exemptions and direct carve-outs on taxes

There are two main ways to avoid the MFN obligation within the GATS, namely (a) through the exceptions provided within Art. II itself; and (b) through the general exceptions provided throughout the GATS. While Art. II para. 3 has a clear exemption for advantages conferred to adjacent countries that have a general objective of facilitating exchanges between contiguous frontier zones of services – hardly applicable to anti-avoidance rules –, para. 2 of this same article was created with the intention of securing the adherence of countries during the Uruguay Round discussions.

This was because it was clear that unrestricted liberalization in some service sectors would be impossible, and it was preferable to allow some (supposedly) temporary exceptions than no liberalization at all.[1342] This is a recurrent problem in multilateral discussions, as seen in relation to the GloBE proposal in Chapter 3.4, where multiple concessions often have to be made, undermining the strength of the main objective, or else there would be no consensus at all about its implementation. Thus, Art. II para. 2 of the GATS allowed countries to maintain, after meeting certain requirements, existing rules that may violate the MFN standard by including them in an Annex on Article II Exemptions. This option only had two routes for being obtained in the first place, namely through a one-off opportunity *before* the entry into force of the GATS; or, after that, through the complex waiver procedure[1343] of Art. IX of the Agreement Establishing the WTO.

Although there are multiple discussions regarding these exceptions, where many of them *e.g.* do not meet the requirements of being limited to a 10-year period with the stipulation of a specific date,[1344] the anti-avoidance measures under discussion are all relatively recent and targeted at a problem that has not arisen but had a surge in the past decade only. Thus, it is to be expected that these exceptions would also hardly apply to any of the anti-avoidance measures relevant to royalties, since, for an inclusion in the annex, it is necessary that not only a time limit is set, but that there is a description of the measure and the sector or sectors to which it applies, as well as the countries to which the measure applies and *why* there is a need for such an exemption.

Considering the specificity required for the implementation of an exception, one can state with relative certainty that they will hardly be applicable for WHT, royalty barriers and even less for the revolutionary inverted tax credit system, although it is worthwhile to exercise a control of the Annex in each concrete case. When it comes to tax exemptions, only 19 WTO-Members have included regulations of this nature, and while all of them but one were implemented for an indefinite period of time – the one by the EU ceased to be valid on January 2005 – most of the

[1342] Refer to Kovačič (2006): The Influence of Exemptions from. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law, P. 151f.
[1343] For more information, see Senti/Hilpold (2017): WTO, P. 402ff.
[1344] Only 9 out of 424 exemptions were said to apply for a duration of 10 years. Many of those exceptions simply have an undetermined validity. See more on this discussion in Sauvé, Pierre (1995): Assessing the General Agreement on Trade in Services. Half-Full or Half-Empty? In *Journal of World Trade* 29 (4), P. 134f.

restrictions imposed are directed at the transport sector only,[1345] of low significance for the anti-avoidance measures under discussion.

The only country with an exception to the MFN that could possibly cover anti-tax-avoidance measures is the US, which is known to have implemented the largest number of exceptions in the Annex in an extremely broad manner, including all countries within the scope of application of (tax) measures inconsistent with Article II. Under the guise of fostering efficient international taxation policies, the US exempts itself from liability for violation of the MFN principle through "measures permitting less favorable taxation for [...] corporations of a foreign country based on discriminatory or extraterritorial taxes, more burdensome taxation or other discriminatory conduct".[1346] Quite broad in nature, this exception, if one considers the corporate group as a whole being impacted by discriminatory measures linked to international taxation policies such as the combat against base erosion and profit shifting, could justify basically *any* anti-avoidance measure.[1347]

However, this ensures that only one country could, in theory, completely evade the scope of application of the GATS MFN provision through anti-avoidance measures. This means that, as a rule, promoting compatibility of such measures through the exceptions defined in the Annex on Article II Exemptions is not feasible. While this reinforces, on the one hand, the transitory character of this agreement, in contrast to that of a finished product, the lack of specific MFN tax exemptions may be considered a result of the confidence that other Member States have in the tax carve-outs foreseen within the GATS itself to protect their tax sovereignty.[1348] This only leaves, therefore, an analysis of these exemptions inscribed in the body of the GATS itself, such as the rules on economic integration of Art. V; labor markets integration agreements of Art. Vbis; mutual recognition of standards for services of Art. VII; alongside the general rules from Arts. XII to XIVbis.[1349]

[1345] In the Annex of countries such as Canada, Estonia, Turkey, Thailand and so on.
[1346] General Agreement on Trade in Services (1994): United States of America: Final List of Article II (MFN) Exemptions. GATS/EL/90.
[1347] The rules adopted by the US in this respect, however, have a different structure than the ones discussed in this subsection and are therefore outside the scope of this chapter. For more information on rules such as the BEAT and GILTI, refer to Subsection 3.2.2.3.
[1348] As defended by Farrell (2013): The Interface of International Trade., P. 185ff.
[1349] As mentioned in the previous subsection.

Most of these exceptions are not directly related to tax measures, but aim at promoting regional integration, as is the case of Arts. V and Vbis; or protect cases in which government procurement of services occurs, as foreseen in Art. XIII. Of special relevance to MFN in tax matters is, however, Art. XIV *lit*. "e", which provides for a direct tax carve-out for the MFN principle if the difference in treatment results from an agreement on the avoidance of double taxation or, more generally, provisions that deal with double taxation in international agreements as a whole.

This means that, under this provision, a Member State is allowed to deviate from the MFN obligation if these apparently inconsistent measures are based on a DTT and satisfy the *chapeau* conditions of Art. XIV.[1350] However, considering the scope of application of the DTTs for the anti-avoidance measures under analysis, only withholding taxes would possibly benefit from this exception, where a Member State could not claim a more beneficial treatment with respect to withholding arising from a treaty – *e.g.* through Art. 12 OECD-MC – with another Member State. Very similar to the tax carve-out for tax treaties commonly present within BITs, the discussions regarding WHT and MFN within the GATS go in the same direction, whereby only in cases where the disadvantage arises from rules provided for in a tax treaty will the exception be activated.

As the main distinctions in treatment present among various DTTs are usually linked either to WHT, capital gains or permanent establishments,[1351] rules such as the royalty deductibility barriers and, of course, the inverted tax credit system will hardly find shelter within DTTs to open the scope of application of Art. XIV *lit*. "e" GATS. While the impact of MFN obligations is already rather limited in the context of WHT within DTTs, since a foreign tax credit based for instance on Art. 23B OECD-MC in combination with some sort of withholding foreseen in Art. 12 OECD-MC would basically constitute a neutral allocation of taxing rights between States rather than a discrimination,[1352] this exception provided by the GATS ensures that tax treaties remain largely untouched by WTO-law.[1353]

[1350] The *chapeau* will be further discussed in Subsection 4.4.2.2.3.
[1351] See for instance Kumar (2006): Scope of Art. XIV:d. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 217.
[1352] For more on this discussion, refer back to Subsection 4.3.3.2.2.
[1353] See Schön, Wolfgang (2004): WTO und Steuerrecht. In *RIW* (1), P. 51ff.

However, a problem that arises with this exception under Art. XIV *lit*. "e" GATS is with respect to its scope of application. While some authors interpret this rule as excluding all the norms contained in the DTT from the scope of application of the MFN obligation,[1354] others are skeptical of this possibility,[1355] and include only those provisions that deal directly with double non-taxation in the scope of this exception. In the case of any other treaty that is not a DTT, there is a general consensus that only those norms on the avoidance of double taxation will be protected against the MFN obligation.

This is relevant to the extent that a provision such as Art. 24 OECD-MC, which deals with non-discrimination between nationals of one contracting state and of another, instead of directly with double taxation, could be outside the scope of the exception provided within the GATS. If this were to be the case, a third country could claim, through the MFN principle, to be treated not less favorably than another nation and use the non-discrimination provision contained within Art. 24 OECD-MC – rather similar in structure to a national treatment obligation. A preposterous idea, as it would allow Member States to get access to a quasi-national treatment provision – which is highly restricted within the GATS itself – in a transversal way, through the combination of the MFN principle and a provision of a DTT that does not directly deal with double taxation.[1356] It seems safe to assume that this was not an intended result throughout the negotiations that lead to the elaboration of Art. XIV *lit.* "e" GATS, and therefore, at least in this case, the scope of this exception should encompass all rules contained within the DTT.

The result for the anti-avoidance rules under discussion should thus be roughly the same: anti tax-avoidance measures that promote differential treatment among taxpayers are susceptible of being challenged by WTO law due to the most-favored nation obligation. This means that, while the provisions of tax treaties and those related to double taxation are excluded from the scope of the GATS, specific domestic tax regimes such as the ones being debated are still largely affected

[1354] As defended by Cockfield, Arthur; Arnold, Brian J. (2010): What can Trade Teach Tax? Examining Reform Options for Art. 24 (Non-Discrimination) of the OECD Model. In *World Tax Journal* 2 (2), P. 143ff.; and Kumar (2006): Scope of Art. XIV:d. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 219f.
[1355] Stated by Farrell (2013): The Interface of International Trade., P. 186f.; and van Thiel (2005): General Report. In: Lang/Herdin/Hofbauer (Eds.) - WTO and Direct Taxation., P. 37.
[1356] The possibility of invoking the national treatment provision within the GATS is also restricted by Art. XXII para. 3 GATS (Consultation) if the measure falls within the scope of a treaty merely *relating* to the avoidance of double taxation.

by the MFN principle, since the exception contained in Art. XIV is not applicable to them.[1357] This will therefore still restrict the possibility of using measures such as (nationally provided) conditional WHT and royalty deductibility barriers due to Art. II GATS in cases of like services and/or service providers, as discussed in the previous subsections.

4.4.2.2.2 Direct tax carve-outs in the NT of GATS

The problems concerning the exceptions foreseen for the national treatment obligation within the GATS are of a simpler and more straightforward nature when compared to its MFN counterpart. Apart from the enormous hurdle that is the need for WTO Members to include NT commitments in their schedules in the first place, these commitments will apply to tax measures, including tax incentives, *except* where such measures are aimed at ensuring "the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members", as stated in Art. XIV *lit*. "d" GATS.

The meaning of "equitable or effective" is further spelled out in footnote 6 to this provision, in a very broad fashion. Especially item (iii) deserves further attention, as it includes measures that apply both to non-residents or residents with the ultimate goal of preventing the avoidance or evasion of taxes, with additional reference to the tax definitions under domestic law of the Member State that decides to take a certain measure. This provision is unparalleled within the GATS, especially when taking into consideration the MFN principle.

This means that the respective WTO Member will be responsible for tax concepts and measures involving avoidance, which are automatically excluded from the scope of the national treatment obligation. This is a breath of fresh air for the tax measures under discussion, which, if properly designed[1358] with a clear nature aimed at combating base erosion and profit shifting, will not have to fear, at least within the context of the GATS NT, about violations of WTO law. All rules, in particular a (conditional) WHT and the royalty deductibility barrier benefit from this exception, whilst further ensuring that the inverted tax credit system[1359] is also compatible

[1357] Refer to Falzon (2006): Most-Favored-Nation Treatment in the GATS. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 127ff.
[1358] More on this discussion, refer to Chapter 5.
[1359] *E.g.* through sub-item "v" of Footnote 6 to Art. XIV *lit*. "d" GATS.

regardless of the interpretation one gives to the importance of granting the tax credits as equal treatment.[1360]

Hence, Art. XIV *lit*. "d" can be interpreted as a rule that gives a greater degree of freedom to the tax practices of WTO Members, protecting their tax sovereignty and removing the GATS rules as an obstacle to domestic tax policies, especially if these measures have as their ultimate goal the protection of a Member State's tax base against profit shifting.[1361]

Furthermore, a second and final exception can be found in Article XXII para. 3 GATS on Consultation, as according to it a Member may not invoke the NT obligation if a measure of another Member falls within the scope of a treaty relating to the avoidance of double taxation, which further adds to the ease of implementing anti-avoidance measures. This would be of usage especially for rules on WHT foreseen within the tax treaty themselves, hardly debatable in the first place, considering they have been bi- or multilaterally accorded on.[1362]

One can see, therefore, that regardless of the inclusion in the schedule of commitments by the Member States, that anti tax-avoidance rules, unlike what happens with the MFN principle, do not present problems in light of the NT obligation of the GATS. Whilst such rules will most likely be compatible with the NT due to its GATS exception, a last bastion of protection to these obligations should, however, be analyzed, since the exceptions foreseen in Art. XIV GATS have applicability only in cases where compatibility with its *chapeau* is assured.

4.4.2.2.3 The requirements of the *chapeau vis-à-vis* tax anti-avoidance rules

The rule presented under the *chapeau* of Art. XIV GATS – identical to Art. XX GATT – represents a further requirement for the exceptions indicated in its subtopics to be applicable, in the form of a reasonableness test, or an exception for exceptions. It reflects the policy objectives recognized by Member Countries as legitimate, but that might still violate WTO law if there is an "abuse" of the exemptions foreseen within Art. XIV itself.[1363] That is to say that the provisions

[1360] For more practical examples regarding the various measures affected by this exception, refer to Kumar (2006): Scope of Art. XIV:d. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 224ff.
[1361] See Farrell (2013): The Interface of International Trade., P. 193f.
[1362] There are no real conflicts between the multilaterality of the WTO agreements and the bilaterality of DTTs, as indicated by Schön, Wolfgang (2004): WTO und Steuerrecht. In *RIW* (1), P. 51.
[1363] Galán (2006): The Meaning of "Arbitrary and. In: Lang/Herdin/Hofbauer (Eds.) - The Relevance of WTO Law., P. 196ff.

contained on Art. XIV *lit*. "d" and "e" are not absolute tax carve-outs. Much like a FET clause within BITs, this provision seeks to ensure that a given discrimination cannot be arbitrary or unjustifiable, or represent a disguised restriction on trade in services. This means that, unless the minimum requirements of this part of Art. XIV are met, the other exceptions – including those linked to anti-avoidance rules – may not be used.

For this to be determined, a two-part test is usually applied, where (a) the provision will be rejected under the *chapeau* if it is imposed in an arbitrary or unjustifiable manner that discriminates between countries when the same conditions prevail; or (b) if the measure is recognized as a disguised restriction on trade in services. The Appellate Body has pronounced that an arbitrary measure is one that is "capricious, unpredictable, or inconsistent",[1364] which would certainly not be the case with any of the anti-avoidance measures under discussion. With a clear-cut objective of protecting their tax base against profit shifting, and ensuring that royalty payments will be relevantly taxed at least once, those measures are predictable and consistently targeting aggressive tax planning structures within a multinational corporate group, commonly using the effective tax rate as a proxy.

