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THE SPREAD CONSEQUENCES OF HYBRID MISMACHES AND TAX AVOIDANCE:

A Breach into European Legal Framework

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INTRODUCTION

The Twentieth Century has led to an impressive degree of evolution; therefore, Globalisation has shattered both physical boundaries and economic barriers.

A free unique market has been created, so companies can operate throughout the world. However, the great opportunities such as free capital mobility and labour mobility, have come with a high price to pay.

Corporate Tax Avoidance is a practice that involves different corporations and different territories simultaneously and, as such, it has global consequences because these companies do not pay their fair share of taxes in the countries in which they perform. As the last decades have witnessed, the free-market has provided multiple opportunities for Tax Avoidance when nations and territories strive to attract international investment by changing their tax rules in favour of powerful corporations. Tax Evasion as it is largely known, represents all actions taken by the taxpayer beyond the law in order to not applying the norm.

As a result, the fiscal duty is really difficult to identify because of his disrespect of the rule. Unlike Tax Evasion, Tax Avoidance is such an intrigued concept, because there is no violation of the rules there may be just a misapplication of norms. Nevertheless, Tax Avoidance is not illegal at all; the norm's usage is completely different and unexpected with respect to the meaning given by the tax authority.

There are many legitimate ways in which tax can be saved and that are actively promoted by governments. Through tax planning, a taxpayer exercises an option clearly allowed such as Tax Avoidance, which seeks to minimise a tax bill in a way that respects the letter of the law, but not necessarily the spirit of the law.

In the wake of the secret rulings called Panama Papers and LuxLeaks, that have been revealed, aggressive tax avoidance planning and strategic loopholes exploitation have become ordinary. Unfortunately, so many jurisdictions have started offering and providing advantageous agreements and customized regulations in order to attract foreign investments. Tax regulations have been re-written by tax authorities, financial controls have been removed, and secrecy has been guaranteed to provide a favourable atmosphere for investors.

The analysis of the phenomenon has stimulated a particular interest in the presented topic. Nowadays, the issue has worsened, in an increasingly interconnected world, businesses and individuals operate across many countries, all with slightly different tax rules. The loopholes that are exploited by Tax Avoidance maybe your home country's tax law alone but can also seek to exploit gaps that exist between domestic tax law and the law of other countries.

Furthermore, whenever a scheme involves arrangements that appear very complex, artificial or contrived; offshore companies and tax haven are involved in order to simplify the entire system.

Profits have been shielding from the tax authorities, they have been made intangibles given to a royalty conduit business, which is build up only to play an exact part of the plan. Their secrecy laws prevent overseas tax authorities from accessing the information on the money that's held in these offshore jurisdictions.

The fiscal and social cost of Tax Avoidance is a major concern for European fiscal policy. Not only does it limit the capacity of countries to finance their economic and social policies, but it is also fundamentally unfair.

From the one hand, because taxpayers with similar incomes end up paying different amounts of tax; from the other hand, it reduces the redistributive power of the tax-benefit system. Income underreporting by individuals is believed to make up a major part of the overall share of taxes.

The thesis is aimed at highlighting that Corporate Tax Avoidance is a widespread practice worldwide, not only great American Corporations implement an aggressive profit shifting pattern, but also European companies exploit the same loopholes effectively. Therefore, after providing a general overview of the International Taxation's functioning, the attention is moved towards the tangled patterns and techniques applied in order to avoid the fair share of taxes and shift huge amounts of profits. However, the nexus of the paper is surely the IKEA case, which depicts the weaknesses of the European legal regulations, dealing with the previously listed tax aggressive planning strategies.

The IKEA Group has exploited since the constitution of the Group a series of favourable taxation and a tangled net of jurisdiction conduits, in order to make up differently their profits completely shield from the taxman.

The core of the issue is that the tax system of norms is too fragmented, as a matter of fact, the force of the law is likely to be ineffective and fail. Besides, the lack of availability to cooperate with certain European jurisdictions, seem to decelerate the resolution of the issue. Nevertheless, a set of possible solutions exists and can be implemented, they surely require quite a time and effort, notwithstanding never before, reactions are needed. The only problem which is not possible to turn out positively and solve is the one it is not desired to be so.

INTRODUZIONE

Il Ventesimo Secolo ha portato ad un impressionante grado di evoluzione; non a caso la Globalizzazione ha infranto sia le barriere geografiche che i confini economici. È stato realizzato un mercato unico e gratuito, cosicché le aziende potessero operare in tutto il mondo. Tuttavia, la libera circolazione dei capitali e della forza lavoro è stata raggiunta con un alto prezzo da pagare che si è manifestato negli ultimi anni. L'elusione fiscale delle grandi società è una pratica che coinvolge diverse imprese e diversi territori contemporaneamente e, come tale, ha conseguenze globali. Infatti, i grandi gruppi aziendali non pagano la loro giusta quota di tasse nei paesi in cui generano la loro ricchezza.

Come gli ultimi decenni hanno potuto testimoniare, il libero mercato ha generato grandissime opportunità, ma allo stesso tempo ha permesso all' elusione fiscale di manifestarsi frequentemente ogni qualvolta numerose nazioni e territori si sono sforzate di attrarre investimenti internazionali modificando le loro normative tributarie a favore di società potenti.

L'evasione fiscale, come è ampiamente noto, rappresenta tutte le azioni intraprese dal contribuente al di fuori della legge al fine di non applicare affatto la norma.

Di conseguenza, a causa della mancanza di rispetto della norma, il debito fiscale è davvero difficile da identificare.

A differenza dell'evasione fiscale, l'elusione fiscale è molto più intricata, perché non vi è alcuna violazione delle regole, potrebbe esserci solo un'errata applicazione delle norme. L'elusione fiscale non è affatto illegale; tuttavia, l'utilizzo della norma è completamente errato ed imprevedibile rispetto a ciò che il legislatore aveva elaborato inizialmente. Esistono infatti molti modi legittimi in cui le tasse possono essere evitate generando un notevole risparmio e che sono attivamente promosse dai governi. Attraverso la pianificazione fiscale, un contribuente sfrutta un'opportunità di manipolazione chiaramente consentita dalle strategie di elusione fiscale. Sulla scia delle rivelazioni degli accordi secretati ed inseguito diffusi chiamati "Panama Papers" e "LuxLeaks", l'applicazione dell'elusione fiscale e lo sfruttamento di alcuni veicoli opportunamente creati sono diventati ordinari.

Sfortunatamente, ad oggi così tante giurisdizioni hanno iniziato ad offrire accordi vantaggiosi e normative personalizzate al fine di attrarre investimenti stranieri.

I codici in materia fiscale internazionale sono stati riscritti dalle autorità numerose volte. I controlli fiscali sono stati rimossi e la riservatezza assoluta è stata garantita per fornire un'atmosfera maggiormente favorevole agli investitori.

L'analisi del fenomeno ha stimolato un interesse particolare nei confronti della tematica appena presentata. Attualmente il problema è in costante peggioramento, in un mondo sempre più interconnesso, le imprese e gli individui operano in molti paesi, tutti con normative fiscali completamente disomogenee.

Le lacune normative sfruttate dall'elusione fiscale possono essere la sola legge fiscale del tuo paese di origine, ma possono anche cercare di sfruttare i numerosi punti ciechi esistenti tra la legislazione fiscale nazionale e la legge di altri paesi.

Inoltre, ogni volta che uno schema di elusione prevede disposizioni che appaiono molto complesse, artificiali o inventate; le società off-shore o alcuni condotti per attività economiche intangibili vengono coinvolti al fine di semplificare l'efficienza dell'intero sistema. I profitti sono stati protetti dalle autorità fiscali, sono stati distribuiti ad imprese create al solo scopo di fare da contenitore per marchi, diritti d'autore su proprietà intellettuali, in pratica sono tasselli mancanti di piani ben congeniati. Le loro leggi sulla segretezza impediscono alle autorità fiscali internazionali di accedere alle informazioni sul denaro detenuto in queste giurisdizioni "d'oltremare". Il costo sociale dell'elusione fiscale è una delle principali preoccupazioni per la politica fiscale europea e non solo.

La capacità dei paesi di finanziare le loro politiche economiche e sociali risulta fortemente compromessa. In aggiunta, è un fenomeno fondamentalmente ingiusto, sia perché da un lato i contribuenti con redditi simili finiscono per pagare diversi importi di imposta; dall'altro lato si riduce il potere redistributivo del sistema fiscale-previdenziale. Si ritiene che i redditi sottostimati dagli individui costituiscano una parte importante della quota complessiva delle imposte.

La tesi ha lo scopo di evidenziare la portata del fenomeno dell'elusione fiscale in tutto il mondo, non solo da parte delle grandi società americane, ma anche alcune società europee sfruttano efficacemente lo stesso modus operandi.

Pertanto, dopo aver fornito una panoramica generale del funzionamento del diritto tributario internazionale, l'attenzione viene rivolta verso i modelli macchinosi e le varie e creative tecniche applicate al fine di schermare i profitti dall'equa quota di tassazione a cui dovrebbero essere soggetti. Pertanto, sono stati ampiamente indagati gli strumenti diffusi utilizzati in linea con le strategie di elusione.

Tuttavia, il fulcro del documento è sicuramente il caso IKEA, che pone in risalto le debolezze del sistema normativo europeo, affrontando le aggressive strategie di pianificazione fiscale precedentemente elencate.

Il Gruppo IKEA fin dalla costituzione ha implementato un sistema di accordi favorevoli e di scudi fiscali ben strutturati in varie giurisdizioni, al fine di proteggere i loro introiti dalle autorità fiscali. La questione che emerge è che il sistema fiscale è troppo frammentato, non a caso l'Europa fatica a compensare la mancata efficacia della legge, che nella maggior parte dei casi risulta fallace. Inoltre, la totale assenza di disponibilità a collaborare da parte di alcune regioni europee sembra rallentare l'invalidazione dell'annosa complicazione. Mai come adesso, il tempo per delle contromisure efficaci è maturo, l'unico problema che non si può risolvere è quello che non si vuole risolvere.

1. THE INTERNATIONAL TAX LAW FRAMEWORK: GUIDANCE PRINCIPLES AND TAX POLICY WARNINGS

1.1 The Basis of International Law System

Public international law is a combination of rules and customs governing relations between states in different fields, such as armed conflict, human rights, the sea, space, trade, territorial boundaries, and diplomatic relations.

Private international law, also referred to as "conflict of laws", consists of rules which govern relations between private entities and decide which domestic law and courts can adjudicate issues with an "international" component[1].

Nevertheless, states are the primary subject of international law, international law can also regulate the actions of other entities, namely: international organisations, non-state actors (including national liberation movements and individuals), international non-governmental organizations, and multinational companies. All can be defined as subjects of international law and can be considered as if they had legal personality, meaning that they have both duties and rights provided for by international law. The norms and rules of international law are codified in a range of different tools and other forms of rulings. The main sources of international law are[2]:

[1]Victor Uckmar CEDAM 1999 CORSO DI DIRITTO TRIBUTARIO INTERNAZIONALE
[2]https://www.oecd.org/tax/treaties/1914467.pdf

Treaties and Conventions are written agreements that state willingly sign and ratify and as a result are required to be followed. Such agreements, which are also called statutes or protocols, govern the mutual relations between states.

However, they are only binding on those states that have signed and also ratified the particular treaty. ***The Vienna Convention of the Law of Treaties*** of 1969 sets out the fundamental legal rules relating to treaties. The Vienna Convention defines a treaty, identifies who has the capacity to conclude a treaty, and outlines treaty interpretation, disputes, and reservations. The basis of treaty law is "pacta sunt servanda", which means that agreements must be honoured and adhered to[3].