This ensures that the standards would not be imposed in an arbitrary or unjustifiable manner between countries *when the same conditions prevail*, since the conditions in each case will be different due to the tax treatment given to the amounts derived from royalty transactions in the payee's country of residence. This means that this measure may be discriminatory – and therefore must be justified within the subparagraphs of Art. XIV GATS – but not necessarily arbitrary.[1365]

Another crucial component of the arbitrariness analysis is the (lack of) flexibility that a given standard possesses. An anti-avoidance provision that guarantees Member States or taxpayers directly affected by the rules the opportunity to demonstrate that the corporate structure adopted is not an aggressive tax planning one, and that the requirements for no/lower withholding, or for the deductibility of royalties to be granted, are met, is one step closer to demonstrate that the measure is not arbitrary.[1366]

[1364] See the report on the famous decision *United States – Import Prohibition of Certain Shrimp and Shrimp Products* (Panel Report WT/DS58/RW), para. 5.124.
[1365] This test was also conducted by the AB in *US – Shrimp* (WT/DS58/AB/R), para. 160ff.
[1366] On this same line of reasoning, see Falcão, Tatiana (2021): Ensuring an EU Carbon Tax Complies With WTO Rules. In *Tax Notes International* 101 (1), P. 46.

Furthermore, it would be interesting to illustrate that efforts of a bi- or multilateral nature have already been made to address the problem – such as the OECD's attempts in 2015 with the BEPS project or the more recent Pillar proposals. Although there are also doubts as to the full compatibility of the OECD proposals with the GATS, those measures are internationally seen not only as appropriate, but also as the best means to neutralize harmful effects of "unfair" tax regimes.[1367] However, if those international measures are deemed to be insufficient, it is a further argument that unilateral measures would not, in this sense, represent an arbitrary decision aimed at restricting the trade in services, assuming its design has a minimum degree of reasonableness and proportionality. Thus, as long as the exceptions of Art. XIV are not applied in a way that frustrates or defeats the legal obligations of Member States under the GATS entirely, the *chapeau* will not be activated.[1368]

4.4.3 Interim results on the relation between specific anti-avoidance measures on royalty payments and WTO law

Despite being an area of law that is often overlooked when drafting national tax rules, WTO law has proven to have a relevant impact on policies that involve not only indirect taxation, but also direct taxation and anti-avoidance rules. Especially when dealing with the problem of royalty payments and aggressive tax planning within a corporate group, the importance of the GATS and its guarantees is evident.

Much like with the most-favored nation and national treatment obligation comprised within BITs, discriminatory treatment in the form of less favorable treatment promoted by anti-avoidance rules such as a subject-to-tax WHT or a restriction on royalty deductibility will have to be justified in the event of falling within the scope of these provisions. While the applicability of the NT is largely restricted within the GATS, due to the mandatory inclusion of this provision within a specific schedule of commitments, the MFN principle finds broad application within this treaty.

[1367] Refer for instance to the discussion by Hofbauer, Ines (2004): To what extent does the OECD harmful tax competition project violate the most-favoured-nation obligations under WTO law? In *European Taxation* 44 (9), P. 400ff; and Scott, Cordia (2001): OECD 'Harmful' Tax Competition Move May Violate WTO Obligations, Expert Says. In *Tax Notes International* 22.

[1368] As indicated by the AB in *United States – Standards for Reformulated and Conventional Gasoline* (WT/DS2/AB/R), P. 22. More on design choices, refer to Chapter 5.

Due to the desire of WTO Members to retain much of their tax sovereignty with respect to cross-border supply of services, the drafting of Art. XIV *lit*. "d" GATS ensured that, at least with respect to the NT obligation, Member States had greater autonomy to determine their national tax policy. This explicitly includes rules that have as their objective the effective imposition or collection of direct taxes, which is precisely the goal pursued by the anti-avoidance measures under scrutiny.

However, with respect to the MFN principle, only those rules that derive directly from a double tax treaty, or that have their nature linked to the fight against double taxation, will be excluded from this obligation under Art. XIV *lit*. "e" GATS. As at the time of the drafting of this treaty the main concern was with regards to double taxation, and there was little talk of single taxation, *i.e.* ensuring that taxes are levied no more but no less than once, the MFN treatment will be applicable to the measures at hand, since they will hardly derive from a DTT.

Normally this would not pose a problem due to the fact that national tax rules generally apply equally to all non-residents irrespective of their country of residence, which, however, is not the case with anti-avoidance measures that, for instance, deny the deductibility of costs paid to companies established in low-tax jurisdictions.[1369] Thus, the main problem to be faced by tax measures that differentiate between taxpayers of different jurisdictions is the GATS MFN on Art. II, that will most likely be violated without a feasible justification within the treaty as soon as *likeness* between services or service providers is established.

Even in cases where justification is possible, as is the case with the NT provision or the MFN in the context of DTTs, a final hurdle presents itself in the form of the *chapeau* of Art. XIV GATS. This, however, merely requires fairness criteria to avoid arbitrariness, a requirement that can easily be fulfilled by well-designed anti-tax avoidance rules that are relatively flexible by allowing the taxpayer to provide evidence of meeting the legal requirements of the rule in a proportionate manner. Moreover, the OECD's and Member State's failed attempts to solve the problem multilaterally fuel the need for unilateral responses – or at least their adequacy and compatibility with the *chapeau*.

[1369] For other concrete cases, see van Thiel (2005): General Report. In: Lang/Herdin/Hofbauer (Eds.) - WTO and Direct Taxation., P. 39.

As is noticeable, GATS negotiators have largely insulated taxation against the reach of non-discrimination rules. WTO Members commonly have to pass through a maze of tax exceptions to establish a violation,[1370] this, however, still happens especially in relation to the MFN principle. Nonetheless, a problem of a practical-political nature represents perhaps, at least in the near future, a certain "safety" that these measures will not be questioned under WTO law. Whilst the appellate body is supposed to have a total of seven judges, with a minimum of three for constituting a panel, it currently has only one, since the US refuses to endorse the appointment of new judges, apparently as a part of Trump's administration plan to prioritize bilateral trade relationships over multilateralism.[1371] It remains to be seen to which point this is going to be reversed by the Biden administration.

4.5 General results on the compatibility of anti tax-avoidance measures with higher-ranking law

From the analysis conducted in this chapter – and the overview in the Appendix II at the end of this book –, it can be seen that the difficulties in implementing anti-tax avoidance measures go far beyond their practical effectiveness in dealing with an already highly complex problem such as the one involving royalty payments. The current international tax system presents, at different levels, restrictions on the tax sovereignty of individual countries with regard to the possibilities of designing specific measures. One of the biggest challenges for Member States of the European Union, for example, is to coordinate anti-avoidance measures with the market freedoms provided for in EU treaties, consolidated through ECJ case law, and its various directives.

While the implementation of WHT seems to be virtually impossible in this case due to restrictions in the Interest and Royalties Directive – which in turn is unlikely to be reformed in the near future, considering past attempts and the different interests of Member States – the implementation of the alternative royalty deductibility barrier raises many other concerns. Within the EU alone, there is a high chance that the ECJ will consider that this system of restricting deductions not only violates the fundamental freedoms, but also cannot be justified on any of the previously accepted grounds, similarly to the *Lexel* decision, that clarifies the conditions of EU

[1370] As indicated by Farrell (2013): The Interface of International Trade., P. 201f.
[1371] Refer to Goulder, Robert (2020): The Futility of Challenging DSTs Under International Law. In *Tax Notes International* 98 (12), P. 1446f.

compatibility of national tax measures limiting (interest) deductibility.[1372] Although it is possible to draft a rule that violates the fundamental freedoms in a more proportional or “milder” way,[1373] the prospects of success are relatively low if there is no considerable evolution in the jurisprudence of the Court in a direction favorable to anti-avoidance measures as in cases like *T-Denmark* and *N-Luxembourg*.[1374]

And while justifying such unilateral discriminations under EU law are as of now already quite the challenge considering the requirements the ECJ has developed in the past decades – as they are linked to an idea of substance and protection of the EU market instead of “relevant taxation” or a single tax principle – concerns are raised also for multilateral initiatives. Newer proposals, such as the undertaxed payments rule within the Pillar 2 of the OECD GloBE, as it is structured in a very similar way to a withholding tax as a subject-to-tax rule combined with restrictions on the deductibility of cross-border payments, which includes royalties, would also most likely constitute a violation of EU law.

Even though it would certainly be more likely for the ECJ to accept the implementation of an OECD-level proposal in comparison to an unilateral one – and we have seen this tendency of the ECJ to foster OECD developments[1375] –, one cannot forget that the EU legislator is also bound by EU primary law, and cannot implement directives that violate it. This means that, especially in the case of the implementation of the GloBE proposal, a significant modification of the current system of anti tax-avoidance rules in the EU context is necessary and to be expected, at least from a case-law perspective, considering the weight that an agreement made by 136 countries has in the international taxation scenario, going as far as shaping directly a directive proposal. Insofar as EU law has a market freedom and business-oriented purpose, and OECD projects such as this one have an anti-avoidance and revenue objective, these contrasted streams will enter conflict. The whole

[1372] See Bañuelos, José A. García; Calderón, José M. (2021): Lexel: Not All Base-Erosion Measures Are 'EU Proof', CJEU Says. In *Tax Notes International* 101 (11), P. 1416ff.
[1373] To be discussed in the next Chapter.
[1374] Even though the Court has, in recent times, adopted two different lines of decision which are difficult to reconcile. See Lazarov (2020): Chapter 3 - The Relevance of. In: Lang/Pistone/Schuch/Staringer (Eds.) - Introduction to European Law on., P. 93ff. However, the criteria of wholly artificial arrangement persists despite these newer decisions, as clarified in *Lexel*. See Schnitger, Arne (2021): Verbot des Zinsabzugs für Zahlungen an ausländische Gruppengesellschaften und die Frage nach Zinsschranke und GloBE. In *IStR* (4), P. 147f.
[1375] For instance when Member States adopt national measures that resonate with the structure of the OECD-MC on double tax treaties. See, for instance, Schön, Wolfgang (2020): Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan. In *Bulletin for International Taxation* 74 (4), P. 290ff.

point of having a (supra)constitutional paradigm is that it ensures legal certainty and respect to general principles and objectives, which is to say that EU law cannot be taken lightly even though many countries have agreed so far on the implementation of pillar 2 of the OECD GloBE proposal.[1376] Such barriers would still likely persist, at least to a certain extent, even if all the EU MS agreed on its implementation.[1377] An implementation within the EU by means of a directive is, however, at the moment this book has been written, still a distant reality due to the unanimity requirements.

On the other hand, treaty law problems arise from a different source than one would assume at first sight. While Art. 12 OECD-MC commonly restricts the possibility to withhold taxes, through (broad) renegotiations or, in the worst case scenario, a treaty override, its implementation would not be the most problematic. The same occurs with Art. 24 OECD-MC, specifically its paragraphs 4 and 5, and the issue of discrimination with royalty barriers, in which, although there is apparently no violation of the provision due to the discrimination being only indirect and not based on the taxpayer's domicile, a treaty override would ensure, without further questioning, its implementation. The real obstacle arises within the BIT network, due to the national treatment and MFN principle. If there are no tax carve-outs that allow for the application of anti-avoidance rules, it is very likely that a violation of these treaty provisions occurs due to discrimination, insofar as rules such as the royalty barriers or WHT as a subject-to-tax clause affect investors from countries with different tax rates in a distinct manner. And while on these cases justification might be possible depending on the line of reasoning, design of the rule and on the arbitral tribunal, a similar issue arises concerning the MFN within the GATS on WTO law, and here with a rather difficult justification, since the possible exceptions to these guarantees are already foreseen within the treaty itself, definitely not contemplating anti-avoidance measures such as a royalty barrier, for instance.

This suggests once again that initiatives such as the GloBE proposal and its Pillar 2 may have to face conflicts and reforms in other areas of law for their implementation, depending on the definitive outcome of the negotiations of the countries involved and, specially, the structure chosen

[1376] See the opinion of Goulder, Robert (2021): The Lexel Decision: Does Pillar 2 Have a TFEU Problem? In *Tax Notes International* 102 (6), P. 846f.
[1377] As noted by Englisch, Joachim (2021): Designing a harmonized EU-GloBE in compliance with fundamental freedoms. In *SSRN Journal*. DOI: 10.2139/ssrn.3829090., P. 2ff.

for their realization. Unless it is developed in the form of a double tax treaty – which is unlikely to occur in a practical perspective – the exception provided for in Art. XIV lit. "*e*" of the WTO GATS will not apply, which ensures *prima facie* the applicability of the MFN principle also for a multilateral solution at the OECD level.

One realizes that it is precisely in the area of discrimination – a recurring theme when dealing with anti-avoidance rules – where points of intersection between EU, treaty and WTO law become clear. Similarities between the fundamental freedoms within EU treaties, DTTs on Art. 24 of the OECD-MC, BITs, and even in the GATS are evident, even though they might differ in some details. It is indeed for this very reason that the results of these analyses lean either one way or the other based on particular technical issues, threading a thin needle, and it is in these details that it has to be ensured that a rule can be not only effective in dealing with the problem of aggressive tax planning structures with royalty payments, but also that they are compatible with higher ranking law.

Chapter 5: Design recommendations regarding anti-avoidance rules and reform proposals on the basis of normative standards

In this final part, the main objective is to coordinate the findings of the last chapters in a logical and structured way to present realistically feasible approaches to solve the problem of base

erosion and profit shifting involving royalties. While it is true that there is no single or easy answer to this question – due to the numerous variables not only of a legal and economic nature, but also of distinct political interests on the international scene – it is possible to establish minimum design parameters that would ensure not only greater effectiveness of anti-avoidance measures, but also coherence in their implementation, better coordination in their interactions with each other, as well as compatibility with higher-ranking law.

Therefore, within this scope, proposals for reform of the current systems will be discussed on the basis of the appropriateness of a given measure and the eventual need for harmonization with others, besides taking into account the differences arising from the negotiation and coordinated implementation of a given provision – as is the case with the OECD GloBE proposal – or the unilateral adoption by a country that aims to protect its tax base. Finally, the designs of the alternatives that present the most promising results and that have practical prospects of success will be presented, since legal solutions that would be utopian from a political-economic point of view have little value for the resolution of a problem of the magnitude offered by aggressive tax planning strategies that use licensing structures with royalties.

5.1 Appropriateness of the measures

In order to discuss how "appropriate" a certain measure is, it is necessary to make it clear what the *objectives* of said measure are. While the purpose of these anti-avoidance measures broadly speaking is to ensure that royalty payments made abroad are taxed at least once – to a minimum amount – there is a huge difference whether this is done to promote only royalty transactions with economic substance or to protect the tax base against any and all transactions that may be low-taxed. Especially given the restrictions of EU law with regard to anti-avoidance measures and wholly artificial arrangements seen in the previous chapter on the one hand, as well as a clear desire of countries not only to combat aggressive tax planning structures and harmful tax practices, but also to increase their national revenue due to the expenses with the COVID-19 pandemic on the other, determining the intent of a given measure has become more important than ever.

5.1.1 The support provided by broad rules

The effectiveness of a measure is, therefore, not one-dimensional, which moreover leads to a major differentiation between the broad measures discussed in Chapter 2 and the SAARs discussed in Chapter 3. Standards such as transfer pricing rules cannot even be considered anti-avoidance measures *per se*, and their purpose – that of ensuring a correct allocation of profits between companies of the same corporate group –, while still important, will naturally diverge from that of other measures specifically aimed at treating royalty payments. Although GAAR and CFC rules have, in contrast, a clear anti-avoidance purpose, it has become evident from previous discussions that these rules are *not* sufficient, on their own, to solve the problem involving royalties.[1378] The attempt to strengthen residence taxation through CFC rules, for example, widely discussed, defended and implemented both through the OECD BEPS Project and its Action Plan 3, as well as the ATAD within the EU, has shown that not all countries may be willing to implement and apply them extensively, in defiance of international efforts.[1379] This occurs, in particular, for fear of reducing the competitiveness of domestic companies in the international market, and the contest for tax bases leads to the adoption of harmful tax practices that undermine healthy and economically rational market competition in favor of companies that have the best aggressive tax planning strategy.