Many states are involved in the process of drafting a treaty, which often includes conflicts and disagreement on the scope and content of the arrangement. In order to increase the number of signatories and ratifications of a treaty, international law does allow for states to limit the full application of a treaty, hence, they clarify their specific understanding of the legal content. This is done through reservations, declarations and derogations[4].

a) ***Reservations*** *are defined by the Vienna Convention as a unilateral statement, however phrased, made by a State, when signing, ratifying, accepting,*

[3]https://www.oxfordbibliographies.com/view/document/obo9780199796953/obo-9780199796953-0063.xml

[4]Alessandro Dragonetti, Valerio Piacentini, Anna Sfondrini IPSOA 2010 Manuale di Fiscalità Internazionale

approving or acceding to a treaty, whereby it purports to exclude or to modify the legal effect of certain provisions of the treaty in their application to that State.

b) ***Declarations*** *do not affect legal obligations but are often made when a State expresses its consent to be bound by a specific treaty. The State uses the declaration to explain or clarify its understanding of particular aspects of the treaty text.*

c) *Some treaties are provided with some* ***Derogations****, which allow for a state party to temporally suspend or limit their legal obligations under exceptional circumstances, for example during armed conflict or national emergency. However, some rights can never be derogated from under any circumstances, notably the prohibition on torture, inhumane and degrading treatment.*

Customary international law is composed of a set of rules that derive from "a general practice accepted as law". Customary international law is comprised of all the written or unwritten rules that form part of the general international concept of justice. Unlike treaty law, which is only valid to those states that are parties to a designed agreement, customary law is binding upon all states, regardless of whether they have ratified a treaty[5].

[5]https://ec.europa.eu/taxation_customs/publications/taxation-services-papers/taxation-papers_en

An essential component of customary law is ***Opinio Juris***, which means that these norms must be carried out as to be evidence of a common belief.

Indeed, a certain practice is rendered obligatory by the existence of a rule requiring it. The principle of ***Jus Cogens*** is outlined in *Article 53* of the Vienna Convention on the Law of Treaties. It is a peremptory norm accepted and recognised by the entire international community of States as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character[6].

General Principles of law are basic rules, recognized as one of the authoritative sources of international law, having been codified in the Statute of the ***International Court of Justice (ICJ)***, in the *article 38(1)*. Since, general principles are characterized by great generality and abstractness, they constitute necessary rules for the very functioning of the system. Indeed, they are inducted from the legal reasoning of those entitled to take legal decisions in the process of applying the law, notably the judiciary. They also constitute integrative tools of the system as they fill actual or potential legal gaps and they are a relevant source of arguments in situations where other sources fail[7].

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[6]Victor Uckmar, Giuseppe Corasaniti, Paolo De' Capitani di Vimercate, Caterina Corrado Oliva CEDAM 2012 DIRITTO TRIBUTARIO INTERNAZIONALE

[7]Angharad Miller FCA CTA, Lynne Oats PhD Bloomsbury Professionals Fourth Edition 2014 PRINCIPLES OF INTERNATIONAL TAXATION

Thus, when they are put into practice and are applied by the judge, principles like the principle of good faith, the rule of law, or human dignity, provide a means of finding an answer to a legal question where no law or colliding rules exist.

Article 38(1)(d) refers also to ***Judicial Decisions*** as a subsidiary meaning for the determination of rules of law. In contrast to the position in common law countries, there is no doctrine of binding precedent in international law. Indeed, the Statute of the ICJ expressly provides that a decision of the Court is not binding on anyone except the parties to the case in which that decision is given and even then, only in respect of that specific case, as indicated in the *Article 59*. Nevertheless, the ICJ refers frequently to its own past decisions and most international tribunals make use of past cases as a guide to the content of international law, so it would be a mistake to assume that "subsidiary" indicated a lack of importance[8].

A controversial difference between international law and domestic law exists and it is how they are enforced. The national tax pattern is a domestic bunch of regulations, developed in a long period of time, which provides for how it intends to tax its residents and what kind of activities it is advisable to bring to the tax net.

Whereas, international tax law, consists of customary international law and agreements[9].

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[8]https://www.diakonia.se/en/IHL/The-Law/International-Law1/Sources-of-IL/
[9]https://www.academia.edu/10675251/GENERAL_PRINCIPLES_OF_LAW_RECOGNISED_BY_CIVILISED_STATES

These sources of law cover the right belonging to a state to settle tax treaties and to regulate disputes, in case of unclear or ambiguous respective taxing rights between two states. They may also extend the protocols for exchanging information on taxpayers. Since the sources of international law are public international norms, it is often a matter of acceptance and interpretation by the countries affected[10].

Unfortunately, international law lacks a common executive, which means that there is no power that can make a state accept a court decision. Thus, the countries operating under international law often have a weak sense of community, meaning that obeying the law will often come second to them. Furthermore, domestic law consists of three separate branches of government such as executive, judicial, and legislative; based on a solid system of checks and balances. This limits the power of each branch so that no one becomes too powerful. In general, as long as a State carries out its obligations under international law, how it does so is not the concern of international law. The only exception is made in the area of human rights, in which states have undertaken to make certain conduct such as torture and genocide a crime punishable under national laws[11].

[10]http://legal.un.org/avl/pdf/ls/greenwood_outline.pdf
[11]https://www.slayerment.com/international-law-vs-domestic-law

Many states still see international law and domestic law as two separate legal systems and require formal incorporation of international laws into national law by the legislature before they become operational in the countries. *Article 27* of the Vienna Convention on the Law of Treaties States that if a treaty is in conflicts with a Nation's municipal law (even the constitution of the country itself), the Nation is still obliged to meet its obligations under the treaty's recommendations[12].

1.2 The Jurisdiction of International Taxation

Nowadays, much of the complexity is found in current tax systems from the need to interact with other tax models in the global field. Each tax legislation has been implemented differently, so when they come in contact with the others, plenty of opportunities for taxpayers to pay a tax regime off against another arise.

From one side, the taxpayers implement methodologies to minimise worldwide tax burdens; from the other side, national governments are forced to take actions in order to prevent capital flow and loss of tax revenues. One of the most common examples is ***Withholding Tax***, which is an income tax to be paid to the government by the taxpayer of the income rather than by the recipient of the income[13].

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[12]https://study.com/academy/lesson/domestic-law-vs-international-law-enforcement-intervention.html

[13]Alessandro Dragonetti, Valerio Piacentini, Anna Sfondrini IPSOA 2010 Manuale di Fiscalità Internazionale

The tax is thus withheld or deducted from the income due to the recipient. In most jurisdictions, withholding tax applies to employment income, in addition, many jurisdictions also require withholding tax on payments of interest or dividends. Additional withholding tax obligations exist if the recipient of the income is resident in a different jurisdiction, and in those circumstances withholding tax sometimes applies to royalties, rent or even the sale of real estate[14].

Governments use withholding taxes as a tool to tackle tax evasion. Sometimes they impose extra withholding tax requirements if the recipient has been delinquent in filing tax returns, or in industries where tax evasion is perceived to be common.

Typically, the withholding tax is treated as a payment on account of the recipient's final tax liability, when the withholding is made in advance. In some cases, the withholding tax is treated as discharging the recipient's tax liability, and no tax return or additional tax is required, such withholding is known as final withholding. Most countries require payers of interest, dividends and royalties to non-resident payees withhold from such payment an amount at a specific rate. A few jurisdictions treat fees paid for technical consulting services as royalties subject to withholding of tax. Income tax treaties may reduce the amount of tax for specific types of income paid from one country to residents of the other country[15].

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[14]https://www.investopedia.com/terms/w/withholdingtax.asp

[15]Piergiorgio Valente, Franco Roccatagliata, Giovanni Rolle Il Sole 24 Ore 2002 CONCORRENZA FISCALE INTERNAZIONALE - SCENARI DELLA FISCALITA' COMUNITARIA E RIFLESSI SULLE IMPRESE

Due to the increasing complexity of tax policies, rules and administration, a greater co-operation among nations seemed to be necessary, as well as changes in tax policies to strengthen tax framework in the global era. Economic efficiency and development take on a different layer of meaning in the context of interaction among national tax frameworks. Protecting the tax base from erosion is one of the focal objectives of any governments, in a globalised world it has become increasingly difficult.

OECD adopts fundamental interventions in solving debates about which principle should have primacy concerning the allocation of taxing rights across borders, residence principle and source principle. Developed in the context of the OECD/G20, the ***BEPS (Base Erosion and Profit Shifting)*** project, has been designed. It addresses tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. BEPS refers to corporate tax planning strategies used by multinationals to shift profits from higher-tax jurisdictions to lower-tax jurisdictions, thus eroding the tax-base of the higher-tax jurisdictions. The OECD defines BEPS strategies as also exploiting gaps and mismatches in tax rules[16].

[16]https://www.oecd.org/tax/beps/

Working together within OECD/G20 Inclusive Framework on BEPS, over 130 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment. The essential concept of international taxation is the issue of whether and to what extent, a country has the right to tax an individual or a company. Tax competition among countries implies sometimes, that a government is induced to legislate lower taxes or to provide attractive tax incentives rather than other countries in order to acquire foreign investments. However, this attitude is an unfair practice and it is called *Harmful Tax Competition*, which is strongly addressed by the European institutions.

Tax competition in the form of harmful tax practices can distort trade and investment patterns, erode national tax bases and shift part of the tax burden onto less mobile tax bases, as well as labor and consumption, hence adversely affecting employment and understanding the fairness of tax structures. The benefits a country can obtain having more inbound capital investments, would basically mean more profits to allocate to it; as a result, this will induce the involved country to take advantage of the opportunity[17].

[17]Piergiorgio Valente, Franco Roccatagliata, Giovanni Rolle Il Sole 24 Ore 2002 CONCORRENZA FISCALE INTERNAZIONALE - SCENARI DELLA FISCALITA' COMUNITARIA E RIFLESSI SULLE IMPRESE

Like all taxpayers, multinational enterprises have been always seeking to lower their worldwide tax liabilities, so they certainly will exploit the possibility to allocate total profits of the company among its various parts located in different countries at this beneficial tax regime. In recent times, OECD has focused its effort towards the striving of the harmful preferential tax regimes.

The detected fiscal systems are characterized by mechanisms of favourable taxation within their ordinary fiscal regime, the lack of transparency and the lack of information exchange. Furthermore, it has been considered also the artificial definition of the tax base, failure to adhere to international transfer pricing principles and foreign source income exempt from residence country tax; as other targeted factors. As such, they are considered *Non-Cooperative Countries* that are collected on a blacklist by the European Commission, which intends to dismantle the tax-erosion phenomenon. A Non-Cooperative Country is defined when a state presents some loopholes in financial regulations, obstacles raised by other regulatory requirements, obstacles to international co-operation, inadequate resources for preventing and detecting money laundering activities[18].

[18]Victor Uckmar, Giuseppe Corasaniti, Paolo De' Capitani di Vimercate, Caterina Corrado Oliva CEDAM 2012 DIRITTO TRIBUTARIO INTERNAZIONALE

Initially, those states were not at all collaborative nor they had a formal commitment to removing the damaging measures. Even if the international context with regard to taxation has improved since the very first "blacklist", the solution to the problem is far to be found. The critical focus seems to be still the transparency and the information exchange among jurisdictions. Although, some countries have accepted to collaborate and to provide full information about their fiscal regimes, they have discovered the way to game the system. As a matter of fact, Harmful preferential regimes, continue to give access to tax network avoidance by proving negotiated tax base, customized arrangements and secrecy provisions[19].