While GAARs still maintain much of their splendor and have high relevance in resolving issues involving wholly artificial arrangements or other blatant cases of abuse of national tax rules, the specificity of more targeted measures hold their value not only under a perspective of legal certainty for taxpayers, but for providing clearer parameters of application for tax administrations as well, with greater independence from the interpretation of a general rule by the national courts. Each of the measures evaluated in Chapter 3 are, to a greater or lesser degree, appropriate for combating royalty structures, even though they act at different points in the chain of aggressive tax planning with intangible assets.

[1378] Refer to Chapter 2.1.
[1379] Similar to the insufficiency of CFCs, the OECD GloBE proposal foresees alongside the IIR the subsidiary usage of the UTPR, highlighting the problem in an international context.

5.1.2 Targeting the problem directly through specific rules

Withholding taxes, for instance, would allow royalty payments made abroad to be taxed, to a minimum level, before exiting the country to a related company located in a low-tax jurisdiction, preferably followed by a tax credit in the country of residence to avoid double taxation. This would be feasible with both a broad WHT and a WHT as a subject-to-tax clause, although the nuances of each are a bit different. To avoid the problem of pass-through enterprises, for example, a conditional WHT would either have to rely on the cooperation of other countries to also introduce some sort of withholding – which requires intense international consensus[1380] – or develop mechanisms to evaluate the effective tax rate of the beneficial owner who receives the payment,[1381] problems that would not be faced in the hypothesis of a broad withholding tax on all royalty payments. While it has been demonstrated that the absence of withholding is one of the main factors that allows for the elaboration of strategies involving royalties,[1382] there are many difficulties in its implementation with the existing network of tax treaties, especially within the EU, despite recent attempts to make this option more viable or attractive.[1383]

This was one of the main factors that led to the development of royalty deductibility barriers, inspired by thin capitalization rules for cross-border interest payments, already applied by many countries. While there are to the best of my knowledge no studies to date that directly test and corroborate the effectiveness as well as the impact on the economy and on the decision-making process of corporate groups that a royalty barrier actually has – considering that they are relatively recent – there are some that discuss the effects that deductibility rules such as thin-capitalization might have. It is well known that MNEs adapt their financial policies in tax-efficient ways, supported by the fact that high-tax countries like Germany attract above-average tax-deductible costs.[1384] The success that interest deductibility barriers have had in reducing the

[1380] To be discussed in the next subsection.
[1381] Further design issues will be discussed in Subsection 5.3.
[1382] Recall the study commissioned by the European Commission in Ramboll Management Consulting; Corit Advisory (2016): Study on Structures of Aggressive Tax Planning Indicators. European Commission. Luxembourg (Taxation papers, Working Paper N. 61).
[1383] See the EU's attempts with Council of the European Union (2016): ECOFIN Report to the European Council on tax issues. 15254/16. Edited by General Secretariat of the Council. Council of the European Union. Brussels. Available online at https://www.parlament.gv.at/PAKT/EU/XXV/EU/12/65/EU_126531/imfname_10679895.pdf, checked on 07.01.19; and the new developments by Frey, Michael; Jung, Maike (2019): Bewegung bei der automatischen Abwicklung von Quellensteuererstattungen durch TRACE. In *IStR* (23), P. 924ff.
[1384] See Weichenrieder, Alfons J.; Windischbauer, Helen (2008): Thin-Capitalization Rules and Company Responses. Experience from German Legislation. In *CESifo Working Papers* Nº 2456, P. 2.

prominence of base-eroding intragroup transactions is evident from an econometric point of view,[1385] and no directly related significant reduction of real investment has been observed so far.

While it is not possible to immediately transfer these findings to royalty barriers, in particular due to the existence of a unique trade-off between countering tax avoidance and encouraging business investment in intangible assets, the similarities between the two rules may confer a greater degree of certainty regarding the possible success of restricting the deductibility of cross-border (royalty) payments for curbing BEPS. While it is undeniable that uncertainty surrounds more recent standards such as royalty barriers[1386] and even those that have not even been actually implemented such as the inverted tax credit system, as long as the method of action is targeted and clear, its effects may be predicted in advance.

While one could naturally argue that a reduction in the attractiveness of a country as a business location with the introduction of a royalty barrier occurs, it will simultaneously increases revenue by ensuring that payments made to low-tax jurisdictions after a strategic location choice for IP are taxed at least at the level of the payor. A trade-off of a similar nature occurs with the implementation of IP-Boxes, as while they tend to attract investments and R&D activities and/or acquisition of IP,[1387] it is possible that a net revenue loss due to lower preferential rates may arise, if they lead to benefits exceeding the investment and revenue gains.

One of the natural risks arising from this measure is, of course, the occurrence of double taxation. However, as demonstrated in the previous chapters, it is possible for these rules to have a design that takes into consideration, in a proportional way, taxes paid abroad in order to secure only a minimum amount of tax collection, not leading to excessively high or double taxation. This is, in fact, one of the major problems arising from the feasible alternative discussed last, namely, the inverted tax credit system. By disallowing the deductibility of (royalty) payments in their entirety and compensating this extra burden with a tax credit in the exact amount of the taxes paid in the end over this revenue, one ensures that the final tax rate will *always* be identical to that of the country of origin of the payment, which would completely eliminate any international tax

[1385] *Ibid*., P. 29.
[1386] Refer to Asen, Elke (2021): What We Know: Reviewing the Academic Literature On Profit Shifting. In *Tax Notes International* 102 (8), P. 1043f.
[1387] And this was the main argument for their implementation, in the form of an increase in competitiveness. Refer to Mason, Ruth (2020): The Transformation of International Tax. In *American Journal of International Law*. Available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3576520, P. 8f.

competition and excessively reduce the attractiveness of the implementing country as a business location.

5.1.3 Striking a balance between anti-avoidance and competition

For countries that wish to simultaneously combat harmful tax practices and aggressive tax planning while maintaining, at least to a certain degree, their competitiveness as a business location,[1388] the measures that seem to better combine appropriateness and feasibility are thus the royalty deductibility barriers, followed by WHT and finally the inverted tax credit system, in this order. This conclusion is supported not only by the potential that each rule has to prevent, at one point in the chain of aggressive tax planning, the occurrence of a base-eroding payment, but also by the appropriateness of the *implementation* of such a measure considering the side effects and restrictions that anti-avoidance measures naturally have, that have been thoroughly discussed previously.

This leaves, thus, three essential aspects to be discussed with respect to such implementation: (a) the *means* by which it will be implemented, that is, whether through international coordination or unilaterally by each interested country; (b) the specific *design* of the norm, so that it is as targeted and efficient as possible in achieving its objectives, while avoiding adverse effects of a legal or economic nature; and (c) the need for eventual *coordination* of this provision with other anti-avoidance measures in order to avoid eventual loopholes and try to cover in a far-reaching manner all possible cases of BEPS with royalty payments. It is important to keep in mind that attempts that seek to accommodate short-term political desires at the expense of fundamental principles,[1389] leaving aside technical aspects of this discussion in the name of achieving a political goal at any cost will more likely than not be regretted later, which reinforces the need for these points above to be discussed as methodologically thoroughly as possible.

5.2 Dealing with the problem: two ways into the future

[1388] As is to be generally expected, as stated in Peyrol, Bénédite; Framon, Valentin (2019): Rapport d'information sur l'évasion fiscale internationale des entreprises. In *Fiscalité Internationale* (1), P. 223f.

[1389] As warned by Wille, Hans Georg (2019): The OECD's 'Unified Approach': Should Priority Be Given to Pillar Two? In *Tax Notes International* 96 (11), P. 1019ff.

It is no secret that when it comes to the possible methods of implementing an anti-avoidance measure, there are two main paths that can be followed by interested countries. The first and simplest involves only the national sovereignty of the country and its domestic legislative procedure, where it is decided in the form of a national tax policy to unilaterally implement a defensive measure against base eroding payments involving royalties. The advantages of this approach are apparent, in that it does not require the wear and tear of negotiations with other international actors and it allows for a quick reaction to BEPS problems that one wishes to address.

However, since this is a *domestic* tax policy that has *external* effects related to the competitiveness of domestic companies, the country's attractiveness as a business location and respect for supranational rules,[1390] an "ideal" solution would preferably go through the second path, one of coordination and international cooperation, in order to reduce the harmful side-effects of a unilateral measure. This would ensure, in theory, that the response given to BEPS would be better because it would be more coordinated and harmonized among the countries involved, where through a consensus about minimum norms or standards a more efficient system would be elaborated. This would allow for tax administrations to fight against the loss of revenue resulting from the mismatch between the current international tax system and the contemporary business setting[1391] – the latter being far ahead of the former in many senses.

Although they represent entirely different forms of implementation, much like single-player and multiplayer games are different, the elements of a well-designed unilateral anti-avoidance measure are certainly the building blocks of a multilateral version of such a rule. Lately, there has been a tendency to promote a rough around the edges justice instead of a taxation perfectly based on the ability-to-pay principle.[1392] This is what the US BEAT (and SHIELD) – unilaterally – and the OECD undertaxed payments rule – internationally – represent. With this in mind, it is important to determine which way should a country choose moving forward when dealing with the issue of royalties. Therefore, what will be discussed in this subsection is linked

[1390] Especially discrimination, refer to Chapter 4 and Fuest, Clemens (2013): Besteuerung multinationaler Unternehmen: keine Alleingänge! In *Wirtschaftsdienst* (3), P. 139.
[1391] See for instance the opinion of Adegite, Victor; Dushime, Aimée (2020): Pillars 1 and 2: African Perspectives. In *Tax Notes International* 98 (12), P. 1413ff.
[1392] See Kempelmann, Goetz (2019): The Future of International Tax. In *IStR* 16, P. 663.

more to the feasibility of the process itself – be it cooperative or individual – than to the specific design of the rules, which will be discussed in further detail on Subsection 5.3.

5.2.1 International coordination

The choice to discuss the more complex option, namely, international cooperation, before its simpler counterpart is justified insofar as (i) it is precisely due to this complexity that this is the part in the need for more attention and care when discussed; besides, (ii) since it is a solution based on international negotiations, ensuring greater coherence of the international tax system, it should be the priority and preference of the countries to solve the problem. Ideally, only if international negotiations fail – or worse, if the negotiations present an unsatisfactory result – should the use of unilateral measures be considered. Unfortunately, reaching consensus is much more of a political issue than a technical one,[1393] which makes it difficult to implement efficient new systems and answers.

It is important to note that when one talks about consensus and international cooperation, this does not necessarily imply a global agreement, which is currently being headed by the OECD, in the form *e.g.* of the GloBE proposal. Regional initiatives, such as within the EU, could also represent, in a more restricted universe, a coordinated response to the problem with royalties.[1394] Some authors even suggest that it would be more efficient if regional level initiatives were prioritized and successful first, to facilitate the work of the OECD interceding on a global scale.[1395] This reasoning resembles the logic that in order to have a well-designed and successful anti-avoidance measure on an international framework, that this measure would first need to go through a good design and receive incentives on a smaller scale.

Thus, one could imagine that the solution might rather lie in the (re)negotiation of double tax treaties, in the form of producing an incentive of a bilateral nature that precedes discussions on a larger scale. While this idea has its worth, it is to be expected that the inherent difficulty of renegotiating individual treaties, coupled with the already existing conflict of interests, especially with countries that take advantage of the current system to promote harmful tax practices, would

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[1393] As indicated by Dueñas, Sebastian (2019): Comparing CFC Rules Around the World. In *Tax Notes International* 95 (6), P. 528.

[1394] Much like the directive wishing to implement the GloBE proposal.

[1395] Brauner, Yariv; Pistone, Pasquale (2017): Adapting Current International Taxation to New Business Models: Two Proposals for the European Union. In *Bulletin for International Taxation* (12), P. 681ff.

hardly lead to a quick resolution – if at all – of the BEPS issue. While there are attempts to affect the existing large tax treaty network through modifications to the OECD model convention commentary, these are generally not accepted to modify the content of already existing DTTs.[1396] This means that the reform of double tax treaties, while important, is unlikely to be responsible, on its own, for accomplishing rapid and significant reforms in the international tax environment.

Moreover, the bargaining power that a group of countries has at the regional and global level *vis-à-vis* a minority of actors that wish to maintain harmful tax practices is much greater than the pressure that can be exerted bilaterally through the discussion of DTTs.[1397] Unfortunately, this does not mean that the difficulties for states to cooperate with each other are eliminated. Problems such as the different interests involved remain relevant, and the more countries are involved in the discussions, the more heterogeneous the opinions formed become.

Another serious problem is the – understandable – unwillingness of some countries to give up some part of their tax sovereignty. While the general fear of a country to give up tax sovereignty sometimes has a relatively vague meaning, this concern cannot be seen as unfounded. Giving up part of one's autonomy to allow an initiative of a supranational nature to determine relevant aspects of its tax system impairs the leeway national legislators have to react to the interests of their constituents, as well as preventing, especially for small countries or those with an infrastructure deficit, for this sovereignty to be "traded" in the form of tax benefits and harmful tax practices to attract investment.[1398]

These aspects, combined with the powerful corporate lobby to resist robust responses against aggressive tax planning structures[1399] and the cloud of uncertainty that surrounds economists' varying estimates of profit shifting using IP,[1400] make the process of international

[1396] As discussed on Subsection 4.3.1 about a dynamic interpretation of treaties. See also the decision by the German Federal Tax Court on Bundesfinanzhof, Änderungen des OECD-Musterkommentars haben keine Auswirkungen auf die Interpretation unveränderter DBA, "Entscheidung" of 11.07.18, case number I R 44/16. In *IStR* 7/2019, P. 272.
[1397] This is clear by the recent GloBE negotiations, as many States that stand to "lose" by the OECD proposal decided to nevertheless take part in the project, certainly also to protect their international reputation.
[1398] See the contribution of Palan, Ronen (2002): Tax Havens and the Commercialization of State Sovereignty. In *International Organization* 56 (1), P. 151ff.
[1399] See the US example in Enrich, Peter (1996): Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business. In *Harvard Law Review* 110 (2), P. 377ff.
[1400] Which has already led other multilateral projects and initiatives to fail miserably, as indicated by Mason, Ruth (2020): The Transformation of International Tax. In *American Journal of International Law*. Available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3576520, P. 13ff.

negotiation and cooperation on tax issues very difficult. However, in recent times, a growing political dissatisfaction with the taxation of corporate groups, most likely coupled with the need to increase national tax revenues due to the Covid-19 pandemic, has allowed for unprecedented progress in the negotiations on this topic, especially with regards to the OECD GloBE proposal, where 136 countries have initially agreed on preliminary action against BEPS in the form of a minimum tax at 15%.[1401] As it stands, one could argue that the emergence of a crisis is certainly one of the biggest incentives for States to seek cooperation and productive negotiations.