1.3 Residence for Tax Purposes

Under the residence principle, a country has the right to tax the worldwide income of a company which is tax residence. Concerning the residency, the territoriality principle holds, a country tax the resident companies on profits earned in the country of residence. Two distinct approaches to determining residency for tax purposes exist. Processing the legal approach, tax residence is determined according to the country of incorporation in the commercial register.

Whereas, by following the economic approach, tax residence is determined according to one or more three factors:

[19]Victor Uckmar CEDAM 1999 CORSO DI DIRITTO TRIBUTARIO INTERNAZIONALE

Place of Management, Business Location, Tax Residence of Shareholders. At this level, the focus is moved towards the place of central management and control and how to recognize it. The tax residence should be identified where the governing bodies meet, where the key decisions are carried out, where strategic operations and control are exercised. Then where the policies are conceived or adopted, differently respect to the place in which they are carried out. It is crucial to the taxing rights of states to be aware of the *Permanent Establishment* of a business. The PE means a fixed place of business through which the affairs of an enterprise is entirely or partially carried out. This term refers also to a place of management, a branch, an office, a factory, a workshop and even a place of extraction of natural resources. The explanation provided by the OECD's *Model Tax Convention*, specify that a building site or construction or installation constitutes a PE only if it lasts more than twelve months. Going deeply, basic requirements for a fixed place of business exist: there must be a place of business with machinery, offices, equipment. The place must be fixed, established at a distinct location with a certain degree of permanence. The businesses must be conducted there, since the permanent establishment includes branches, it is necessary to explain what it is meant. Independently from the physical configuration of the company, an intrinsic feature of the permanent establishment is the imputation of judicial situations[20].

[20]Angharad Miller FCA CTA, Lynne Oats PhD Bloomsbury Professionals Fourth Edition 2014 PRINCIPLES OF INTERNATIONAL TAXATION

The juridical charge refers to the subject which has actually build it up or through an entity that acts on its behalf. For these reasons, a distinction between a subsidiary and a branch is required.

Branches are a part of the parent organization, which is opened to perform the same business operations as performed by the parent company, to increase their coverage. A Branch is defined as an extension of the parent organisation, which is set up at another location. The officer-in-charge of the branch is known as the branch manager, who is directly responsible for the work of the branch, as well as reports to and takes instructions from the head office. Most of the banks and financial institutions have branches that are opened to play the agency role. Setting up branches at various remote locations, increases the customer base, accessibility and also, helps in the timely and effective distribution of goods and services.

Indeed, one of the common strategies for firms is to expand their business at the national or international level, is to set up branches, in different places. However, the parent organization has 100 percent ownership interest in the branch, indeed its liabilities extend to the parent company[21].

[21]https://keydifferences.com/difference-between-branch-and-subsidiary.html

Subsidiaries are companies, whose controlling stake is held by another entity, the so-called holding company. The term subsidiary company is a business entity, whose ownership and control are in the hands of another business enterprise. Usually, when a company buys another company, the buying company, is called holding the company and the company so bought is the subsidiary. A company is said to be a subsidiary of another if any of the three conditions are satisfied: Ownership Stake, if another company owns at least 50 percent of the total equity share capital of the corporation. Composition of Board of Directors, if in a company the composition of Board of Directors (BOD) is decided by another company. The composition of BOD means that another company appoints all or the majority of directors. The last one, is the Deemed Subsidiary, if a company is a subsidiary of a company, which itself is a subsidiary of another company. A subsidiary company is purely reporting to the holding company, in fact, it is a completely separate legal entity with a different identity and maintains its own separate financials.

Obviously, a firm may trade not only in the resident country, indeed it operates across borders. In this case, the company may be liable to tax in more than one country on the same profits[22].

[22]https://lawpath.com.au/blog/whats-the-difference-between-a-branch-and-a-subsidiary

The country of a source will generally have the primary taxing rights over those profits, if the country exercises its right to tax the company's worldwide income then it will usually have to give double tax relief for the tax charged in the country of a source. Since companies can operate all around the world, the central management and control centre is interpreted distinctly.

In order to deal with the presented obstacles, the OECD Model on tax convention about taxes on income and on capital defines the boundaries of the jurisdiction in the fourth article[23]:

Article 4

1. *For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof.*

This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. *Whereby reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:*

[23]https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

a) *he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);*

b) *if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has a habitual abode;*

c) *if he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;*

d) *if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.*

3. *Whereby reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.*

The Article is intended to define the meaning of the term "resident of a Contracting State" and to solve cases of Double Residence disputes, in order to clarify the scope of the Article itself. Some general sources of conflict arise because, under the domestic laws, one or both Contracting States claim that the person concerned is resident in their territory[24].

[24]Angharad Miller FCA CTA, Lynne Oats PhD Bloomsbury Professionals Fourth Edition 2014 PRINCIPLES OF INTERNATIONAL TAXATION

International ruling standards may be settled out for international activity companies. Firms that have a relationship and operate in international markets have access to special rulings. The ruling has a preventive nature, it may be employed in a large number of revenue's components circumstances. In a collaborative context between the organization and the administration, the company can avoid investigation inspections and legislative disputes during all the ruling's duration.

On the one hand, international rulings do not include the launching of fact-finding activities either the conclusion of a monitoring procedure.

On the other hand, rulings are refining only with the establishment of an agreement since its programmatic nature since it is not adequate to ensure a greater income volume. An ***APA (Advanced Price Agreement)*** is an agreement between a taxpayer and tax authority determining the transfer pricing methodology for pricing the taxpayer's international transactions for future years. The methodology is to be applied for a certain period of time based on the fulfilment of certain terms and conditions, the so-called critical assumptions. An APA can be unilateral, bilateral, or multilateral: A Unilateral APA involves only the taxpayer and the tax authority of the country where the taxpayer is located. A Bilateral APA involves the taxpayer, the associated enterprise of the taxpayer in the foreign country, the tax authority of the country where the taxpayer is located, and the foreign tax authority[25].

[25]https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/thoughtpapers/in-tax-deloitte-apa-faqs-noexp.pdf

A Multilateral APA involves the taxpayer, two or more associated enterprises of the taxpayer in different foreign countries, tax authority of the country where the taxpayer is located, and the tax authorities of AEs. An APA provides several benefits such as agreeing in advance, the arm's length pricing or pricing methodology to be applied to the tax payer's international transactions covered by the APA. Besides, provides the removal of an audit threat, and deliverance of a particular tax outcome based on the terms of the agreement. Moreover, it offers a substantial reduction of compliance costs over the term of the APA.

1.4 The Double Tax Concern

The term double taxation refers to the situation in which it is possible to be exposed to tax more than once on the same profit. Indeed, whenever a company undertakes its main activities in another country, it will deal with more than one set of tax rules. Two distinct double taxations may exist:

Economic Double Taxation covers every situation where an amount of income is taxed twice, as in the case of corporate profits. For instance, post-tax profits are distributed to shareholders in the form of dividends, the shareholders are subject to income tax in part or in full over the dividends they receive.

Juridical Double Taxation occurs when more than one country state to have the right of taxing the same income. A jurisdictional conflict may arise, because different countries apply to clash tax attribution.

Double tax relief applies where the country of residence acts to prevent or minimize the extent to which its residents are taxed more than once. Three main methods by which countries obtain relief from double taxation it exists:

a) *Deduction Method* in which foreign taxes are treated as an expense of doing business. In this case, the country of residence taxes foreign incomes but allows a deduction for any foreign taxes paid.

b) *Exemption Method* in which the country of residence does not tax at all foreign profits of its tax residence, since they are exempt.

c) *Credit Method* in which income earned by overseas country is taxed in the country of residence. Foreign taxes paid are deducted from domestic taxes charged on profits gained. Hence, the country of residence gives a credit for foreign taxes sustained[26].

When choosing among the presented methods which to adopt, a country needs to consider several factors. Firstly, capital export neutrality, that means whether or not a tax is distortionary. An appropriate tax is one that does not distort taxpayer's commercial decisions, as well as the incentive to invest in the home country rather than abroad.

[26]Angharad Miller FCA CTA, Lynne Oats PhD Bloomsbury Professionals Fourth Edition 2014 PRINCIPLES OF INTERNATIONAL TAXATION

Ideal capital export neutrality would be achieved if every country had the same tax system, so that the after-tax return is exactly the same no matter where in the world a company is taxed. Secondly, the protection of the domestic tax base means that by eliminating the foreign income of corporations from the tax base, so the residents are encouraged to move mobile capital directly abroad.

In this scenario, interests, dividends payments and capital gains are exempt in the country of tax residence, this will incentive the legal use of tax heavens.

Lastly, the costs and the complexity of the methods to taxpayers have to be taken into accounts. It is considered good practice for a country to adopt a method of double tax relief which ensures both capital export neutrality and capital import neutrality. If this condition holds, the economy would not be affected by the double taxation problem. Mechanisms for double tax' relief are often settled out in ***Double Tax Treaties***, which are bilateral or multilateral agreements between pairs of countries in which the two countries figured out how to erase double taxation in their residents with respect to income or gains originated from the other country[27].

They are applied if a taxpayer operating in two states and relying solely on the domestic tax law of those states, may be subject to double taxation.

Double Taxation Treaties are generated in order to:

- Provide a means of setting upon a uniform and harmonic basis

[27]Victor Uckmar CEDAM 1999 CORSO DI DIRITTO TRIBUTARIO INTERNAZIONALE

- Prevent evasion of tax by making provision for exchange of information between tax authorities and for assistance in collection of tax debts owed to the treaty partner
- Protect taxpayers against double taxation direct or indirect to a greater extent than the protection offered under domestic law
- Prevent tax from discouraging the free flow of international trade and investment and the transfer of technology
- Provide a measure of fiscal and legal certainty in international operations; indeed, an individual or an enterprise considering investing in a foreign state, can obtain an indication of how the investment be it financial manufacturing sales or otherwise will be subject to tax in that state[28].

Tax treaties are developed considered that two states called contracting states to decide how their tax system will interact so as residents of each state get the double tax relief. All tax treaties, therefore, contain a clause whereby the two states agree how they will interpret tax residence to limit the circumstances in which a company or an individual can find itself dually resident and hence fully liable to tax in both states.

[28]Piergiorgio Valente, Franco Roccatagliata, Giovanni Rolle Il Sole 24 Ore 2002 CONCORRENZA FISCALE INTERNAZIONALE - SCENARI DELLA FISCALITA' COMUNITARIA E RIFLESSI SULLE IMPRESE

Besides, the key function of providing relief for double taxation is assigned to a tax treaty, which will have provisions aimed at preventing tax avoidance. One other extremely important function of a tax treaty is that they provide a mechanism whereby two states can interact in a relatively informal way. So that, double tax disputes and problem situations can be dealt with directly by the tax authorities of the two states rather than having to go through the normal diplomatic channels.

Treaties are governed by international law, usually under the Vienna Convention on the law of treaties, so as a state cannot renege its obligations on a treaty. The rules dealing with the allocation of taxing rights between the two contracting states in double tax arrangements are referred to as some distributive rules such as rules from certain businesses, rules for income from certain types of assets paid for the use of intellectual property or rent from immovable property.

Other rules are related to capital gains, rules concerning the status of the taxpayer involved. They operate nominating which state can actually tax-relevant types of income or in some other cases, they give the priority to one state without giving it exclusive rights. Recalling that a double tax treaty cannot create a right to tax which does not already exist under a state's own domestic tax laws[29].

[29]Victor Uckmar, Giuseppe Corasaniti, Paolo De' Capitani di Vimercate, Caterina Corrado Oliva CEDAM 2012 DIRITTO TRIBUTARIO INTERNAZIONALE

All double tax treaties are slightly different, simply because a treaty cannot be properly interpreted without a thorough examination of its exact wording. The OECD Model offers several types of double tax relief, as previously explained.

However, it is up to the contracting states to decide which method to use, generally, is a matter of negotiation between them. Each state will set out and then adopt a different methodology with respect to the others, in fact, rarely all two states apply the same technique. Treaties between EU member states do not all provide for a tax credit for underlying corporation tax on profits used to pay dividends but merely from withholding tax charged on the dividends. Withholding taxes are deducted from interest earned by European Union's residents on their investments made in another member state, by the state in which the investment is held. Though signing a double taxation avoidance agreement is a way to solve the tax problems, there still can be other problems led out, that it is possible to call "*side effects*". The impact and the aim of the tax treaties are integrated, they are both to avoid double taxation in order to improve economic exchanges and relationships, to enhance the government cooperation in order to avoid tax evasion. Though tax provides possibilities of avoiding tax in a legal way to transnational taxpayers. In order to avoid double taxation, the agreement divided the jurisdiction of taxation, including shared and excluded jurisdiction of taxation. Furthermore, it established the limited tax rate in the origin countries, so that can be called the preferential treatments of the taxation agreement.

The transnational enterprises, in order to get maximized profits, can use the terms of domestic law and taxation agreement, to avoid both taxations from origin country and residence country legally and achieve double taxation free. This can be a severe undermine to the international order and a challenge to the domestic governments[30].

1.5 Tax Avoidance versus Tax Evasion

Tax Avoidance is an arrangement made to beat the intent of the law by taking unfair advantage of the shortcomings in the tax rules. The advantageous agreement refers to finding out new methods or tools to avoid the payment of taxes which are within the limits of the law. This can be done by adjusting the accounts in a manner that will not violate any tax rules, as well as the tax incurrence, which will also be minimised. Formerly Tax Avoidance is considered lawful, but now it comes to the category of crime in some special cases. The only purpose of Tax Avoidance is to postpone or shift or eliminate the tax liability, by exploiting government schemes which offer like the tax credit, tax privileges, deductions. Some Examples of Tax Avoidance Strategies[31]:

[30]Alessandro Dragonetti, Valerio Piacentini, Anna Sfondrini IPSOA 2010 Manuale di Fiscalità Internazionale
[31]https://ec.europa.eu/jrc/sites/jrcsh/files/fairness_pb2019_taxevasion.pdf

- Taking legitimate tax deductions to minimize business expenses and thus lower your business tax bill
- Taking tax credits for spending money for legitimate purposes, like taking a Work Opportunity Tax Credit for hiring workers in your business.

Tax Evasion is an illegal act made to escape from paying taxes which is completely illegal. Such illegal practices can be deliberate concealment of income, manipulation in accounts, disclosure of unreal expenses for deductions, showing personal expenditure as business expenses, overstatement of tax credit or exemptions suppression of profits and capital gains. This will result in the disclosure of income which is not the actual income earned by the entity.

Tax Evasion is a criminal activity for which the assessed is subject to punishment under the law. In general, it's considered Tax Evasion if you knowingly fail to report income or you don't file an income tax return. However, some may include:

- Under-reporting income (claiming less income than you actually received from a specific source
- Not reporting an income source
- Providing false information to the IRS about business income or expenses
- Deliberately underpaying taxes owed

- Substantially understating your taxes (by stating a tax amount on your return which is less than the amount owed on the income you reported).
- Filing false payroll tax reports or failing to file these returns.
- Deliberately underreporting or omitting income,
- Overstating the amount of deductions
- Keeping two sets of books
- Making false entries in books and records
- Claiming personal expenses as business expenses
- Claiming false deductions
- Hiding or transferring assets or income[32].

1.6 The Thin Capitalisation

Aimed at expanding or make investments, multinational corporations often take external loans or lend money within their global corporate structures.

However, in some cases, such structures can also be used to decrease worldwide tax liability. Thin Capitalisation refers to a condition where a company is financed with a high level of debt compared to the equity (highly leveraged)[33].

[32]https://www.thebalancesmb.com/tax-avoidance-vs-evasion-397671
[33]Piergiorgio Valente Il Sole 24 Ore 2003 ELUSIONE FISCALE INTERNAZIONALE – CONTROLLED FOREIGN COMPANIES, DISPOSIZIONI ANTI-PARADISI FISCALI, THIN CAPITALIZATION

An entity's debt-to-equity funding is sometimes expressed as a ratio, for example, a gearing ratio of 1,5:1 means that for every $1 of equity the entity has $1,5 of debt. A high gearing ratio may generate several problems both for creditors, which bear the solvency risk of the company, and revenue authorities, which are concerned about excessive interest claims. Multinational companies are often structured through this arrangement whereby they get advantage by having the lender in a very low tax rate country (as they receive interest income) and the borrower in a country where interest cost can be deducted for income tax purposes. This structure can be made in a way to shift profit to the lower income tax rate countries Even where countries' corporate laws allow companies to be thinly capitalised, revenue authorities in those countries will often limit the amount that a company can claim as a tax deduction on interest, particularly when it receives loans at non-commercial rates. Some tax authorities limit the applicability of thin capitalisation rules to corporate groups with foreign entities to avoid "base erosion and profit shifting" to other jurisdictions. Thin capitalisation rules determine how much of the interest paid on corporate debt is deductible for tax purposes.

Such rules are of interest to private-equity firms, which use significant amounts of debt to finance leveraged buyouts, and in the context of strategic acquisitions, where the purchaser wishes to push debt into higher taxed countries with significant pre-tax income. Many reasons occur in going for thin capitalization for companies, it is a weighted decision to make.

The choice between equity and debt is not free, that choice is decided by the solvency risk to be covered, the conditions in the capital market and, by the possible reduction in tax liability. A new company would prefer equity to debt because interest cannot be postponed but dividends can, thus, the deciding factor, however, is the market. If it is on the downturn companies will find it difficult to issue IPOs (Initial Public Offering) and consequently, capitalisation becomes thin.

Even when equity is easy companies will still go in partly for debt because equity is more expensive to service. Tax laws allow interest as cost while the whole of the profit becomes taxable. As such, debt, by reducing the tax liability, enhances the return on equity. To prevent tax avoidance by excessive leveraging, many countries have introduced rules to prevent thin capitalisation.

Since money is mobile so a multinational can simply shift debt into high tax counties to ensure that a tax deduction is received for the interest paid.

This reduces the overall profits in the high tax country, thereby reducing their tax liability. High-tax countries create an incentive for companies to finance investments with debt because interest payments are tax-deductible, which is usually not the case for equity costs[34].

[34]https://theconversation.com/thin-capitalisation-the-multinational-tax-avoidance-strategy-the-budget-forgot-58041

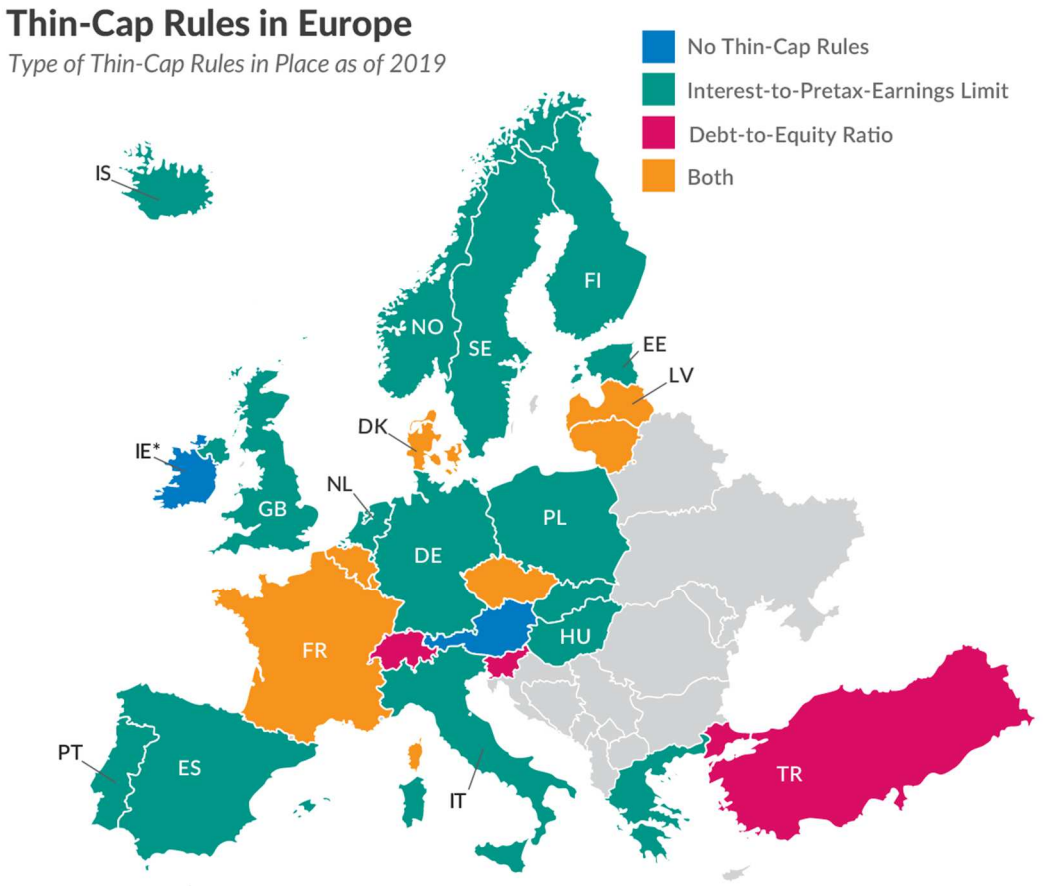
This encourages global businesses to lend money internally from entities in low-tax countries to entities in high-tax countries. Tax savings in high-tax countries can exceed the increased tax paid in low-tax countries, decreasing worldwide tax liability. In order to discourage such international debt shifting, many countries have implemented so-called thin-capitalisation rules, which limit the amount of interest a multinational business can deduct for tax purposes. Thin-capitalization rules (henceforth thin-cap rules) are made to prevent businesses from using debt financing or international debt shifting for tax planning reasons. The two most common types used in practice:

Safe harbor rules restrict the amount of debt for which interest is tax-deductible by defining a debt-to-equity ratio. Interest paid on debt exceeding this set ratio is not tax-deductible.

Earnings stripping rules limit the tax-deductible share of debt interest to pre-tax earnings.

Most commonly, the limit is set at 30 percent of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). For instance, a parent company takes a $100 loan from its subsidiary requiring interest payments of $5.

EBITDA is $10, so only $3 (30 percent of $10) of the $5 in interest paid are tax-deductible. As shown in the following map, more than half of the European countries covered have an interest in pre-tax-earning limits in place.



[35]

What it is fundamental to bear in mind is that thin-cap rules not only limit international debt shifting but can also impact real economic activity, such as investment and employment. Digging in, some countries have been applicated several different systems:

[35]https://taxfoundation.org/thin-cap-rules-europe-2019

For instance, in Austria, it is used the Arm's Length Principle. Ireland has no specific thin-cap regulations notwithstanding interest paid by a no trading company to a no resident parent can be reclassified as dividends under certain conditions.

Luxemburg uses an informal 85:15 debt to equity ratio; while Switzerland implements a variable debt to equity ratio depending on the asset class[36].

[36]https://theconversation.com/thin-capitalisation-the-multinational-tax-avoidance-strategy-the-budget-forgot-58041

2. THE INTERNATIONAL TAX AVOIDANCE ISSUE: USE AND ALLEGED ABUSE OF TAX SHELTERS

2.1 The Tax Heaven Bias

Telecommunication, E-commerce and the world wide web have broken down all the boundaries allowing the world's citizens to access global resources, knowledge with relevant consequences. However, today it is almost too easy to open a company in a low-tax jurisdiction and shield its own profits to make them intangibles from the tax authority. Tax avoidance can be called art not to pay taxes without breaching any taxation norm and not reducing a tax burden.