5.2.1.1 A close-up approach through regional solutions

From a regional perspective, while achieving unity within the EU in the form of Art. 115 TFEU remains an extremely difficult task, one could imagine the possibility of using the so-called "enhanced cooperation" between Member States. This alternative would allow, for interested countries – most likely the ones that already have high corporate tax rates –, to establish tax norms that otherwise would be blocked by the unanimity requirements of EU law. According to the requirements set by the TFEU itself in its Arts. 20 Subsection 2 and 326ff., in cases where a joint action within the EU cannot be achieved within a reasonable period of time, MS have the possibility to enhance their integration process through joint cooperation. As long as it is not a matter of exclusive competence either of the EU itself or of the MS as such, States are free to engage in enhanced cooperation, in this case by unanimous decision of the participating MS, in order to create a Union within the Union in tax matters.

Although one of the objectives of the enhanced cooperation procedure is to obtain different levels of integration within the EU, obstacles to trade resulting from this cooperation cannot be accepted merely because they were formed from a procedure of unification of laws by a group of MS. Some consider this possibility generally a bad idea,[1402] since it might also violate Arts. 326 and/or 327 TFEU by distorting or at least reducing competition between different MS due to these anti-avoidance measures. Moreover, this could possibly be considered a violation of the tax sovereignty of the countries not participating in enhanced cooperation, since the activation of the

[1401] The economic effects of this rate have been presented, among other studies, by Sullivan, Martin (2021): Estimated Effects of Proposed 15 Percent Minimum Tax on Individual Companies. In *Tax Notes International* 104 (5), P. 492ff.
[1402] Refer to the analysis on other issues by Brauner, Yariv; Pistone, Pasquale (2017): Adapting Current International Taxation to New Business Models: Two Proposals for the European Union. In *Bulletin for International Taxation* (12), P. 682ff.

measures is, as a rule, based on the ETR of the payee's country of residence, which means that actually non-participating MS will be mostly affected.

In cases of negative effects following from enhanced cooperation law, it is required that this obstacle to trade can pass the test to meet the ordinary justification threshold,[1403] that is, the one to which an MS measure is subject if it had been implemented unilaterally. Thus, enhanced cooperation initiatives are also subject and bound to the thresholds set forth above in Chapter 4.2 under EU law. The fundamental freedoms will therefore protect non-participating MS in cross-group economic transactions from being treated worse than before the introduction of an enhanced cooperation,[1404] which is not only likely, but actually the underlying goal of a cooperation that involves anti-avoidance measures linked to aggressive tax planning structures and harmful tax practices.

Regardless of how one seeks to adopt a measure within the EU, it should always be compatible with EU primary law and the case-law established by the ECJ, which also applies to enhanced cooperation and the OECD GloBE proposal, for example. In this sense, an initiative that was adopted not only by a fraction of the MS would probably be more likely to be considered EU-compatible. This brings us back to square one of the problem once again. While the EU is signaling that it wants to see OECD initiatives succeed, it also indicated that even if this did not happen it would take its own regional initiatives.[1405] Nonetheless, even after the discussions at the level of the OECD inclusive framework, there is still a lot of resistance and difficulties presented by some of the MS.[1406]

In an ideal world, policy cooperation within the EU should not be a problem, where there would only be a common *external* barrier high enough to deter tax planning involving tax havens. As there is a huge conflict of interest on tax issues within the EU itself, the second best option

[1403] See the work of Heber (2021): Enhanced Cooperation and European Tax., P. 321f.
[1404] *Ibid*.
[1405] See Paez, Sarah (2020): EU to Propose Minimum Corporate Tax if OECD Can't Get Consensus. In *Tax Notes International* 98 (9), P. 1065; and Valério, Carla (2022): Proposal for a Directive on Ensuring a Global Minimum Level of Taxation for Multinational Groups in the European Union: First Steps in Pillar Two Implementation in the European Union. In *European Taxation* 62 (4), P. 155ff.
[1406] See the case of Cyprus in Paez, Sarah (2021): Cyprus Won't Support EU Minimum Tax Rate. In *Tax Notes International* 102 (10), P. 1368f.; and the difficulties of the past in Council of the European Union (2016): ECOFIN Report to the European Council on tax issues. 15254/16. Edited by General Secretariat of the Council. Council of the European Union. Brussels. Available online at https://www.parlament.gv.at/PAKT/EU/XXV/EU/12/65/EU_126531 /imfname_10679895.pdf, checked on 07.01.19, P. 21f.

would be to allow MSs to raise, unilaterally or through enhanced cooperation, their internal barriers to a value above zero to counter the erosion of their tax base.[1407] However, the difficulties of implementing tax anti-avoidance measures within the EU are a result of the intrinsic tension between economic integration and protection against BEPS, and while an enhanced cooperation and/or secondary law could in some cases influence or even contradict ECJ case law on a specific issue,[1408] the difficulties of a regional coordination within the EU make this goal hard and unlikely to be achieved, especially considering the limitations already existing within EU primary law.

5.2.1.2 A global view through plurilateral cooperation worldwide

From an international cooperation perspective, only multilateral initiatives of a more comprehensive nature remain, as was the case with the Multilateral Instrument (MLI) approved in November 2016.[1409] Some authors argue that the choice on whether to cooperate in a multilateral, bilateral or even unilateral way is directly linked to the perception that States have of the economic gain resulting from each course of action. If the economic advantage of a certain behavior is perceived as large and certain, States have a tendency to distribute their gains and negotiation efforts in targeted cooperation such as bilateral agreements, for example. However, in the case of small and uncertain gains, the focus is usually on multilateral principles of cooperation, rather than an agreement on specific rules,[1410] as was the case with the BEPS Action Plan.

While this is not necessarily always the case, while dealing with the specific issue of anti-avoidance measures linked to royalties, many of the countries that decided to implement a unilateral royalty deductibility barrier based their legislative drafts on the certainty of obtaining significant tax revenue from the measure.[1411] However, despite the initial forecasts, there is still no concrete information to support these claims of revenue increase, and the conclusion of a

[1407] As defended by Johannesen, Niels (2012): Optimal fiscal barriers to international economic integration in the presence of tax havens. In *Journal of Public Economics* 96, P. 402ff.
[1408] See Davies, Gareth (2014): Legislative control of the European Court of Justice. In *Common Market Law Review* 51 (6), P. 1587ff.
[1409] Online available at https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf, checked on 21.07.2021
[1410] See Broekhuijsen, Dirk; Vording, Henk (2016): The Multilateral Tax Instrument: How to Avoid a Stalemate on Distributional Issues? In *British Tax Review* (1), checked on 12.12.18, P. 39ff
[1411] Review, for example, Bundesfinanzministerium (2014): Vorblatt AbgÄG 2014. Available online at https://www.bmf.gv.at/steuern/Vorblatt_AbgAeG_2014.pdf?67ry2a, checked on 08.05.19, P. 7; and Max, Marcel; Thiede, Jesko (2017): Der Gesetzesentwurf zur Einführung einer Abzugsbeschränkung für Lizenzaufwendungen - "Lizenzschranke". In *StB* (6), P. 178f.

multilateral agreement on the subject could be equally enticing, provided that the objective of combating aggressive tax planning practices is also achieved.

This is the underlying objective of the current OECD GloBE proposal – discussed in more detail in Chapter 3.4 –, certainly one of the most ambitious OECD projects after the drafting and approval of the MLI. Viewed by many with skepticism, the fear is that, after the "beta testing" that was the Multilateral Instrument,[1412] that the GloBE treads the same path and that the result of the negotiations is merely a watered down version of what is really needed to solve the problem with royalty payments, and that ultimately it will not be implemented nationally by important actors such as the USA. While the multilateral nature of this agreement is welcomed by many,[1413] and even seems to be a natural process, insofar as competition and cooperation always go hand in hand – States compete with each other by reducing their tax rates or offering incentives for income from intangible assets and, on the other side, band together to discourage and penalize BEPS to tax havens[1414] – this project seems in many regards an ultimatum from developed countries exerting pressure on other countries to tax the income of resident companies at a specific, "agreed upon" minimum tax rate.[1415]

The OECD's priority is, based on the very tight proposed timeline, on *time to consensus*, and not what the *process to consensus* looks like.[1416] The urgency of this matter makes pressure for some sort of consensus to be achieved and delivered in an impossibly short timeline, which ends up making the quality of the discussions and final result suffer dramatically. While countries have generally agreed on a course of action and on the minimum 15% rate, many design questions arising from such an ambitious project remain unanswered, especially considering that the results

[1412] In the words of Goulder, Robert (2019): The Next MLI: Rejection Is Just Around the Corner. In *Tax Notes International* 95 (5), P. 462

[1413] See, for instance, Weggenmann, Hans; Blank, Alexander; Brunnhübner, Andreas (2019): OECD Public Consultation Document/Programme of Work betreffend Vorschläge zur Besteuerung der Digitalwirtschaft - schöne neue Steuerwelt? In *IStR* 19, P. 769ff.

[1414] Morse, Susan C. (2018): International Cooperation and the 2017 Tax Act. In *The Yale Law Journal Forum* (October), P. 372f.

[1415] Currently, as mentioned previously, at 15% for the UTPR and 9% for the STTR. See the opinion of Arnold, Brian J. (2019): The Evolution of Controlled Foreign Corporation Rules and Beyond. In *Bulletin for International Taxation* 73 (12), P. 647f.

[1416] See Christians, Allison (2019): A Unified Approach to International Tax Consensus. In *Tax Notes International* 96 (6), P. 500.

so far point at the direction of a "common approach",[1417] and no minimum standards have actually been achieved.

Even in the case of relatively successful implementation, considering that such a minimum tax restricts the possibility that a given state has to offset real investment conditions through a more favorable tax rate, possibly substantially changing the fiscal and economic conditions present before the signing of an agreement of this magnitude, it is to be expected that there will be substantial resistance from some countries to its implementation.[1418] Despite the respectable progress that the discussions on GloBE and, of special interest to this thesis, Pillar 2 and its undertaxed payments rule[1419] have made, the model rules proposed are absolutely not guaranteed to be implemented nationally by relevant international actors as they have been presented in the OECD "common approach" to the GloBE, especially when considering more controversial matters such as the presence of (substance) carve-outs,[1420]– that restrict immensely the effectivity of the measures –, different *de minimis* thresholds for developing countries, blending[1421] etc.

While there is naturally an interest in the approval of these measures because they have the potential to restrict serious weaknesses that the current international tax system has, namely profit shifting to low-tax entities,[1422] there are mixed feelings regarding the actual results of this rushed consensus. The potential of Pillar 2 is extremely dependent on its design, and the fact that it presents a single optional answer for countries with completely different realities and interests,[1423]

[1417] Refer to Chapter 3.4 and OECD (2021): Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. Available online at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf, checked on 11.10.21.
[1418] As defended by Schreiber, Ulrich (2020): Remarks on the Futurue Prospects of the OECD/G20 Programme of Work - Profit Allocation (Pillar One) and Minimum Taxation (Pillar Two). In *Bulletin for International Taxation* 74 (6), P. 343ff.
[1419] To have entry in force by 2024.
[1420] Poorly draper carve-outs could defeat the entire purpose of the proposal. See the discussion on Chapter 3.4 and Cipollini, Claudio (2021): Reshaping the Pillar 2 Carveouts. In *Tax Notes International* 101 (1), P. 50ff.
[1421] The same argument of a purpose-defeating measure can be made for a global blending. See Dourado, Ana Paula (2020): The Global Anti-Base Erosion Proposal (GloBE) in Pillar II. In *Intertax* 48 (2), P. 156.
[1422] According to Tørsløv, Thomas; Wier, Ludvig; Zucman, Gabriel (2019): The Missing Profits of Nations: Updated Figures. In NBER Working Paper Series (no. 24701), more than 600 billion dollars only in 2015. Refer back to Chapter 1.4 for more on this discussion.
[1423] As mentioned, the current unified approach proposal is very unlikely to attend to the needs of developing countries. See Fedan, Alexander (2021): Case Study Analysis of the OECD Pillar One and Pillar Two Allocations to Developing Countries. In *Bulletin for International Taxation* 75 (8), P. 382ff. It is important for developed jurisdictions to take this into account when devising international tax rules, as recently recognized by the Netherlands and Sarfo, Nana Ama (2022): Going Dutch on BEPS 2.0: Developing Country Lessons for the OECD. In *Tax Notes International* 105 (4), P. 401ff.

without a supranational body with enforcement rights, achieving a satisfactory answer for the parties involved seemed from the very beginning nigh impossible.

Many of the issues that one currently sees in the discussions about GloBE mirror the events connected with the development of the BEPS Action Plan in 2015. There is certainly a compelling narrative, and many good points are made in favor of the project, with a sound analysis of the problems, jointly with extremely ambitious goals and timelines. However, with each step of the negotiation process and the influence of important international stakeholders, the revolutionary character of the project is undermined little by little, and the final result is awfully similar to the existing system with the same problems it started with.[1424] While the efforts of the BEPS project were certainly laudable, its results in the area of royalties were suboptimal to say the least.[1425] It would seem that BEPS 2.0 in the form of Pillars One and Two is following a similar path,[1426] and while it currently possesses the somewhat previously absent important support of the US – which has great influence on the pace and direction of the negotiations – resistance has emerged from other important parts of the project, which might have remained inert up to a point because there were already enough obstructions to the progress of the GloBE proposal by others.[1427]

Thus, it seems reasonable to assume that even though the negotiations about the two Pillars achieved some sort of timely result, that this result will, during it's implementation by individual players, more likely than not still fall short of what is needed to resolve the issue with cross-border royalty payments and BEPS in its entirety, which implies more unilateral measures to come. In reality, the consensus achieved in the form of a common approach and not on minimum standards might *foster*, by itself, the strength of unilateral interpretations of the GloBE discussions. This means to say that each State has considerable freedom on the implementation or not of these rules – the major advantage being that other inclusive framework countries will have to accept such

[1424] See the insight of Sarfo, Nana Ama (2020): How the OECD became the Worlds Tax Leader. In *Tax Notes International*, P. 628.

[1425] Refer to the analysis on Chapter 2 and Carvalho, Lucas de Lima (2020): The Trouble With 'Pillars' in International Tax Policy. In *Tax Notes* (Special Report). Available online at https://www.taxnotes.com/special-reports/digital-economy/trouble-pillars-international-tax-policy/2020/07/02/2cnhm, P. 3ff.

[1426] Considering, for instance, how Pillar 1 has been left behind in general, and the STTR – one of the main rules of interest for developing countries – has barely been discussed so far.

[1427] As is the case with the UK, see Johnston, Soong Stephanie (2021): U.K. Lawmakers Vote Down Proposals Linked to Global Minimum Tax. In *Tax Notes International* 102 (9), P. 1251; and the opinion of Goulder, Robert (2020): Breaking Up With BEPS. In *Tax Notes International* 97 (2), P. 219ff.

rules[1428] – and while there have been so far some specific design considerations as a result of these OECD discussions, ultimately each country will have to decide on how to implement this rule in an effective manner and in compatibility with higher-ranking law.[1429] This path is the one that will be addressed by the following subsections, in which the procedure for individual implementation by interested countries will be elucidated, followed by design proposals that are both efficient and reasonable to implement from a legal-political perspective, tailored to different needs, and not uniform as is the case with GloBE.