Nevertheless, a better coordinated international taxation and greater information sharing between countries would make it more difficult for multinationals to artificially shift profits offshore to pay little tax.

Indeed, some multinationals keep exploiting gaps and mismatches in the international ruling, like several famous brands that have filled the recent year's headlines, spurring public and political outrage. However, the majority of tax avoidance strategies were in most cases legal, and largely overlooked until the OECD/G20 BEPS Project. Multinationals were taking advantage and avoid paying their fair share of tax that were not well co-ordinated across countries and which had not been updated for a global and digitalised economy[37].

[37]https://www.ciat.org/which-are-the-causes-of-tax-evasion/?lang=en

Nowadays, taxation is aligned with where economic activity takes place, in the vastly complex space of international tax provisions covering virtually all of the world's economic activity requires enormous effort and commitment.

Although, significant milestones have been reached, leading to an important shift in practices both by policymakers and multinational corporations; the issue is extremely complex. Undoubtedly, it is an exercise, which all countries must undertake, by detecting some of the causes of tax evasion, among others are:

- The current structure of the countries' tax system
- Anarchic distribution of powers among the different government levels, especially in federal countries
- Permanent regularization regimes (moratoriums, whitewashing)
- Promotional regimes (tax incentives, exemptions and tax expenses)
- Inefficiency of the Tax Administrations (AATT)
- Presence of multinational enterprises with aggressive tax planning
- Tax havens, jurisdictions of null or low taxation or as it is said in many countries, non-cooperating jurisdictions
- Great weight of intangibles, which makes it difficult to assign them their true value and determine their place of origin
- Proliferation of special tax regimes for attracting investments (like privileged tax rulings)

- Difficulty to control the transfer prices of related multinational enterprises: currently over 60 percent of world trade is carried out through these enterprises and 50 percent are intragroup operations
- Digital economy, with significant technological development: electronic commerce, collaborative platforms, digital currencies and new ways of commercializing goods and services, there are increasing difficulties for taxing and controlling[38].

As for the system of sanctions, one must analyse, among other things, the level of the sanctions, the juridical accuracy of the verdicts, the timeliness of their application and the effectiveness of the collection. Regarding the simplicity of the tax structure, it is clear that complex tax systems favour evasion and avoidance, since they create uncertainty concerning the scope of the tax regulations, increase the costs of examination and compliance and multiply the evasion and avoidance formulas or mechanisms. No less important is the acceptance of the tax system because if a taxpayer perceives that the tax system is unfair, he will be less willing to comply. The acceptance of the system depends, among other aspects, of the moderation of the tax burden, the equity of the tax structure, the use made of the collection, the compliance costs and taxpayer service.

[38]https://www.theguardian.com/commentisfree/2017/dec/13/stop-big-corporations-dodging-tax-avoidance-paradise-paper

It is often debated that no country is immune to corruption, indeed, abuse of the public function for one's own benefit reduces the people´s trust in the government and institutions. As a result, it undermines the effectiveness and equity of the public policies and misappropriates the taxpayers' money, originally intended for schools, roads and hospitals. In most of the cases, the most corrupt countries collect fewer taxes, because the people pay bribes to avoid them; for example, through tax gaps conceived in exchange for bribes. In addition, when the taxpayers believe that the State is corrupt, tax evasion becomes more probable.

Globally, less corrupt governments collect 4 percent more GDP in tax revenues than the countries having the same level of development with the highest levels of corruption. The willingness of taxpayers to pay taxes is linked to their trust in the institutions, the perceptions of corruption, as well as satisfaction with the public services. In general, many of the causes listed are interrelated and many have a common denominator in corruption, which, calls for a firm political decision to promote greater transparency, education and justice in each of our countries.

Despite what can be imagined about traditional tax havens, there are in fact, more than 60 low-tax financial centres around the world, according to the International Monetary Fund[39].

[39]https://www.oxfam.org/en/even-it/inequality-and-poverty-hidden-costs-tax-dodging

The following infographic shows the scale and global spread of such favourable tax jurisdictions, locating them by country, city and island or political region. Detecting carefully the below map, it is possible to state that Europe is the second source of tax heaven jurisdictions.

[40]

The ***Corporate Tax Haven Index*** ranks the world's most important tax havens for multinational corporations. The ranking is based according to how aggressively and how extensively each jurisdiction contributes to helping the world's multinational enterprises escape paying tax and erodes the tax revenues of other countries around the world.

[40]https://www.grantthornton.co.uk/insights/locations-of-offshore-tax-jurisdictions-infographic/

The Corporate Tax Haven Index (*CTHI*) is a politically neutral ranking that relies on combining two core measures. The first is a *Haven Score* based on 20 mostly tax-related indicators of corporate tax haven-ness, assessing how aggressive a jurisdiction's corporate tax haven laws and loopholes and relevant policies are.

The second is a Global Scale Weight showing the scale or size of corporate investment activity as a proxy for the magnitude of the profit-shifting potential in that jurisdiction. These two measures are mathematically combined to create a CTHI value for each jurisdiction, which is the basis of our ranking.

Rank	Jurisdiction	CTHI Value[4]	CTHI Share[5]	Haven Score[2]	Global Scale Weight[3]
1	**British Virgin Islands**	2,769	7.29%	100	2.12%
2	**Bermuda**	2,653	6.98%	100	1.86%
3	**Cayman Islands**	2,534	6.67%	100	1.62%
4	**Netherlands**	2,390	6.29%	78	12.76%
5	**Switzerland**	1,875	4.93%	83	3.41%
6	**Luxembourg**	1,794	4.72%	72	10.53%
7	**Jersey**	1,541	4.05%	98	0.42%
8	**Singapore**	1,489	3.92%	81	2.11%
9	**Bahamas**	1,377	3.62%	100	0.26%
10	**Hong Kong**	1,372	3.61%	73	4.37%
11	**Ireland**	1,363	3.58%	76	3.11%
12	**United Arab Emirates**	1,244	3.27%	98	0.22%
13	**United Kingdom**	1,067	2.81%	63	7.30%
14	**Mauritius**	950	2.50%	80	0.65%
15	**Guernsey**	890	2.34%	98	0.08%
16	**Belgium**	822	2.16%	68	1.82%

Rank	Jurisdiction	CTHI Value[4]	CTHI Share[5]	Haven Score[2]	Global Scale Weight[3]
17	**Isle of Man**	804	2.11%	100	0.05%
18	**Cyprus**	698	1.83%	71	0.73%
19	**China**	658	1.73%	58	3.67%
20	**Hungary**	560	1.47%	69	0.49%

[41]

The above table clearly depicts the top 20 jurisdictions in terms of corrosiveness to the global tax system as of 2019 ranking. The Haven Indicators mostly use criteria that are like those identified by the IMF, the European Union, or by the OECD. Our 20 indicators can be grouped into five categories:

The lowest tax rate available to multinationals in that jurisdiction. Sometimes the headline rate of corporate tax is zero, as in the Cayman Islands. At other times, the headline rate is much higher, but multinationals may be able to pay a much lower rate. The single indicator in this category is the Lowest Available Corporate Income Tax Rate (LACIT).

Loopholes and Gaps. Seven of our 20 indicators focus on what gets taxed and what gets excluded or carved out. Some income may be excluded from corporate tax, or there may be deductions that reduce the tax base.

[41]https://www.corporatetaxhavenindex.org/introduction/cthi-2019-results

Transparency. Does the jurisdiction allow corporations to hide their financial affairs there? What kind of information must they file? Is it available to foreign tax authorities? Is it made public?

Anti-avoidance. This category rests on five indicators and looks at defensive measures that the jurisdiction puts in place to constrain tax-dodging by multinational enterprises.

Double Tax Treaty Aggressiveness. When a multinational enterprise based in one jurisdiction invests in or earns income in another jurisdiction, the question arises as to which jurisdiction gets to tax it.

Countries sign *Double Tax Treaties* to resolve these issues, so that the same income doesn't get taxed twice. Treaties can be adjusted to help multinationals escape tax. This category relies on a single indicator, assessing how aggressively a jurisdiction uses tax treaties to lower the applicable withholding taxes that multinationals would have to pay when they send or receive income from abroad. The chart also indicates how much each place contributes to a global" race to the bottom" on corporate taxes. The term tax competitiveness has become a staple of tax policy, frequently used as a justification for tax cuts, tax incentives or deregulation which removes social, environmental and economic protections. This has resulted in a 'race to the bottom' in terms of both taxation and regulation.

The world of offshore tax havens is a global ecosystem, where different jurisdictions offer different mixes of facilities to mobile forms of financial capital. Corporate tax havens are among the most important players in this system, but others exist. The Corporate Tax Haven Index complements our *Financial Secrecy Index*, which ranks tax havens according to financial secrecy which attract illicit financial flows by providing laws and other facilities to hide that capital and its ownership from the public, or from the forces of law and order. As acknowledged even by the International Monetary Fund, inequality hampers growth, when the rich get richer, benefits do not trickle down, exacerbates financial instability, erodes social cohesion, and leads to political polarisation. Allowing a small minority to amass obscene amounts of wealth leads them to wield disproportionate influence and power. It is often argued that the EU, by establishing free capital mobility among its members, has forced countries to engage in tax competition with each other, since these have little choice but to lower their corporate tax rates if they want to attract foreign direct investment. The argument brings up promptly the conclusion that the only viable solution to tax avoidance and declining corporate tax rates is to 'harmonise' tax rates across Europe[42].

[42]https://financialsecrecyindex.com/en/

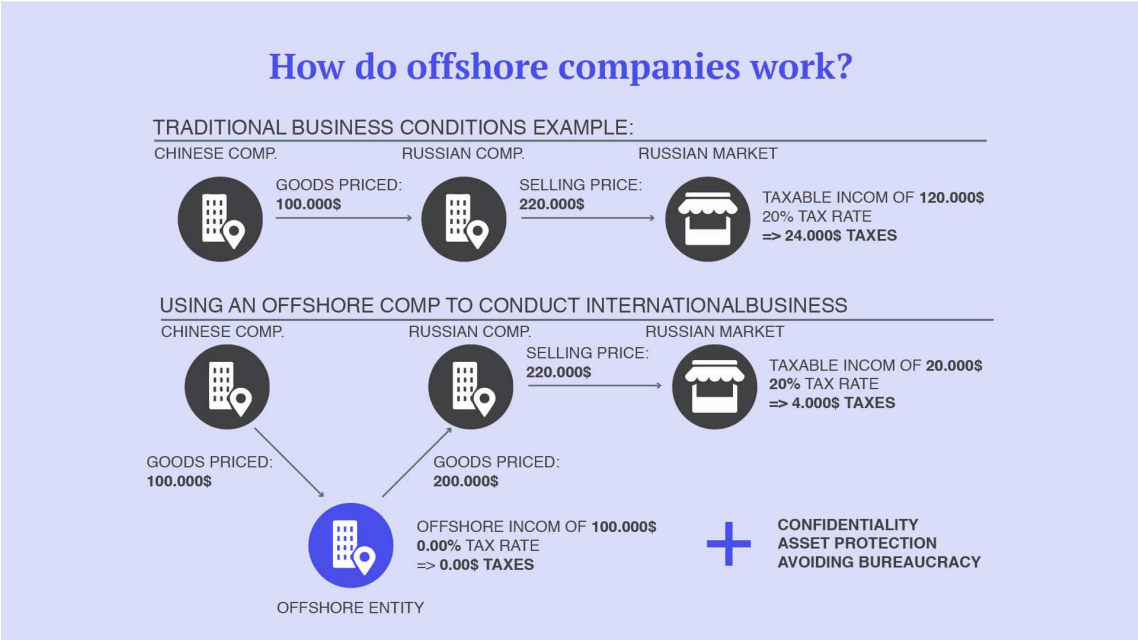
However, a negligible relationship between foreign direct investment and lower corporate tax rates exists, finding a much more significant relationship to things like labour costs, skill levels, infrastructure quality, and political stability.

Gaining a greater control over the tax base would also allow governments to tax high incomes and wealth more efficiently not with the aim of 'raising more money' but of creating a more equitable society. Therefore, for currency-issuing governments, taxation is first and foremost a way to redistribute economic and therefore political power between classes, as well as a means to alter the allocation of resources away, by encouraging or discouraging certain industries or products (think for instance taxes on alcohol or carbon taxes) [43].

2.2 Off-Shore Businesses

The term offshore refers to a location outside of one's national boundaries, whether or not that location is land or water-based. The term may be used to describe foreign banks, corporations, investments, and deposits.A company may legitimately move offshore for the purpose of tax avoidance or to enjoy relaxed regulations. As the following picture highlights, offshore financial institutions can also be used for illicit purposes such as money laundering and tax evasion.

[43]https://www.corporatetaxhavenindex.org/



44

The offshore entity acts as the third party in order to shelter the earnings from tax authorities. In traditional business operations, tax rate is applied on the differential between the buying price and the selling price. The same international business operation conducted with the third entity, nevertheless, it is computed always with the differential of the two prices, the implication of the offshore company allows to drastically reduce the taxable income in order to gain a large amount of profits by saving tax expenditure.

[44]https://www.razvanzamfira.ro/british-virgin-islands/

Moreover, this kind of international entities not only taxes at a rate of 0 percent the incoming profit, but also provides confidentiality and secrecy, asset protection and avoid bureaucracy delays. More specifically, offshore companies have three characteristics:

Firstly, they should be registered as an entity within the jurisdiction of incorporation. Secondly, the 'incorporators' should be domiciled outside of the jurisdiction of incorporation. Finally, the company should transact the majority of business outside of the jurisdiction of incorporation. However, most associate the term 'offshore company' as a means of increasing tax efficiency[45].

Placed at number 1st of the Corporate Tax Heaven Ranking, The British Virgin Islands has proven to be one of the most attractive jurisdictions in the world for establishing an offshore business. The British Virgin Islands are in the Eastern Caribbean. The territory lies to the east of Puerto Rico and is close to the northeast of the US Virgin Islands. There are approximately 60 islands and islets in the BVI of which 16 are inhabited. The BVI is an internal self-governing overseas territory of the United Kingdom. The Chief of State is the Queen of England who is represented by the BVI Governor.

[45]https://www.offshore-protection.com/bvi-british-virgin-islands-tax-havens

The British Virgin Islands (BVI) has an open economy that is driven largely by the financial sector, as well as tax laws coupled with a strong regulatory framework that highly favours doing business in the territory. The BVI's is a member of the International Organization of Securities Commissions (IOSCO), the Caribbean Financial Action Task Force (CTATF) and the Organization for Economic Cooperation and Development (OECD), and has been 'white listed' by all three organizations and continues to remain in good standing with all other international financial bodies. The British Virgin Island economy is the most prosperous in the Caribbean. Together with a high per capita GDP, nearly 100 percent literacy rate and a strong legal and accounting presence. Therefore, it gives several benefits by setting up a BVI Offshore Company[46]:

- A BVI offshore company pays zero income tax. There is no British Virgin Islands tax on capital gains tax, nor are there gift taxes, inheritance taxes, sales taxes, or value added taxes
- Leading international legal and accounting businesses have a strong presence in the BVI and exploits a strong international reputation in the Funds and Investments, Corporate Business, Ship and Aircraft Registration, Captive Insurance and Trust and Estate Planning

[46]https://www.razvanzamfira.ro/british-virgin-islands/

- The BVI has signed over 17 Tax Information Exchange Agreements (TIEAs) including agreements with Britain, France, Germany, Italy, and Spain
- The government of the British Virgin Islands is noted for its stability. The law in the territory is based on British common law
- The BVI offers a significant amount of flexibility in the way which corporate mergers and acquisitions can take place. BVI companies and foreign companies can merge and existing companies are allowed to transfer to or from the BVI
- International banks having a presence in the British Virgin Islands include the London International Bank and Trust Company Ltd., The Bank of East Asia (BV) Ltd., Scotia Bank, and the First Caribbean National Bank.

The British Virgin Islands features one of the most prosperous economies in the Caribbean with a per capita GDP that ranks within the top 20 in the world.

Approximately 60 percent of the BVI economy is based on financial services, primarily offshore financial services. The territory is amongst the largest in the world for the formation of offshore investment funds, second only to the Cayman Islands. Similarly, the islands attract a huge amount of foreign direct investment and is second only to Hong Kong. The British Virgin Islands has no exchange controls, the US dollar is both legal tender and the standard local currency.

There are no restrictions on the movement of dollar funds into or out of the BVI, holders of US dollars may freely convert them to other currencies.

The BVI Financial Services Commission is the single financial services regulator in the territory and in conjunction with the British Virgin Islands corporate registry is responsible for authorizing and registering companies or individuals to conduct business in the territory. The majority of British Virgin Islands company law addresses financial services, key statues being the Securities and Investment Business Act 2010, the Companies Management Act 1990, and the Financing and Money Services Act 2009. The British Virgin Island law provides a stable framework for the formation of offshore companies and for all foreign investors. It worth pointing out that the BVI government takes some pains to avoid the use of the term 'tax haven' lest investors look upon the jurisdiction as a place where tax evasion is practiced, which is illegal, rather than a place where tax avoidance is practiced, which is legal. Corporate groups which apply an aggressive tax planning strategy, have to select not only the jurisdiction to exploit, but also the most appropriate legal status of the company. In the majority of the cases, two main legal entities prevail for off-shore businesses: LTD company or a BV company.

When mentioning an English ***LTD Company*** **(*Limited Liability Company)*** and envies a type of limited liability company established according to the laws in force in England, Wales, Scotland, in some Commonwealth countries and in the Republic of Ireland.

This kind of company has shareholders with limited liability to the capital contributed and its shares cannot be offered to the public, unlike what is instead foreseen for the shares issued by a public limited company (plc or public limited company). *Limited by Shares* means in fact that the liability of the shareholders to the creditors of the company is limited to the capital originally invested, that is, the nominal value of the shares and any rights recognized in exchange for the release of shares by the company. The personal assets of each shareholder are thus protected in the event of the company's insolvency, risking the mere money (or value conferred) invested in the company. Private LTD companies are usually required to have the suffix "limited" (often bearing the word "Ltd" or "Ltd.") or "Incorporated" ("Inc."), as part of their name, even if this last abbreviation cannot be used in the UK or the Republic of Ireland[47].

BV Company (Besloten Vennootschap Private Limited liability Company) is the Dutch and Belgian version of a limited company. The company is owned by shareholders, and the company's shares are privately registered and not freely transferable. A Dutch BV may be created by one or more individuals or legal entities, Dutch or foreign, with a minimum paid in capital of €0,01.

[47]http://www.taxlawplanet.it/aprire-ltd-londra/societa-ltd-significato-ltd/

Corporate income tax will be levied on the profits of the BV, indeed, the general assembly of shareholders may decide on what manner the profit after corporate tax will be distributed. The profits that will be distributed to the shareholders is called dividend. The BV is responsible for withholding the dividend tax which is due for payment to the shareholders. The usual dividend tax rate is 15 percent[48].

2.3 Royalty Conduits

Exploiting tax legislation in order to obtain tax savings is a widespread practice. A so-called Royalty Company is a company established for the sole purpose of holding intangibles, which is the ownership of intangible assets, such as trademarks, patents, design models, formulas and other copyrighted rights.

In recent years the foreign Royalty Company has been one of the most widely used corporate vehicles on an international level, especially by multinationals corporations. Given these premises, the objectives of establishing a Royalty Company are:

- Properly manage intangible assets. For example, through the direct management of research and development costs
- Carry out activities of purchase and sale, from other activities, subsidiaries or otherwise, other intangible assets

[48]https://finance.belgium.be/en/ondernemingen/vennootschapsbelasting/belastingvoordelen/notionele_interestaftrek#q4

• Sign license agreements with third parties

• Collect fees (like royalties or franchise fees) from licensees[49].

The greatest advantage of the Royalty Company is that the firm itself is established and domiciled in a country that provides favourable tax arrangements.

Such ensuring the application of a reduced rate on profits generated by the management of intangible assets. Identifying one of these countries is one of the fundamental steps in drafting an effective international tax planning strategy. The possibility of establishing a conduit company for the management of financial flows deriving from the exploitation of royalties is facilitated the *Directive n. 2003/49 CEE of 3 June 2003*, for payments between holding companies' resident in different member countries. In the international arena, besides the advantages provided by the typology of the company, it is possible to exploit the advantages deriving from the Conventions against double taxation. These are international agreements, of a bilateral nature, which may allow reducing the taxation at source on the profits generated. In this way, a double benefit can be achieved for the multinational group:

On the one hand, the deductibility of the fees paid by the companies of the group for the exploitation of the same rights in the form of royalties.

[49]https://fiscomania.com/royalty-company-estera-intangibles/

On the other hand, low reduced taxation (or even complete exemption) of the income attributable to the ad hoc company established. In the European context, countries such as Luxembourg, Ireland, The Portuguese archipelago of Madeira, Switzerland and The Netherlands have stipulated numerous and advantageous Conventions against double taxation. Agreements that provide for the application of reduced withholdings or the exemption in relation to the out-bound royalties.

As anticipated, within the EU the establishment of a Royalty Company is possible through the Directive 2003/49, which is a regulation that provides, in compliance with some requirements, special benefits for exemption from taxes on interest and fees paid to individuals residing in the EU Member States. To gain the exemption, the conduit beneficiary company and the company paying the fees must reside for tax purposes in an EU Member State.

The University of Amsterdam's CORPNET Group has published in 2017 an empirical and quantitative method of classifying corporate *Tax Havens, Offshore Financial Centres and Royalty Conduit (**OFCs**)*:

24 global Sink OFCs: jurisdictions in which a "disproportional amount of value disappears from the economic system" (the traditional tax havens).

5 global Conduit OFCs: jurisdictions "through which a disproportional amount of value moves toward sink OFCs" (modern corporate tax havens)[50].

[50]https://business.gov.nl/starting-your-business/choosing-a-business-structure/private-limited-company-in-the-netherlands/

The Netherlands situated in western Europe, bordered by Belgium, is the largest royalty conduit jurisdiction of the entire European Union. A Netherlands royalty conduit company is a company which intercedes between the owner of intellectual property rights (a patent owner) and the final user of those rights (licensee of the patent) with a view to realizing fiscal advantages. In order to better explain the advantages of using a Netherlands royalty conduit company an example is provided:

A German company X the owner of a patent, gives to Y, a Dutch company, the right to license that patent to any licensees based in Japan. Y grants a license to Z, a Japanese company, to use the patent for 5 years subject to a royalty fee. The fiscal consequences of this transaction are as follows:

Royalty payments made by the Netherlands company to the German company for the right to sub-lease the patent to the Japanese company at a fee are free of withholding taxes since in Holland no withholding taxes are levied on royalty payments. Because of the provisions of double taxation treaties payment of royalties by a Japanese company to a Dutch company for the right to use the patent in Japan may be either free of or subject to a very low rate of withholding taxes.