5.2.2 Unilateral handling

Unilateralism in itself, including within the context of a group such as the EU Member States, is alive and well, even after the BEPS project. To different degrees and with different timings, countries that considered the results of the OECD negotiations unsatisfactory – or even before their conclusion, as was the Austrian case – decided to act on their own and implement a faster and more direct response to the problem involving royalty payments. In the form of specific anti-avoidance rules, this type of initiative is even welcomed by some authors in parallel to any OECD work,[1430] because, adapted to the specific needs and characteristics of each country's legal system, such rules may help in obtaining a more effective protection against the erosion of its tax base.

Considering that the harmful side-effects that this type of measure has are usually offset through cooperation and negotiations at the international level, when these attempts fail or are insufficient, it is time to resort to unilateral measures designed so as to avoid the negative impacts naturally arising from their implementation. Several countries are even conducting projects parallel to the international negotiations, as is the case of the new SHIELD proposal of the Biden administration, created with the intention of replacing the BEAT as a form of deductibility barrier, rather than a minimum tax. This is a stand-alone proposal that is being pursued independently of

[1428] Refer to Chapter 3.4.

[1429] In this sense, one can only hope that the EU will manage to implement a directive to harmonize the interpretation and implementation of GloBE. However, it should be careful when trying to opt *out* of the minimum tax, as updating or repealing a directive might be even harder than agreeing on one to begin with, as experience has shown with the Interest and Royalties Directive, for instance.

[1430] See Bush, John N. (2019): A Roadmap for a Tax on Base-Eroding Payments. In *Tax Notes International* 96 (7), P. 605f.

the results of the Pillar 2 negotiations,[1431] which has ended up providing countries with a reason to also adopt a measure nationally that, by following the general design recommendations of Pillar 2, that are likely to have to be accepted by other members of the inclusive framework.

Although they are usually treated separately, the international and national spheres have a strong influence on each other, and it is to be expected, for instance, that the adoption of unilateral measures would compel the OECD to encourage other members to adopt similar policies. This should not amount to a tax war, but rather characterize a long overdue reaction to base erosion and profit shifting using royalty transactions by multinationals.[1432] Some unilateral measures actually might represent an international solution in the form of an international web of interlocking unilateral compounds,[1433] paving the way forward much like the GloBE proposal. If this reaction cannot be accomplished directly through a multilateral measure, unilateral steps create an incentive for these to occur better and faster; which in turn will allow a broader inclusion of these measures in the respective national legal systems, in a sense like a hermeneutic circle, in which the development of the part fosters the understanding of the whole and vice-versa, in a spiral process.

While it is to be welcomed that a country can demonstrate, before resorting to unilateral measures, that it has made efforts towards bi- or multilateral negotiations on this matter,[1434] one cannot deny the impact that unilateral solutions also have on the international scene. With the enactment of the Tax Cuts and Jobs Act in the USA in 2017, for instance, the arm's length principle was hit hard as the allocation of taxing rights started to be evaluated based on other criteria as well.[1435] This shows how a relatively isolated measure taken by an internationally relevant actor ends up setting a precedent for other measures to be built outside universally accepted standards, as is the case with the arm’s length principle.

[1431] Refer to Velarde, Andrew (2021): BEAT Being Both Over- and Underinclusive Led to Treasury Rebuff. In *Tax Notes International* 102 (10), P. 1396ff.

[1432] See the opinion of Avi-Yonah, Reuven (2018): Beat It: Tax Reform and Tax Treaties. In *University of Michigan Law & Economics Working Papers* (Research Paper nº 587), P. 6.

[1433] See Faulhaber, Lilian V. (2019): Taxing Tech: The Future of Digital Taxation. Available online at https://ssrn.com/abstract=3460741, P. 47f.

[1434] Also valid for other areas, refer to Falcão, Tatiana (2021): Ensuring an EU Carbon Tax Complies With WTO Rules. In *Tax Notes International* 101 (1), P. 47.

[1435] See Finley, Ryan (2020): TCJA Marked a Big Step in The Arm's-Length Principle's Demise. In *Tax Notes International* 97 (10), P. 1123f.

The reverse path has also occurred before, for example with §4j EStG, providing for the German royalty deductibility barrier, where this provision makes a direct reference to the OECD report on the nexus approach and IP-Boxes.[1436] The intention of this reference was to ensure, within a one-sided measure, a unified interpretation based on international work,[1437] not allowing, thus, an independent definition of the nexus approach to emerge within Germany itself. This demonstrates how, despite being *prima facie* an independent and one-sided way of acting, that the influence of this measure can go far beyond national borders, creating a more advanced starting point for negotiations than would be available if made solely through international talks.

While the economic and higher-ranking law problems of unilateral measures such as the royalty deductibility barriers, withholding taxes and so on are a reality, there is nothing inherently wrong or harmful in taking unilateral initiatives to solve a problem that is otherwise unlikely to have a satisfactory solution, especially if this is made in the form of a *constructive* unilateralism – contributing to the international tax system as a whole.[1438] This means that, considering how all other efforts have failed, been insufficient or led to the enactment of national measures without minimum standards so far, it is high time that the possibility of implementing well-designed unilateral measures to deal with the royalty payments issue is categorically envisioned and accepted, which will be done in the last section below.

5.3 Best-practice approach with practical prospects of success

As mentioned previously, there is no single or simple answer to the BEPS problem involving royalties. Especially considering the economic, political and constitutional specificities of a given country, the recommendations made in this section can and should be adapted to realities other than the one assumed for the proposed anti-avoidance measures contained therein. Moreover, in some cases the coordination of different measures will create a firmer and more secure safety net for taxpayers and tax administrations alike, which should also be taken into consideration by

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[1436] The middle ground is being also attempted currently by the EU while trying to implement a directive based on the OECD GloBE, making direct references to it. See European Commission (2021): Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union (COM(2021) 823 final). Available online at https://taxation-customs.ec.europa.eu/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf, checked on 27.12.21.

[1437] Schön (2018): Internationalisierung des Internationalen Steuerrechts. In: Drüen/Hey et al. (Eds.) - 100 Jahre Steuerrechtsprechung in Deutschland, P. 940ff.

[1438] Refer to Schildgen, Frederik (2019): GloBE - Lehren aus GILTI. In *ISR* (11), P. 405f.

countries that already have or seek to implement other measures that can be applied to the same issue in parallel.

That said, some of the distinctions – for example between EU MS and third countries, as well as between developed and developing countries – are clearer and will be taken into account in the suggestions that will follow. And lastly, the criteria used to determine what would be "best practices" in this context are directly linked to (a) the effectiveness of the rules, *i.e.* their ability to achieve their objectives; and (b) the feasibility of implementation of the norm in the current international tax environment.[1439]

The first group for which it seems relevant to make a proposal is the *EU Member States*. Not only are they all bound to their (bilateral) tax treaty network and the dictates of WTO law, but also to supranational boundaries in the form of EU primary and secondary law, alongside the relatively strict understandings of the European Court of Justice. As these boundaries restrict the leeway that these countries have to adopt unilateral measures, while still retaining much of their tax sovereignty, these are the measures that should be crafted with the maximum possible care.

5.3.1 Practical solutions for EU countries

It was proven in the last chapter the virtual impossibility of implementing a WHT within the EU on royalties, which naturally pushes forward the already seen tendency of developing royalty deductibility barriers as an alternative answer. As the economic effect of both of these solutions is similar, they have a comparable effectiveness in dealing with aggressive tax planning structures. However, the differences in the *mechanisms of application* of these rules makes their viability entirely distinct from a legal point of view. While there are many concerns regarding the viability of royalty barriers from an EU law point of view as well, this (in)viability is not as clear-cut as the one involving WHT. This means that there is a margin of adaptation for restrictions on deductibility which is not present in other types of anti-avoidance measures, and it is on these aspects of its layout that one should concentrate efforts to allow for or at least increase the chances that this rule will be considered compatible with EU law.

[1439] For more information on these criteria, refer back to Subsection 5.1.

While it would be possible to envisage the inverted tax credit system proposed by *Lodin* as an alternative that presents far fewer problems from a higher-ranking law perspective, it is not possible to say with absolute certainty that this system would not be questioned in an EU context.[1440] This is especially so because of the main problem that this solution presents: the end of international tax competition from the point of view of the country implementing such a system, in which every company would be taxed as if it were resident in this country, according to its own tax rate. This mortally wounds some of the basic principles of the EU single market, in addition to reducing – and greatly so – the attractiveness of a country as a business location. Thus, between two different rules with varying issues, the royalty deductibility barrier still represents a more moderate and targeted measure, representing probably the best chance that an EU Member State has to deal with the royalty issue, apart from being one of the options offered by the UTPR of the OECD GloBE proposal.

The main argument employed against the compatibility of royalty deductibility barriers within the context of EU law is its discriminatory aspect. This is because the treatment of purely domestic royalty transactions and those of a cross-border nature is materially different, even if formally there is no differentiation contained within the law. Regardless of whether the rule's activation criterion is linked to the effective tax rate of the payee's and/or beneficial owner's country of residence; or to the existence of a preferential tax regime such as an IP-Box, the fact is that this activation – due to the very nature of an anti-avoidance measure – will essentially only occur in cross-border scenarios. This virtually ensures that the implementation of such a rule has, to a greater or lesser extent, a discriminatory nature. What can be done, therefore, is to adapt this provision in order to make it as less discriminatory and as proportional as possible, so that, despite the narrow interpretation granted to the possible justifications accepted by the ECJ,[1441] to make it at least feasible at the European level.

5.3.1.1 An EU-compliant royalty barrier: step by step

Following this line of reasoning, it is worth determining the basic guidelines that form an effective and (possibly) justified royalty barrier. The first step must be its *criteria for activation*.

[1440] Despite the fact that it has *prima facie* compatibility, there are doubts regarding its concrete applicability. Refer to Chapters 4.2 and 3.3.

[1441] It is of course worth remembering that the agreement made by the inclusive framework within the context of the GloBE proposal might have a weight on these decisions.

While for example the German initiative, which restricts its scope only to cases where a non-nexus compliant preferential regime exists, also has merit in this choice, two main problems are created with this approach: (a) the cases in which a company is resident in a country that is a tax haven or naturally has a low effective tax rate will not be covered by the rule, which still allows for a wide range of tax planning opportunities; and mainly (b) companies with a structure compliant with the nexus-approach that are resident in a country that has legislation that is not compliant with the nexus will nevertheless trigger the rule, since this criterion is linked in an abstract way to the presence of a certain standard in another country, and not to the specific behavior of a given company.[1442] This would not be justifiable from a European perspective,[1443] and anyhow undesired in the design of any anti-avoidance measure in practice.

Therefore, the criterion that seems to be not only the fairest, but also the one that would actually ensure an effective fight against profit shifting is the one linked to the effective tax rate of the entity receiving the payment. If the goal is to limit the possibilities of erosion of the tax base, only a criterion linked to minimum taxation or a single tax principle can satisfactorily achieve this purpose. While there may be endless discussions about the correct tax rate for the activation of this rule, there are basically two main modalities: the *hard* threshold, which has a predefined minimum percentage for the activation of the rule;[1444] or a *soft* threshold, flexible in that it will be tied to a fraction of the tax that would be due nationally.[1445] Both alternatives have their merits. While a hard threshold provides more clarity for the cases it is aimed at, a soft threshold allows an automatic update of what is considered "sufficient taxation" based on the country's own corporate tax rate. Neither of the two has a blatant disadvantage, and the choice for one or the other can be left to the State's discretion.[1446]

Even so, regardless of the method chosen, ultimately the most important factor will be what rate will ultimately trigger the activation of the anti-avoidance rule. One possibility would be to consider setting off the rule for any ETR that is lower than the one practiced nationally, as is, to a

[1442] For more on this discussion, refer to Chapter 3.2.2.2. See also the opinion of Dürmeier (2021): Die Lizenzschranke aus verfassungs- und unionsrechtlicher., P. 270ff.
[1443] See Chapter 4.2.2.1.2, *lit*. "c".
[1444] Such as 10% or 25%.
[1445] Such as 75% of the national corporate tax rate.
[1446] Even though the OECD GloBE proposal has clearly opted for a *hard* threshold of 15% ETR.

certain extent, the case of the German rule with its 25% threshold rate.[1447] This posture would be very similar, from an economic point of view, to the proposal of an inverted tax credit system – to be discussed further below – since, in practice, it would eliminate the possibility of international tax competition. By setting such a high threshold for an anti-avoidance measure, it would ensure that the revenue from cross-border royalty payments would be taxed at least as heavily as a transaction taking place domestically.

Although this is initially a tempting idea, it is questionable whether the intention of such a measure should be to prevent any and all forms of tax competition. While the aim is to achieve "sufficient" taxation, it seems unreasonable to require taxpayers to pay, regardless of their structure, taxes on royalty payments as if all parties to the transaction were residents of the country that instituted such an anti-avoidance rule. Since currently the world average corporate tax rate fluctuates around the mark of 25%,[1448] it is understandable that single digit ETRs on royalties generate a backlash from governments and society alike. However, this does not justify – although it is not inherently prohibited, at least outside the EU – requiring a taxpayer who operates internationally to be so harshly "punished" by its corporate structure by having to pay taxes as if payor and payee were residents of the same country.

Thus, an amount that seems reasonable considering the current world average, also currently agreed upon within the context of the GloBE proposal, would likely be between 10 and 15% ETR.[1449] Thus, a *minimum* taxation would be ensured, without encroaching too much on the tax sovereignty of other countries and without completely destroying any international tax competition involving royalties. It would also be feasible to have an answer that foresees different final tax rates for cases in which there is a greater asymmetry of information between taxpayer and tax administration.

5.3.1.2 Applicability of the barrier and dealing with limitations defined by ECJ case law

[1447] This is of course offset by the fact that this activation occurs only in cases of preferential regimes. See Subsection 3.2.2.2.3.
[1448] Refer to the research by Asen, Elke (2020): Corporate Income Tax Rates around the World, 2020. Tax Foundation (Fiscal Fact, 735).
[1449] As mentioned, an approximate value for this amount could be established either from a "hard" or a "soft" threshold, but the current OECD option is at 15%. A higher amount could also naturally be implemented, but this would most certainly be resisted by low-corporate tax EU countries.

To clarify: the presence of a minimum ETR, especially in the European case, in order to ensure greater compatibility with the fundamental freedoms, should only be considered an *indicator*, *i.e.*, one among multiple factors that may indicate the presence of an aggressive tax planning structure. An absolute presumption of abuse[1450] or a presumption based solely on the ETR of the country of residence of the person receiving the payment would be incompatible with EU law, particularly considering the recent *Lexel* decision of the ECJ.[1451] The taxpayer must be allowed in any case to provide evidence to the contrary that his structure does not exist for the purpose of saving taxes, and while it is the task for the tax administration to present evidence of abuse of the company as a unit, it will be up to the taxpayer to present counterevidence based on the larger picture through a consideration from across the corporate group.[1452]

This evidence cannot, however, as indicated previously, be a mere substance or main purpose test like the ones advocated by the ECJ since *Cadbury-Schweppes*, or even the one currently proposed by the OECD GloBE proposal,[1453] otherwise the meaning and effectiveness of the anti-avoidance measure would be completely undermined.[1454] Furthermore, a MNE that performs BEPS involving royalties will certainly be well prepared for an eventual test of this nature, which will be consistently part of the equation involving its aggressive tax planning structure. While a well-structured corporate group would nowadays hardly fail a substance test, it would be possible to allow for those who provide evidence of their good faith, for instance of the moment and reasons of their corporate structuring, destination of royalty payments and beneficial ownership, as well as effective tax rates of the countries involved, to enjoy a more beneficial final

[1450] It is necessary to make an assessment based on all the circumstances of each individual case, which is in principle in line with the requirements of previous case law of the ECJ. See, for example, *Centros* (C-212/97), para. 25.
[1451] C-484/19. Within this context, a national measure that mechanically applies a presumption of abuse for any intragroup cross-border transaction would likely be incompatible with EU law. See Bañuelos, José A. García; Calderón, José M. (2021): Lexel: Not All Base-Erosion Measures Are 'EU Proof', CJEU Says. In *Tax Notes International* 101 (11), P. 1416f.
[1452] See the general idea by Rothe, Sarah; Schade, Filip (2020): Unionsrechtliche Legitimation unilateraler Missbrauchsbekämpfung am Beispiel des deutschen §50d Abs 3 EStG. In *SWI* 30 (12), P. 685f. This is one of the main aspects criticized on the German license barrier, as seen in Müllmann (2021): Die Lizenzschranke als Abwehrmaßnahme im., P. 335f.
[1453] Refer to PwC (2021): Tax Policy Alert. 136 countries reach political agreement on a new international corporate tax framework. Available online at https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-136-countries-reach-agreement-on-a-new-intl-corp-tax-framework.pdf, checked on 11.10.21.
[1454] See Subsection 4.2.3

tax rate[1455] based on the threshold chosen, *e.g.* of 10% instead of 15% – or, as 15% has already been agreed upon by many countries within the OECD context, this could be the more "beneficial" tax rate against a 20% "penalty" counterpart.

It is important to differentiate between a base tax threshold and the actual tax paid by the taxpayer. Consider the following example: a country decides on a tax threshold of 15%, *i.e.* when the ETR paid by the beneficial owner of a given royalty payment is below this amount, the rule will be triggered. However, a different question is how much of this payment will not be deductible at the payee level. While the fairest option is certainly a proportional non-deduction, based on the amount paid abroad – in contrast to the Austrian system, which has a sharp line instead of a sliding scale[1456] – it is possible to determine a more favorable treatment for taxpayers who show indications that they have not set up their corporate structure for tax purposes and who are cooperative with regards to providing information. Thus, it is possible to have a fixed threshold for triggering the rule, but the deductibility will be higher or lower not only based on the ETR paid abroad, but also based on other factors indicating the presence or absence of abuse, as well as the taxpayer's cooperativeness with information about the destination of royalty payments within its corporate group.[1457]

Based on the previous example, with a minimum corporate tax threshold of 15%, one could determine the amount to be considered *non-deductible* as follows:

$$\frac{15\% - ETR\ in\ \%}{15\%}$$

Formula (1) for non-cooperative taxpayers

$$\frac{10\% - ETR\ in\ \%}{10\%}$$

Formula (2) for cooperative taxpayers

According to these formulas, a royalty transaction subject to a 9% ETR will be 40% non-deductible in the hypothesis (1) of a taxpayer that does not provide adequate information about its corporate structure, making use of pass-through companies, for example, and burdening the tax administration with obtaining this information and thus presenting one more indication that its

1455 A similar idea has been proposed for WHT, see Brauner, Yariv; Baez Moreno, Andres (2015): Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy. In *SSRN Journal*. DOI: 10.2139/ssrn.2586202, P. 2ff.

1456 Refer back to Chapter 3.2.2.1.

1457 This system is simpler to operate than substance carve-outs, for instance, that would furthermore undermine the functionality of the anti-avoidance measure.

structure exists for aggressive tax planning purposes. If it is a cooperative taxpayer (2), an ETR of 9% will result in only 10% of the royalty payment being non-deductible, ensuring a minimum amount of taxation for this kind of transaction. Ultimately, while ensuring an adequate amount of taxation, this approach restricts the activation of the rule more strictly to cases where there are more concrete indications of non-cooperativeness and the development of aggressive tax planning structures.

In this way, there will be an incentive for business groups to share essential information among their different members irrespective of group size, in order to determine the final ETR to which royalty payments are subject to, since a more beneficial rate of non-deductibility will apply to these cases. MNE's would be well advised to simply document the factors that are driving the commercial decisions for a given arrangement involving royalties.[1458] This significantly reduces the chances that a royalty-paying entity, due to being controlled by a parent company, does not receive adequate information about *e.g.* beneficial ownership and ETR, as this information will benefit the group as a whole.

While in practice it is true that one entity in a corporate group does not necessarily have access to information or knowledge about all aspects involving the other group members,[1459] it is almost offensive to indicate that this complexity and difficulty in following this rule – at least initially – would burden the companies involved too much.[1460] The level of complexity of the aggressive tax planning structures[1461] designed to save taxes on royalty payments greatly exceeds any difficulties that an entity within the group may have in obtaining the information necessary to be subject to the most beneficial formula. A royalty barrier designed in this way would, in effect, encourage information exchange and cooperation between a MNE and tax administrations, while ensuring minimum taxation involving royalties. This line of reasoning follows a growing tendency

[1458] Refer to the proposal by Seve, Anthony; Austin, Peter; Wright, Ruth (2020): Australian Taxation Office Audit Focus on Arrangements Involving Intangibles. In *International Transfer Pricing Journal* 27 (3), P. 197.

[1459] See, for example, the discussion on hybrid entities by Velarde, Andrew (2019): U.S. Hybrid Rules Require Extensive Knowledge of Structures. In *Tax Notes International* 93 (3), P. 356. The EU proposal for a directive implementing the OECD GloBE minimum tax also raises compliance concerns, as discussed by Thörmer, Falk Richard (2022): Compliance im Lichte des Richtlinienentwurfs zur Mindestbesteuerung. Überblick über die geplanten Erklärungspflichten und Sanktionsmechanismen. In *IWB* (4), P. 134ff.

[1460] Refer, for instance, to the opinion in Finley, Ryan (2019): Business Group Urge Aggregate Approach to Pillar 2. In *Tax Notes International* 96 (11), P. 1035f.

[1461] Discussed in depth in Chapter 1.4.

of expansion of compliance requirements for cross-border tax structures, as is seen with the DAC6 Directive.[1462]

Another aspect to be considered is that, so far, the royalty barrier has been discussed as affecting only transactions between related parties. This seems to be, as discussed above,[1463] the most reasonable option, since it greatly reduces the scope and complexity of the rule, as well as justifies the requirement for the payee to provide information about those who receive the payment. Moreover, the cases in which there will be an aggressive tax planning structure depends on a high degree of coordination within the MNE, which is unlikely to be achieved between unrelated parties.

The biggest problem with this option could be within EU law, where this alternative could result in discriminatory treatment again based on the *Lexel* decision. However, this decision by the ECJ was based on the concept that there could be no different treatment in transactions between related and unrelated parties if there is no *factual* difference between their situations. However, this is not the case with respect to the possibilities of aggressive tax planning, which are very distinct between the two groups. Therefore, it does not seem reasonable to argue that there is discriminatory treatment in differentiating between these categories: not only is this design choice administratively sound, but it does not represent discrimination because it treats *different* parties unequally.

Thus, within the EU – and taking into consideration the restrictions imposed by EU law – the design of the anti-avoidance measure with the greatest chances of being compatible with higher-ranking law while simultaneously achieving its objectives against BEPS is a royalty deductibility barrier which would activate (a) in transactions involving the assignment of rights;[1464] (b) between related parties only; (c) with rates around 10 to 15%, depending on the country's current corporate tax rate,[1465] either with a hard or a soft threshold; (d) presenting the possibility

[1462] See Directive 2018/822/EU and Max, Marcel; Laile, Matthias; Nolte, Dirk (2021): Meldepflichten für grenzüberschreitende abzugsfähige Zahlungen - DAC6/C1. In *IStR* 30 (17), P. 645ff.
[1463] Refer back to 3.1.2.2.1, which also applies here.
[1464] Depending on the national classification of what royalties would be. Refer to Chapter 1.1.1.
[1465] It is recommended that the threshold be significantly below the country's current corporate tax rate, so as not to completely eliminate international tax competition, but only to ensure a minimum amount of taxation to fight off aggressive tax planning structures.

for the taxpayer to present evidence[1466] that its structure was not created with a tax-saving objective, whereby the provision of information and cooperation may result in a reverse exception to the rule or a more beneficial deductibility rate; and (e) having as a legal consequence the *proportional* non-deductibility of the payments, based on the tax actually paid abroad on the royalty payments.

Restricting the application of the rule only to preferential regimes that are not OECD nexus-approach compliant, as is the case with the German rule, presents many problems, as discussed in Chapter 3.2.2.2. The ideal within the EU would therefore be an anti-avoidance measure that explicitly handles the fight against aggressive tax planning structures using ETR as the main – but not the only – indicator, admitting some evidence to the contrary. So far, a few different forms of royalty deductibility barriers have been implemented within and outside of the EU, however none of them fulfills simultaneously all the requirements presented here – as is the case with the GloBE proposal so far –, which can be checked in Appendix I at the end of this dissertation. It is worth remembering that this does not mean that a rule following these dictates will necessarily succeed before the ECJ when analyzed *in concreto*: as indicated in the previous chapter, the requirements of European law are currently too strict to allow for an (effective) anti-avoidance measure of this nature. However, it is to be hoped that, by following these basic design guidelines, it will be possible to unilaterally implement[1467] a deductibility barrier for royalties – as is currently accepted for interests – through a smoother shift in the Court's jurisprudence.

5.3.1.3 Incidence of factors external to the EU system within the Member States

The main issue is that, in addition to the requirements of European law, there are further requirements that apply to EU member countries as well, as is the case with WTO law. Royalty barriers could only be fully in line with the most-favored nation principle contained within the

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[1466] The issue of the burden of proof might also be relevant, insofar as a rule that intends to prevent tax avoidance cannot place this burden solely on the taxpayer, which would be incompatible with ECJ law. Differently than what was indicated in decisions such as *Cadbury Schweppes* and *Thin Cap*, more recent decisions such as *Eqiom*, *Euro Park Service*, *Juhler Holding* and even the *Danish Cases* advocate for a more proactive tax authority participation in providing evidence of abuse. Refer also to Ravelli, Fons; Franconi, Federico (2021): Numerous EU Member States are in Breach of EU Law by Requiring Taxpayers to Demonstrate Absence of Abuse. In *European Taxation* 61 (10), P. 440ff.

[1467] Or through a directive, which would be even better, although unlikely, as discussed in Chapter 4.2.

GATS, for instance, if a provision for this type of anti-avoidance measure would be established in a double tax treaty, in order to trigger the exception of Art. XIV *lit*. "e" of the treaty. In the case of this same principle within bilateral investment treaties, as a rule there will be no violation only in the event of a broad or specific tax carve-out. Apart from these exceptions, there will definitely be a discriminatory violation of international treaties due to these measures.

This seems, in principle, a dead-end for the implementation of royalty deductibility barriers, and not only within the EU. However, despite the fact that, from a technical point of view, even this more taxpayer-inclusive and less discriminatory rule design would still be incompatible with WTO law and some BITs, in practice its implementation would hardly be questioned. While the enforceability within the EU is very strong, through mutual control between the different MS through the ECJ, the arbitration process within BITs and the dispute settlement procedure within the WTO is as a rule much "softer" – even if it is not soft law – and ends up being much more lenient with measures that do not impair the economy as a whole.

This means that the differences in political influence of certain countries *vis-à-vis* others is more evident in bodies like the WTO, in contrast to the more robust and sedimented supranational legislation of the EU that has to be followed more strictly so that unilateral initiatives are not immediately repelled. Of course, this does not mean in any way that WTO law and the BITs should not be taken seriously, but it is natural to expect that a measure already implemented by several relevant countries in the international market,[1468] coupled with the evident recent interest in combating BEPS,[1469] and intensified by the growing need to increase tax revenue due to the Covid-19 pandemic, would likely prevail in practice – even when they technically shouldn't – against general principles contained within these treaties.

Thus, while it is important that the newest BITs, for example, be negotiated already with tax carve-out clauses to avoid this type of conflict,[1470] or even that a partial reform of the GATT and GATS exceptions should be considered, the imminent need to implement an effective response to the problem with royalties justifies from a practical and political standpoint the violation of

[1468] And being discussed as a directive within the EU.
[1469] Specially now, not just with the BEPS Action Plans, but also with approval of such a rule by the incluse framework of the OECD, since countries are bound to accept the application of the rule by other framework members. See Chapter 3.4. for more information.
[1470] Refer to the suggestions made in 4.3.3.2.

some of the principles of international trade. If the requirements of EU law are met in the implementation of a royalty barrier, which is feasible with the current design constellation presented above, it is to be expected that, despite the violations of WTO law and BITs, these rules will be "tolerated".[1471]

5.3.2 Practical solutions outside the scope of the European Union

For non-EU countries, the restrictions for implementing this type of anti-avoidance measure are thankfully fewer. This means that a deductibility barrier for royalties along the lines presented so far could also be implemented by them. Regardless of the tax treaty network of the countries aiming at this implementation, there are no violations of DTTs identified as problematic.[1472] While other alternatives, such as WHT, are once again among the viable alternatives, since the Interest and Royalties Directive does not apply to them, it would mainly be attractive for *developing countries* – if they do wish to implement such a defensive mechanism.[1473] Due to the simplicity of implementation of WHT, and because it is a system already widely known and used in the context of cross-border transactions, countries with a less developed tax administration benefit from this type of solution.[1474] It would furthermore require, in the worst case scenario, only a treaty override of existing DTTs due to the provision of Art. 12 OECD-MC.

This reinforces the idea that there is more than one effective alternative for resolving the issue with royalties, but higher-ranking law requirements and the political and infrastructure conditions of a given country may directly influence the suitability of a particular anti-avoidance measure. While developing countries might even decide for withholding with a broad specter – certainly the alternative with the lowest administrative costs – it would be interesting to evaluate the possibility of a more targeted answer in the form of a conditional WHT. In this way, a broad

[1471] Even the very strict Austrian rule has, surprisingly, been "tolerated" sofar within the EU itself, let alone on WTO level.

[1472] See Chapter 4.3.1. There is, however, a discussion on whether treaty modifications are necessary for the GloBE proposal as a multilateral option, specially when it comes to the subject-to-tax rule. Refer to Das, Pitambar; Rizzo, Amedeo (2022): The OECD Global Minimum Tax Proposal under Pillar Two: Will It Achieve the Desired Policy Objective? In *Bulletin for International Taxation* 76 (1), P. 51ff.

[1473] Many developing countries already have WHT as their main taxation system for royalty payments, see Abdellatif Khalil (2013): Taxing intellectual property transactions in., P. 247ff. This might, of course, not necessarily be the case, as not even CFCs are implemented everywhere. See Arnold, Brian J. (2019): The Evolution of Controlled Foreign Corporation Rules and Beyond. In *Bulletin for International Taxation* 73 (12), P. 647f.