The Dutch company will only pay tax on the difference between the royalties paid by the Dutch company to the German company and the royalties received by the Dutch company from the Japanese company. The taxable profits of the Dutch intermediary will be considerably less than the withholding taxes that might have been deducted had a different route had been used for the leasing of the patents. Advance tax rulings are available to determine whether or not the royalty differential margin is an acceptable margin for tax purposes[51].

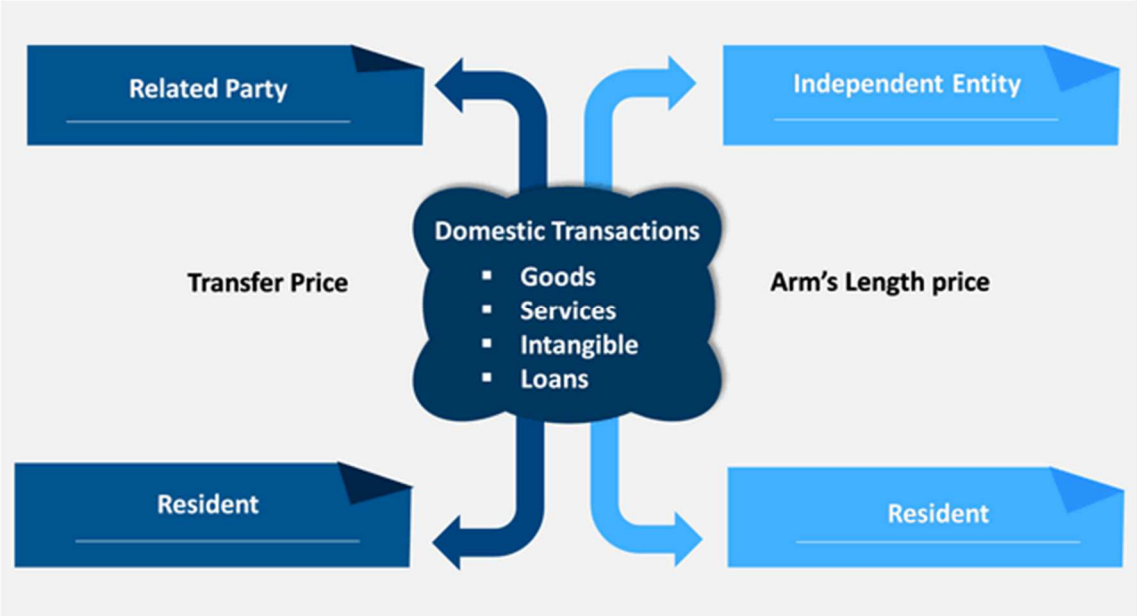
After 2001 the Dutch began to substitute fixed differentials as above (which were still accepted for existing companies until 2005) with Advance Pricing Agreements and Advance Tax Rulings. Under the amended policy, structures that do not have real substance in The Netherlands, such a pure flow-through royalty structure, are in essence no longer eligible for a ruling, unless they agree in advance to a certain exchange of information procedures with other countries. Rulings can however still be obtained for royalty companies provided that the Dutch company meets substance requirements of both an operational and economical nature. As from the tax year 2004, the EU Directive for interest and royalties entered into force.

[51]https://www.lowtax.net/information/netherlands/netherlands-royalty-conduit-companies.html

Under the Directive, a 0 percent withholding tax rate applies for qualifying royalty payments (or interest payments) between qualifying associated corporations established in the EU. A corporation is considered associated if it has cross-holdings of at least 25 percent or a third corporation has a direct minimum holding of 25 percent in two other EU corporations. The corporation is eligible for this EU exemption only if the beneficial owner of the royalties is a qualifying corporation of another EU Member State or is an EU permanent establishment of such a corporation. However, in order to be considered a resident in that Member State (and thus not outside the EU) and as a result, without exemptions, subject to tax in that Member State.

2.4 Transfer Pricing

There are three main channels that multinationals can use to shift profits out of high-tax countries: debt shifting, registering intangible assets such as copyright or trademarks in tax havens, and a technique known as “strategic transfer pricing”. Transfer prices as highlighted by the following scheme, are the prices at which different entities of the same corporation trade. Corporations often acquire other companies to establish a market advantage in their industry or achieve it through organic growth.



[52]

Market advantage can be achieved through lowering the cost of raw material, acquiring, developing intellectual property and other intangible assets to strengthen the longevity of their business. Pricing, corporations located in high-tax jurisdictions can "transfer the prices" of income and expenses and shift their income to a low-tax jurisdiction in order to avoid or reduce taxation. This transaction is done by selling goods and/or services to affiliates in the low-tax jurisdictions at cheaper rates resulting in low revenues for the high-tax jurisdiction company and high revenues and profits in the low tax jurisdiction.

[52]https://www.royaltyrange.com/home/blog/transfer-pricing-methods

Correspondingly, the high-tax jurisdiction company purchases goods and/or services from low-tax jurisdiction affiliates at a high price resulting in high expenses for the high-tax jurisdiction company. Nevertheless, transfer pricing is not in itself illegal or necessarily abusive, what is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing. This is known as "Arms-Length" trading, because it is the product of genuine negotiation in a market. The Arm's Length price is usually considered to be acceptable for tax purposes. Notwithstanding, when two related companies trade with each other, they may wish to artificially distort the price at which the trade is recorded, to minimise the overall tax bill. As a result, it helps to record as much of its profit as possible in a tax haven with low or zero taxes.

Transfer Mispricing refers to trade between related parties at prices meant to manipulate markets or to deceive tax authorities. The legality of the process varies between tax jurisdictions; most regard it as a type of fraud or tax evasion. Generally, if two independent, unrelated parties negotiate with one other for a financial transaction and eventually reach a price, a transaction, the correct market price will take place. According to the Arm's Length Principle, the price at which the transaction occurs is preferred for tax purposes, as it is a fair reflection of the value of the goods or services.

However, when the parties that negotiate a transaction are related, they may set an artificially lower price with the intention to minimise their taxes. Because of these tax benefits, transfer mispricing is favoured by a majority of large enterprises[53].

Imagine for instance that a multinational is composed of two companies, one located in a high-tax jurisdiction like Australia (company A) and one located in a low-tax jurisdiction like Bermuda (company B). Company B is a holding company and fully owns company A. While both companies should pay tax on the profit they make in their respective countries, one of the three channels are used to shift profits from the high-tax country (Australia in our case, with a corporate income tax rate of 30 percent) to the low-tax country (Bermuda, with a corporate income tax rate of 0 percent). For every dollar shifted in this way, the multinational avoids paying 30 cents of tax.

Debt-shifting is when company A borrows money (although it does not need to) from company B and pays interest on this loan to company B. The interest payments are a cost to company A and are tax-deductible in Australia.

[53]https://www.taxjustice.net/topics/corporate-tax/transfer-pricing/

So, they effectively reduce the profit that company A reports in Australia, while increasing the profit reported in Bermuda. In the second channel, the multinational transfers its intangible assets (such as trademarks or copyright) to company B, and company A then pays royalties to company B to use these assets.

Royalties are a cost to company A and artificially lower its profit, increasing the less-taxed profit of company B. Strategic transfer pricing, the third channel, can be used when company A trades with company B. To set prices for their trade, most countries currently use what's called the "Arm's Length Principle". This means that prices should be set the same as they would be if two non-associated entities traded with each other. Basically, it is often difficult to determine the arm's length price and there is considerable space for multinationals to set the price in a way that minimises their overall tax liabilities. The conventional international approach to dealing with transfer mispricing is through the "Arm's Length" Principle: A transfer price should be the same as if the two companies involved were indeed two unrelated parties negotiating in a normal market, and not part of the same corporate structure. The resulting damage from the prevalent "Arm's Length" approach has been, and is, substantial. Governments around the world are systematically hobbled in their ability to collect revenues from the corporate tax system[54].

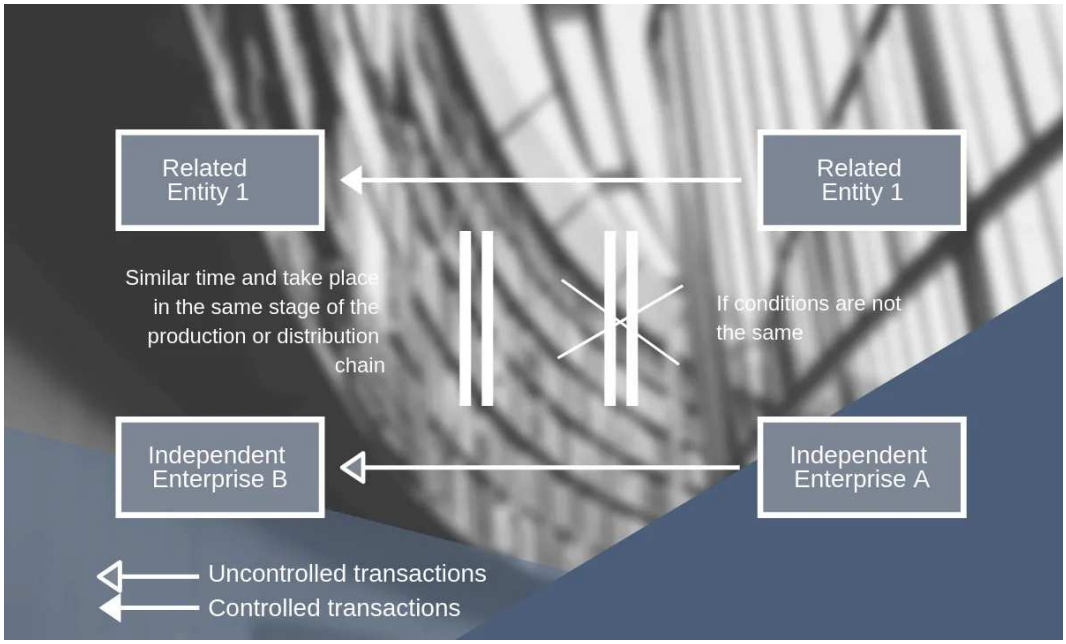
[54]http://www.ustransferpricing.com/arms_length_principle.html

Billions of dollars are wasted annually around the world on governmental enforcement efforts that have little chance of success, and on meeting expensive compliance requirements. Several methods exist that multinational enterprises (MNEs) and tax administrations can use to determine accurate Arm's Length transfer pricing for transactions between associated enterprises. The Organisation for Economic Co-operation and Development (OECD) outlines five main transfer pricing methods that MNEs and tax administrations can use[55]:

Comparable Uncontrolled Price (CUP) method

The CUP method is grouped by the OECD as a traditional transaction method (as opposed to a transactional profit method). It compares the price of goods or services and conditions of a controlled transaction (between related entities) with those of an uncontrolled transaction (between unrelated entities). However, in order to do so, the CUP method requires comparable data from commercial databases. If the two transactions result in different prices, then this suggests that the Arm's Length Principle may not be implemented in the commercial and financial conditions of the associated enterprises. In such circumstances, the OECD says the price in the transaction between unrelated parties may need to be substituted for the price in the controlled transaction.