[1474] If it is simple, effective and viable, there is little reason not to go for it. A line of reasoning also shared by Schön, Wolfgang (2021) on his Taxation of the Digitalized Economy course at the *Max-Planck Law Teaching Session*.

violation of DTTs would be avoided, since only in cases where there is evidence of abuse and/or payments to low-tax jurisdictions[1475] would this kind of withholding be activated, in the form of a subject-to-tax clause,[1476] causing only limited harm to the attractiveness of a developing country as a business location.

As was discussed in Chapter 3.1.2.2.3, for a conditional withholding tax to be successful in achieving its objectives, three main requirements are necessary, namely: (i) that its rate is low enough to avoid distortions in the market, especially distinctions between net and gross taxation; but high enough for MNEs to strive to avoid it; (ii) in order to avoid cases of "pass-through" companies, ideally the tax base should be the broad amount of the royalties received, without the deductions of the royalties paid to third parties; and finally, (iii) the criteria to apply the tax conditionality should be clear, precise and based on the ETR,[1477] also allowing for the taxpayer to submit evidence that there was a tax recollection abroad to avoid the withholding of the tax.

Unlike the case with deductibility barriers, which can easily be made proportionate to avoid double taxation, the issue with WHT allows mainly for a more rudimentary solution in the form of tax credits. Withholding tax relief based on the amount paid abroad is a reasonable alternative with relatively low administrative costs, since it relies on the taxpayer's own reporting and initiative. While this alternative is attractive for developing countries, it unfortunately does not solve the issue with the incompatibility with double taxation agreements, especially Art. 12 OECD-MC.[1478] Considering that the position of developing countries to renegotiate DTTs may not be as strong as that of other countries, treaty overriding is especially here one of the few ways to solve this impasse. Precisely because of this, the measure that presents the least amount of issues in this regard and should be preferred as much as possible – even though it is more sophisticated

[1475] The 10-15% tax rate could be applied to these cases as well.
[1476] Much like the GloBE proposal STTR that would also be an alternative, even though it was currently only accepted at a 9% threshold.
[1477] In some cases it might be acceptable to base it on the nominal rate, to reduce complexity even more for developing countries. Refer to Larking, Barry (2020): What the World Thinks of Pillar 2. In *Tax Notes International* 98 (2), P. 203. Another alternative would be a blacklisting system, such as the one existing within the EU. So far, 13 EU countries have implemented some sort of non-deductibility rule based on these recommendations. Refer to Ditz, Xaver; Seibert, Carolin (2022): Germany's Implementation of EU Defensive Tax Measures against Non-Cooperative Jurisdictions. In *European Taxation* 62 (1), P. 18f. There are, however, some compatibility issues to be considered in this case, as stated by Geringer, Stefanie (2021): Umsetzung und Anwendung der EU-Blacklist in den Mitgliedstaaten. In *SWI* 31 (8), P. 415.
[1478] WHT would not only have to be implemented nationally, but also while reforming DTTs. This requires intense international cooperation, especially to avoid pass-through structures Refer to Vleggeert, Jan; Vording, Henk (2017): A Tax on Aggressive Tax Planning. In *SSRN Journal*. DOI: 10.2139/ssrn.2949840, P. 3ff.

and presents greater challenges due to its complexity – is undoubtedly the royalty deductibility barrier.

5.3.2.1 Nuances between developing and developed countries considering the ease of administration

Therefore, countries that have a better *developed tax administration* and are not part of the European Union should definitely take into consideration the implementation of a deductibility barrier to curb profit shifting through royalty payments, without having to worry too much about the issue of discrimination that presents a problem within EU law, especially after the GloBE negotiations. Here the implementation of the inverted tax credit system would also be feasible without having to worry about compatibility issues, and the only problem that would have to be dealt with is the reduction of the attractiveness of a country as a business location. A developed country might be willing to put this competitiveness at stake if it is confident enough of its market importance in the international scenario, while at the same time wishing to curb BEPS with royalties. However, a less revolutionary alternative is available in the form of royalty barriers, whose implementation would seem to be much more reasonable, fulfilling requirements of simplicity, coherence and a relative ease of administration.[1479]

One of the last issues to be discussed, and the subject of extensive and intense debate within the OECD GloBE proposal, is about the possible exceptions to a royalty deductibility barrier in the form of carve-outs and/or a *de minimis* threshold for activating the rule.[1480] Needless to say, the adoption of a unilateral barrier has the enormous advantage that this type of exception can be tailor-made to the economic reality and the companies present in a given country. Furthermore, it is the author’s opinion that there is no good reason as to why a country should refrain from implementing alternative, stricter measures in order to better deal with the specific aggressive tax planning structures of the MNEs resident in a country, as long as those rules are applied – as proposed here – within the context of this State’s existing international obligations.

[1479] See the opinions of Johnston, Soong Stephanie (2020): Let's Get Back to Basics With GloBE Tax Proposal, Academic Says. In *Tax Notes International* 97 (3), P. 334.

[1480] Since the discussion for a global blending is unecessary, as it would defeat the purpose of the norm in its entirety. Only an entity approach (no blending) is acceptable. See Larking, Barry (2020): What the World Thinks of Pillar 2. In *Tax Notes International* 98 (2), P. 197f.

In general, the understanding is that there can be carve-outs for companies that do not perform activities that could engage in aggressive tax planning structures by taking advantage of harmful tax competition.[1481] This would be the case, for example, for tax-exempt businesses for public policy reasons, such as charities. While it is dangerous to allow specific sectors to fall outside the scope of the rule, since it is precisely this type of measure that can create loopholes within tax law and provide for tax planning opportunities, it is understandable that some countries decide to reduce the scope of the rule to make it more manageable. As long as no *substance* carve-outs are implemented[1482] – as they would, from what was explained before, kill the purpose of the norm – other forms of it should be fine if done in a very restricted way and adapted to the existing classifications in national law.

However, perhaps a more efficient and generic alternative would be to implement only a size carve-out,[1483] in the form of a *de minimis* threshold, whereby in cases where a corporate group has a consolidated annual global revenue below a certain value,[1484] they would be excluded from the application of the royalty barrier. This would allow smaller multinational groups to be spared from the potentially high administrative and compliance costs associated with providing information and obtaining the relevant documentation for this type of barrier. As a unilateral measure, the *de minimis* threshold of 750 million euro commonly used for other BEPS measures such as CbC reporting and accepted in connection with the GloBE proposal[1485] could simply be ignored by countries that feel it to be too high and unfavorable[1486] – or even for bigger markets that consider it to be too low. Some African countries have manifested, for instance, that with a threshold of 750 million euros there would hardly be an activation of such a rule, as their national

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[1481] See the discussion by Herzfeld, Mindy (2020): Want a Pillar 2 Exemption? Get in Line. In *Tax Notes International* 97 (5), P. 470f.

[1482] As is currently being proposed at OECD level. See OECD (2021): Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two). Available online at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf, checked on 22.12.21.

[1483] The compatibility of which under EU law is very disputable. See the upcoming book from Hintermayer, Paul on this matter.

[1484] For instance 3 billion dollars, as suggested by the German Federal Chamber of Tax Advisers.

[1485] With the overall goal of reducing compliance costs for MNEs, but not necessarily successful, as indicated by Dourado, Ana Paula (2022): Pillar Two Model Rules: Inequalities Raised by the GloBE Rules, the Scope, and Carve-Outs. In *Intertax* 50 (4), P. 284f.

[1486] Even though this would be outside of the scope of the proposed OECD project, making this into a full-fledged unilateral measure. Refer to the opinions in Lamer, Elodie (2022): EU Talks Consider Extending Pillar 2 To Smaller Companies. In *Tax Notes International* 105 (9), P. 1052.

companies revenue is lower and would thus be triggered less often.[1487] Reducing this threshold would be a fair and easy way of expanding the scope for developing countries.

Hence, it should be up to each country, in addition to the already discussed basic design requirements of a royalty deductibility barrier, to determine to what extent it would want the introduction of carve-outs and a *de minimis* threshold. While the harmonization promoted by GloBE is desirable up to a certain point,[1488] it is necessary to realize that different countries will have valid different perspectives on the matter. In this sense – and this also applies to the proposal of an EU directive wishing to implement the GloBE minimum tax[1489] – no deal is definitely better than a bad deal. If (developing) countries do realize that an implementation of these rules as they are would be detrimental to their economies, it would be hard to argue that they should be penalized for adopting alternative measures, especially considering the need for revenue in post-Covid times.[1490]

The most reasonable and simplest approach seems to be to design only a minimum threshold, with values compatible with the national economy, considering that carve-outs could not only create opportunities for aggressive tax planning, but also increase the complexity of royalty barrier enforcement. Moreover, cross-border transactions involving intellectual property already create many opportunities for profit shifting, and therefore a solution involving solely a *de minimis* threshold would cover all necessary cases where the activation of the rule would not be necessary.

To briefly summarize: there are, for the royalty issue, three main groups of countries that can be differentiated with respect to feasible and recommended alternatives. For (a) EU MS, a carefully designed royalty barrier, necessarily coupled with a slight shift in the ECJ's jurisprudence,[1491] is the only viable alternative at the moment; (b) for non-EU countries, a royalty

[1487] Adegite, Victor; Dushime, Aimée (2020): Pillars 1 and 2: African Perspectives. In *Tax Notes International* 98 (12), P. 1416.

[1488] This is true both to EU and non-EU relations. Some question – and with good reason – the tax harmonization process arising within the EU from GloBE, as Schön, Wolfgang (2022): Internationale Steuerpolitik zwischen Steuerwettbewerb, Steuerkoordinierung und dem Kampf gegen Steuervermeidung. In *IStR* 31 (6), P. 184f.

[1489] Being currently entirely blocked by Hungary, as seen in Johnston, Soong Stephanie (2022): Hungarian Lawmakers Nix EU Pillar 2 Minimum Tax Directive. In *Tax Notes International* 106 (13), P. 1678.

[1490] As is the opinion of BEPS Monitoring Group (2021): BEPS Monitoring Group Comments on G-24's Reaction To OECD Two-Pillar Solution. In *Tax Notes International* 104 (2), P. 145.

[1491] This shift is strictly necessary, otherwise there will be no solution to this problem within the economic bloc.

barrier would also be a reasonable alternative, and even without the constraints of EU law, it would be legitimate to follow the more balanced design suggested for the EU; alternatively, and in particular for (c) developing countries and countries with a less developed tax administration structure, one could think of implementing a conditional WHT, in the form of a subject-to-tax withholding, secured through an (explicit) treaty override so that eventual incompatibilities with the country's DTT network are solved immediately. While the question involving WTO law and BITs without some sort of tax carve-out depends a lot on the reasoning and justifications employed in each case – and we lack case-law on the matter so far – the implementation of measures like this in recent years, coupled with a growing importance of fighting BEPS might be, as mentioned previously, enough to deter these areas of law from posing problems to such solutions involving royalties.[1492]

5.3.3 Coordinating the royalty deductibility barrier and further anti-avoidance measures

Finally, the last issue to be addressed is not about the royalty deductibility barrier *per se*, but rather its coordination with other anti-avoidance measures that may already exist or be implemented in parallel with it. As was clear from the discussions conducted in Chapters 2 and 3, there is no single answer to the royalty question, and different rules act in different ways and at different points in an aggressive tax planning structure. Thus, rules such as the CFC-rules, while not solving the issue on their own, deal with the so-called *outbound* cases,[1493] an issue of a different nature, much like the income inclusion rule does, suggested within the context of the OECD GloBE proposal.[1494]

It is certain that in cases where a CFC rule is applied, that the ETR to which the payment is subject will increase by being incorporated into the revenue of the payor. While this assumes that the controlling company must be located in the national territory, in cases where this anti-avoidance measure is activated, it should take precedence over a royalty deductibility barrier,[1495]

[1492] Refer back to Chapters 4.3.2 and 4.4.
[1493] See Chapter 2.1.2.4.
[1494] One major criticism directed at the Pillar Two of the GloBE proposal is the fact that it does not provide for a priority rule regarding other national anti-avoidance measures, increasing the complexity burden dramatically for some companies. Ideally, one rule would have to replace the other. This is one of the consequences of seeking a one-size-fits-all approach. Refer to Schön, Wolfgang (2022): Internationale Steuerpolitik zwischen Steuerwettbewerb, Steuerkoordinierung und dem Kampf gegen Steuervermeidung. In *IStR* 31 (6), P. 189ff.
[1495] Much like the relation between the income inclusion rule and the undertaxed payments rule.

since the application of the former ensures the activation of the latter to be unnecessary. Thus, while CFCs and royalty barriers may in some cases deal with the same type of structure, they do so from a different perspective, and it is unlikely that direct conflicts will exist between them.

An entirely different situation occurs with the application of TP rules and documentation requirements, since the use of the arm's length principle remains indispensable for discussions about cross-border royalty payments to be based on a correct allocation of profits. While this correct allocation does not prevent aggressive tax planning structures from taking advantage of asymmetries between tax systems in different countries, it creates an even ground for an actual anti-avoidance measure to do so.[1496] Despite the many difficulties of using transfer pricing on transactions involving intangibles, even with the recent updates in the methods provided by the OECD,[1497] through retroactive price adjustments clauses it is possible to achieve a satisfactory result based on an *ex post* comparison between estimates and actual results. Real alternatives to the arm's length principle are, as of now, out of reach anyway.[1498] Therefore, TP rules by no means lose their importance when implementing a royalty deductibility barrier;[1499] on the contrary, they help with a more precise application of the anti-avoidance rule by allowing a better calculation of the ETR based on a correct allocation of profits. Further calculation of the ETR can be, for instance, based on adapted accounting standards, as advocated currently by the OECD in the GloBE proposal, or even on national standards if a measure is unilateral – which might, however, lead to discrepancies and instability when calculating it.[1500] Nevertheless, transfer pricing will play a role in these calculations, which is to say that, for a royalty deductibility barrier to be effective, the arm's length principle *has* to be applied in the best fashion possible.

[1496] See the coordination between specific anti-avoidance and TP rules in Boidman, Nathan; Kandev, Michael N. (2020): Evaluating Canada's Attempt to Reconcile General Transfer Pricing Rules and Specific Antiabuse Provisions. In *Tax Notes International* 98 (6), P. 699ff.; and the general importance of TP for aggressive tax planning structures in Nir, Daniel; Patrun, Elizabeth (2020): Mitigating the BEAT: Practical Transfer Pricing Strategies. In *Journal of International Taxation* 31 (9), P. 34f.
[1497] Countries still continue, however, using the (for IP largely ineffective) CUP method, while reporting little or no experience with the TPSM.
[1498] Refer to Chapter 2.1.1. and Kaeser, Christian; Owens, Jeffrey; Sim, Sam (2019): Going the Way of the Polaroid: Digital Taxation and the End of the Arm's-Length Principle? In *Tax Notes International* 95 (3), P. 216f.
[1499] See Chapter 2.1.1.4.
[1500] The economic aspects of calculating the ETR go beyond the scope of this research.

Another rule that not only can, but should be employed in parallel with a royalty barrier is the general anti-avoidance rule. Now an integral part of the European legal system,[1501] these rules will naturally play their safety-net role, to cover more severe cases of abuse that may not be contemplated by a royalty barrier. The very notion of specific anti-avoidance rules suggests that certain types of avoidance schemes are acceptable as long as they happen outside the design parameters of these targeted provisions, hence the importance of coordination with GAARs.[1502] According to the principle of *lex specialis derogat legi generali*, the specific deductibility rule will naturally have priority over the general rule.[1503] However, the latter remains very relevant insofar as it is impossible for a specific rule to cover through its design all cases, present and future, of aggressive tax planning. While for reasons of legal certainty the general rule will restrict only the most egregious cases of abuse, this ensures that these are not left unanswered due to a technicality of not falling within the scope of the royalty deductibility barrier.

This coordination between carefully chosen design possibilities, together with the support of other broad measures within the context of international tax law, is the only feasible way, in practice, to solve the problem of base erosion and profit shifting involving cross-border royalty payments. While none of these measures is by itself sufficient, combining the advantages that each of them offers,[1504] whilst keeping a royalty deductibility barrier at the heart of it all, ultimately compensates for any shortcomings they may have on their own. Although the problems with higher-ranking law simply cannot be nullified in its entirety as of now, this course of action in the form of a *constructive unilateralism* has a greater chance of yielding positive results and contributing to an evolution of the system as a whole than simply waiting for multilateral negotiations that mean to solve all issues at once.

[1501] See Chapter 2.1.3.3. Multiple domestic GAARs do lead to more legal uncertainty, so this is a reasonable path to take. See Dourado, Ana Paula (2015): Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6. In *Intertax* 43 (1), P. 51f.

[1502] Refer to Cassidy, Julie (2019): GAAR anti-avoidance vs GAAR anti-abuse. In *Journal of International Taxation* 30 (9), P. 53f.

[1503] See Chapter 2.1.3.4.

[1504] While most countries have no specific anti-avoidance rules, they do have TP and GAARs. See Russo, Caterina Colling; Karnath, Susan (2019): Intercompany Licensing of Intangibles - A Comparative Global Outlook. In *International Transfer Pricing Journal* 26 (6), P. 383f.

Conclusion

This doctoral thesis had a very specific objective: to present a viable answer to the so far unsolved problem of aggressive tax planning structures that use cross-border royalty payments to save taxes. It was proven, due to the very nature and concept of intangible assets, linked to uniqueness, ease of transfer and high value, that it is relatively easy for MNEs to take advantage of tax planning opportunities involving this type of asset. There are several business structures that can benefit from this type of transaction, although there is a clear pattern that can be identified that relies on certain asymmetries between tax rules in different countries, often benefiting from preferential regimes known as IP-Boxes.

Despite the existence of general rules that may indirectly tackle this issue, it has been shown that, considering the current applicability of transfer pricing rules, CFC rules and GAARs, that these regulations are, for different reasons, unfortunately insufficient to deal with the issue of royalties. TP rules are no anti-avoidance measures, and although they remain important for determining the correct allocation of profits and consequently of taxing rights, the uniqueness of IP and the lack of comparables greatly restrict their general usefulness. CFC rules, on the other hand, deal in particular with the so-called outbound cases, only one of the possible structures for saving taxes by multinational companies, which also does not solve the problem in its entirety. Finally, general anti-avoidance rules play a very important backstop role to avoid more crass cases of tax avoidance, but they are by their very nature very generic and offer little legal security for taxpayers and tax administrations alike, which ensures a mere complementary character in relation to more specific rules.

There are several specific provisions that can, in a more targeted manner, deal with the problem of royalty payments. However, it was shown how each one of them has shortcomings in their application and, in particular, different implementation difficulties that range from political, economic, to legal issues. While (the lack of) withholding taxes represent one of the main factors that open up tax planning opportunities involving royalty payments, they are undesirable from an economic point of view and are commonly restricted by treaty and even European law. The decision to restrict the deductibility of this type of payment, much like with interests, represents a more modern solution to a modern problem, but one which may generate significant impacts on the attractiveness of a given country as a business location, besides bringing about multiple

questions involving higher-ranking law, depending on design choices. Other ideas, of a more revolutionary nature, as is the case with the inverted tax credit system, would completely destroy any form of international tax competition, which is not only extremely difficult to implement by itself, but also unlikely to be accepted without some sort of reaction from the international community.

While in recent times there has been progress in the international discussions about solutions to this type of problem in the form of the OECD GloBE proposal – which deals in particular with the challenges of the digitalization of the economy, but also proposes a global minimum tax and rules that would eventually encompass the other solutions to the royalty issue – there are still doubts about the feasibility of implementing these solutions, due to restraints within the EU unanimity system for directives on tax matters and even the US Congress. This happens especially at a multilateral level, particularly due to difficulties involving higher-ranking law and the specific design that a definitive solution to the problem should have. One of the main challenges involves EU law, where the European Court of Justice has developed an extremely restrictive jurisprudence for anti-avoidance measures, commonly linked to a substance requirement that destitute measures of their effectiveness. The justifications for violations of fundamental freedoms seem, to some extent, unattainable without a modification – at least partial – of the understanding held so far by the Court. However, the chances of success of a measure adopted by an EU Member State increase significantly depending on the layout choices for the anti-avoidance measure.

The troubles are not, however, restricted to EU countries only, since there are restrictions not just in double tax treaties, but also in bilateral investment treaties for WHT and royalty deductibility barriers alike. Similar problems are found within the often-forgotten WTO law, in particular due to the MFN principle. Thus, this work sought, in the end, to present a viable solution to this problematic issue surrounded by problems, difficulties and restrictions.

While it is clear that there is not just one solution to the issue of cross-border royalty payments, a best-practice approach has been proposed that combines the suitability of a measure to achieve its objectives effectively and that has a feasible implementation in the current international tax environment. While the international efforts of the GloBE proposal are commendable, its common approach does not propose minimum standards and harmonization for

the countries of the inclusive framework, which ultimately pushes countries to adopt unilateral measures that implement rules similar to those discussed at the international level. However, the reality is that countries may not only have very different interests, but also different economic, legal, and infrastructure realities.

Therefore, the proposal of effective alternatives with practical chances of success necessarily involves an analysis of what *type* of country wishes to implement a solution to the problem. For EU Member States and developed non-EU countries, a carefully designed royalty barrier, necessarily coupled with a slight shift in the ECJ's jurisprudence for the former; and for developing countries and countries with a less developed tax administration structure, a WHT might still be the best option, most likely a conditional one. The "carefully designed" royalty deductibility barrier should, thus, (a) include transactions involving the assignment of rights; (b) between related parties only; (c) with rates in a range of 10 to 20%, considering current world average; (d) presenting the possibility for the taxpayer to present evidence that its structure was not created with a tax-saving objective, as well as ensuring that it does not bear the burden of proof by itself; (e) having as a legal consequence the proportional non-deductibility of the payments; and (f) with a *de minimis* threshold based on the economy and the companies present in the country concerned and without any carve-out, if at all possible.

While we await the final results and in particular the practical implementation of the OECD discussions with bated breath, immediate design solutions have been presented in this thesis based on a careful analysis of the problems, measures involved and restrictions of higher-ranking law in the hopes that countries will have a north to finally solve a not-so-new problem that has taken on immense proportions in recent years.

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Appendix I: Global Overview on Rules Restricting the Deductibility of Royalties

Country	Has some form of Royalty Deductibility Barrier?*
Afghanistan	N
Algeria	N
Angola	N
Antigua and Barbuda	N
Argentina	N
Armenia	N
Aruba	N
Austria	Yes, 10% or lower ETR activates the barrier.
Azerbaijan	N
Bangladesh	Yes, prescribed limits. Limited to 10% of the net profit disclosed in the statement of accounts excluding any profit of subsidiary or associate or joint venture for the first 3 income years from the commencement of business or profession. For subsequent income years, the deductibility is limited to 8% of the net profit disclosed in the statements of accounts.
Barbados	N
Belgium	Yes, anti-avoidance, Royalties are not deductible if they are directly or indirectly paid or attributed to any foreign company, establishment or individual when, according to the law of the country where these are established or resident, they are not liable to income tax or are subject for this income to a tax treatment which is notably more favourable than that of Belgium (article 54 of the ITC). The disallowance of these deductions is intended as an anti-avoidance measure.
Belize	N
Benin	N

Bhutan	N
Bolivia	N
Botswana	N
Brazil	Yes, limited to between 1% and 5% of the net income.
Brunei	N
Bulgaria	N
Burkina Faso	N
Burundi	N
Cabo Verde	N
Cameroon	Yes, deductible up to an overall limit of 2.5% of taxable income
Canada	N
Central African Republic	Yes, payments for royalties, services and interest to non-resident companies incorporated in low-tax jurisdictions or tax havens (article 131 bis of the GTC) are non-deductible.
Chad	Yes, deductible up to a limit of 10% of the taxable profit before deduction of these expenses
Chile	Yes, deductible up to 4% of receipts from sales or services. This limitation does not apply when those payments are subject to income tax in the country where the beneficiary is domiciled at a rate of at least 30%.
China (People's Rep.)	N
Chinese Taipei	N
Colombia	Yes, royalties paid to foreign related parties or related parties located in free trade zones (FTZs) are not deductible.
Comoros Islands	N

Congo (Dem. Rep.)	Yes, deductibility of interest, royalties and service fees paid to foreign entities that are subject to a preferential tax regime or based in a non-cooperative tax jurisdiction is subject to the conditions that the expenses are actual, normal and not excessive. Foreign resident persons are considered subject to a preferential tax regime if they are not subject to tax in their residence country or are subject to corporate income tax or individual income tax which is lower than 50% of the corporate income tax
Congo (Rep.)	N
Cook Islands	N
Costa Rica	N
Croatia	N
Curaçao	N
Cyprus	N
Djibouti	N
Dominica	N
Dominican Republic	N
Ecuador	Yes, are deductible up to 20% of the taxable base for income tax purposes plus the value of these expenses.
Egypt	N
El Salvador	N
Equatorial Guinea	N
Eritrea	N
Eswatini	N
Ethiopia	N
Fiji	Generally non-deductible

France	Yes, The deduction of royalties paid to related companies is limited if such companies meet the three following conditions: they are not resident of a state member of the European Economic Area (EEA); they benefit from a tax regime considered as harmful by the OECD; and they are not subject to an effective tax rate of at least 25% with respect to the royalties (article 39 (12 ter) of the CGI).
French Guiana	Same as France
French Polynesia	N
Gabon	N
Gambia	N
Ghana	N
Greece	N
Greenland	N
Grenada	N
Guadeloupe	Same as France
Guatemala	Yes, are deductible as long as the amounts paid do not exceed the equivalent of 5% of the company's gross income
Guernsey	N
Guinea	N
Guinea-Bissau	N
Guyana	N
Honduras	N
Hungary	N
Ireland	N
Israel	N
Italy	N
Ivory Coast	Yes, limited to 5% of turnover up to 20% of the general expenses of the enterprise
Jamaica	N

Jordan	N
Kazakhstan	N
Kenya	N
Korea (Rep.)	N
Kuwait	N
Kyrgyzstan	N
Latvia	N
Lebanon	N
Lesotho	N
Liberia	N
Libya	N
Lithuania	N
Luxembourg	Yes, owed to a related enterprise established in a country or territory included in the EU list of non-cooperative countries and territories for tax purposes
Madagascar	Yes, to non-resident persons located in a foreign country classified as a low-tax jurisdiction under the general tax code. May present proof
Malawi	N
Malaysia	N
Maldives	N
Mali	Yes, within the limit of 3.5% of turnover excluding VAT
Malta	N
Martinique	Same as France
Mauritania	N
Mauritius	N
Mexico	Yes, deductibility denied if tax payment abroad is under 75% of national mexican rates
Moldova	N
Montserrat	N

Morocco	N
Mozambique	N
Namibia	N
Netherlands	N
New Caledonia	Yes, paid by companies engaged in mining activities to shareholders who hold, directly or indirectly, more than 50% of the capital of the company, are non deductible
Nicaragua	N
Niger	N
Nigeria	N
Niue	N
Northern Mariana Islands	N
Oman	N
Palestine	N
Panama	N
Papua New Guinea	N
Paraguay	N
Peru	N
Philippines	N
Poland	Yes, if paid to a related person or to a company or an individual resident in a country or a territory engaging in harmful tax competition above a certain limit, will be deductible only up to 5% of EBITDA
Portugal	N
Puerto Rico	N
Qatar	N
Romania	N
Rwanda	N
Samoa	N

Saudi-Arabia	Yes, payments made by Saudi branches to headquarters that are wholly owned by foreign companies
Senegal	N
Serbia	N
Seychelles	Yes, only deductible up to 3% of the annual turnover or actual expenditure incurred
Sierra Leone	N
Slovak Republic	N
South Sudan	N
Spain	N
St. Kitts and Nevis	N
St. Lucia	N
St. Vincent and the Grenadines	N
Sudan	N
Suriname	N
Sweden	N
Switzerland	N
São Tomé and Príncipe	N
Tajikistan	N
Tanzania	N
Timor-Leste	N
Togo	Yes, deductible only up to 5% of the turnover without VAT.
Tonga	N
Trinidad and Tobago	N
Tunisia	N
Tukmenistan	N
Uganda	N
United Arab Emirates	N
United Kingdom	N

United States	Yes, royalties paid or accrued to related parties pursuant to hybrid transactions, or that are paid or accrued by or to hybrid entities (IRC § 267A). Also the BEAT has some similarities with a royalty barrier, despite not being one.
Uruguay	N
Uzbekistan	N
Venezuela	N
Yemen	N
Zambia	Yes, but only for mineral royalties payable under the Mines and Minerals Development Act nº.11 of 2015.
Zimbabwe	N

Source: Author's creation based on the IBFD country report database (First semester of 2022).

* Excluding common transfer pricing requirements (such as reality and reasonability of a given transaction), present for instance in many Members of the Economic and Monetary Community of Central Africa (*CEMAC)* countries. Basically restricted to anti-avoidance rules and/or hard limits on deductibility. For WHT, Deloitte has a yearly table on their functioning by country.

Appendix II: Chart on Compatibility Issues of Specific Measures against Profit Shifting through Royalties with Higher-Ranking Law

Specific Anti-Avoidance Measure/Higher-ranking law	*EU Law*	*Double Tax Treaties*	*Bilateral Investment Treaties*	*WTO Law*
Withholding tax (broad)	Secondary law: Interest and Royalties Directive	Art. 12 OECD-MC	-*	-
Withholding tax (subject-to-tax)	Secondary law: Interest and Royalties Directive	Art. 12 OECD-MC	Mostly accepted in relation to national treatment, but concerns regarding the MFN if no tax carve-outs.	GATS MFN principle, no apparent justification possibility.
*Royalty Deductibility Barrier***	Primary law: market freedoms, with hard justification due to ECJ case-law.	-***	NT and MFN if no tax carve-outs. Justification possible.	GATS MFN principle, no apparent justification possibility.
Inverted Tax Credit System	-****	-	-	-

Source: Author's creation based on Chapter 4

* Except for cases in which the MFN is activated due to a DTT with a third country.

** The observations made for the royalty deductibility barrier as well as for WHT apply to the GloBE UTPR where the implementation of the latter occurs in the same manner as the formers.

*** Some argue for a violation of Art. 24 OECD-MC, which however is not the case due to the discrimination being indirect and not based solely on domicile.

**** There are points to be made concerning the *tax credit* being different on cross-border transactions from those occurring nationally, but arguable to be part of this system as a whole.