[55]https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methods-examples/



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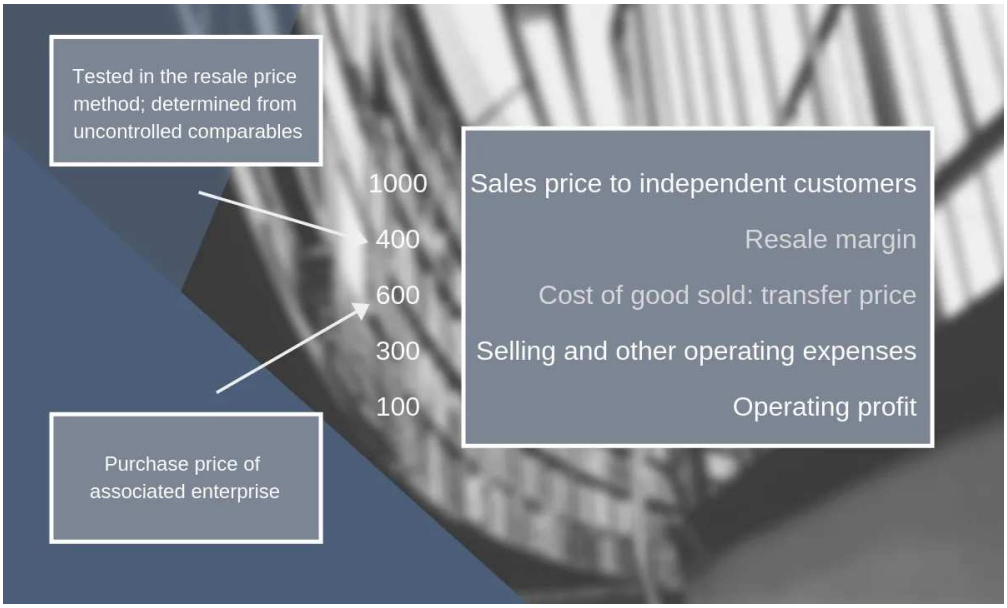
The two transactions can be seen as comparable if the conditions are the same, they happen at a similar time and take place in the same stage of the production or distribution chain. If there are differences in the product sold in each of the transactions, then the associated enterprises would need to determine whether this affected the price. If so, it would need to make adjustments to the cost to ensure it was priced at Arm's Length.

Resale Price method

Another traditional transaction method for determining transfer pricing is the resale price method.

[56]https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methods-examples/

This method starts by looking at the resale price of a product that has been bought from an associated enterprise and then sold onto an independent party. The price of the transaction where the item is resold to the independent enterprise is called the resale price. The method then requires the resale price margin to be identified, which is the amount of money the party reselling the product would require to cover the costs of the associated selling and operating expenses. The resale price margin also includes the amount the reseller would need to make a fair profit, taking into account the functions it performed (including assets used and risks assumed). This gross resale price margin is deducted from the resale price. The amount that remains after the margin has been subtracted and fair adjustments have been made (e.g. expenses like customs duty have been taken into account) is the Arm's Length price for the original transaction between related entities. The resale price method requires resale price margins to be comparable in order for an Arm's Length price to be identified. This means that factors such as whether a warranty is offered (and how it is applied) must be taken into account. If a distributor offers a warranty and sells the product at a higher price to account for that warranty, then they will make a higher gross profit margin than a distributor that does not offer a warranty and sells the product at a lower price.



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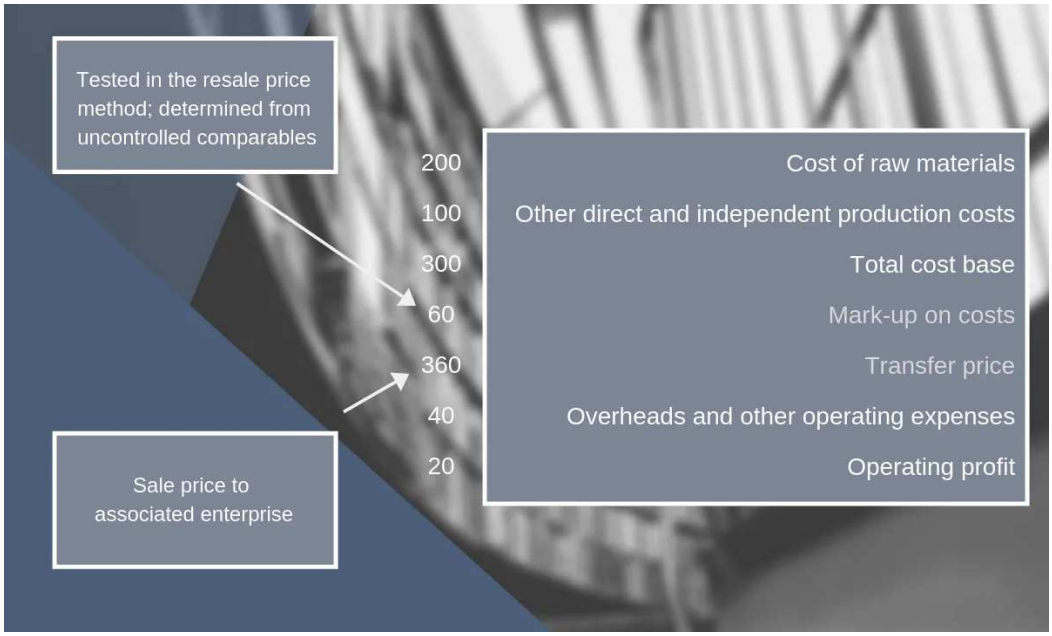
For the two transactions to be comparable, the taxpayer must make accurate adjustments to the transaction cost to account for the margin discrepancy.

Cost Plus method

The cost-plus method is a traditional transaction method that analyses a controlled transaction between an associated supplier and purchaser. It is often used when semi-finished goods are transacted between associated parties or when related entities have long-term arrangements for 'buy and supply'. The supplier's costs are added to a mark-up for the product or service so that the supplier makes an appropriate profit that takes into account the functions they performed and the current conditions of the market.

[57]https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methods-examples/

The combined price is the Arm's Length price for the transaction. Considering for example Party A sells the product to Party B, which is an associated company in another country. From this transaction with Party B, Party A earns a gross profit mark-up. Party A does not include operating expenses at the cost of the product. Party C and Party D are independent enterprises that manufacture the product, then they sell their products to independent clothing brands and also earn a gross profit mark-up for the transaction.



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[58]https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methods-examples/

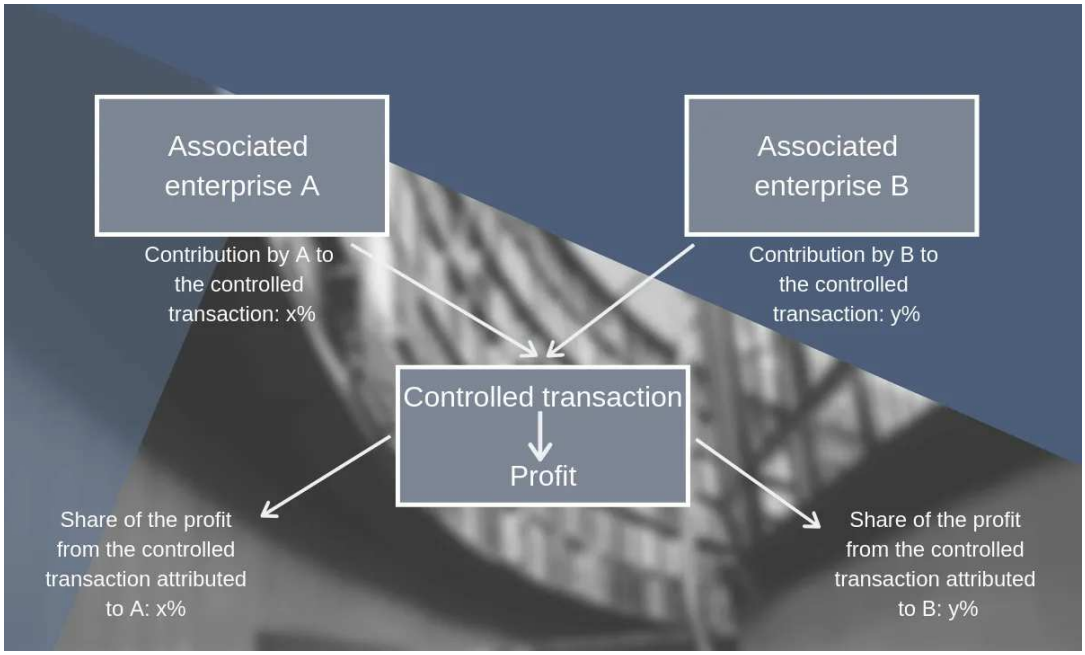
Party C and Party D include operating expenses in the cost of their products, so, the gross profit mark-ups of Party C and Party D need to be adjusted to be comparable with Party A's.

Transactional Net Margin method (TNMM)

The TNMM is one of two transactional profit methods outlined by the OECD for determining transfer pricing. These types of methods assess the profits from particular controlled transactions. The TNMM involves assessing net profit against an "appropriate base", such as sales or assets, that results from a controlled transaction. The OECD states that, in order to be accurate, the taxpayer should use the same net profit indicator that they would apply in comparable uncontrolled transactions. Taxpayers can use comparable data to find the net margin that would have been earned by independent enterprises in comparable transactions.

The taxpayer also needs to carry out a functional analysis of the transactions to assess their comparability. If an adjustment is needed for a gross profit mark-up to be comparable, but the information on the relevant costs are not available, then taxpayers can use the net profit method and indicators to assess the transaction.

This approach can be taken when the functions performed by comparable entities are slightly different.



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The cost of the support is included in the price of the product but cannot be easily separated from it. An associated enterprise sells the same product but doesn't offer this support. So, the gross margins of the transactions are not comparable.

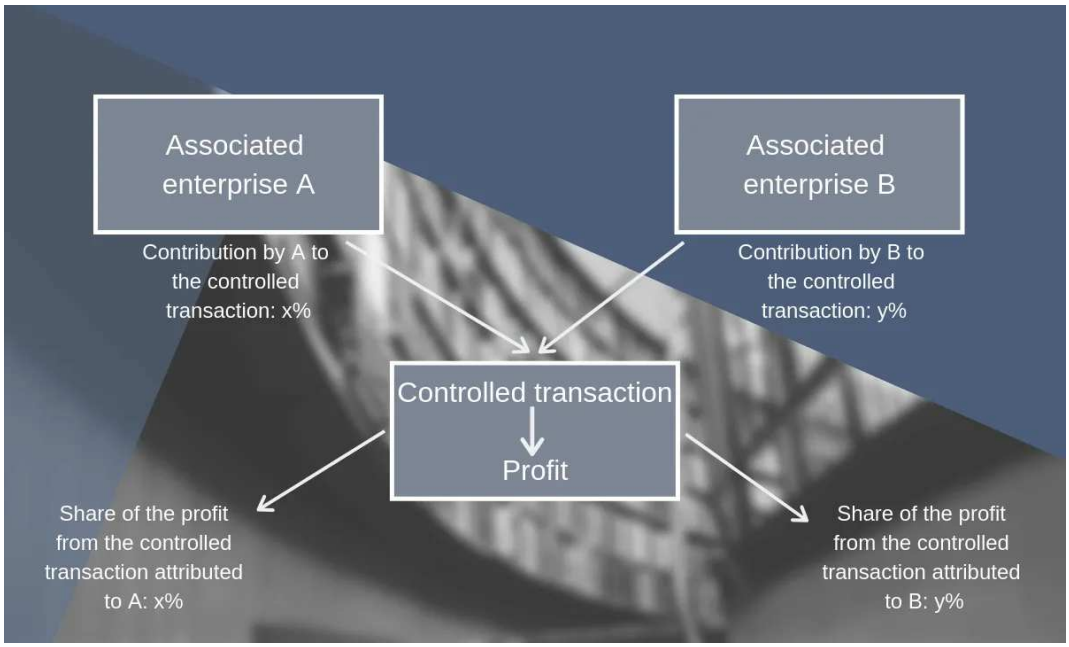
By examining net margins, associated enterprises can more easily identify the difference in transfer pricing in relation to the functions performed.

Transactional Profit Split method

The second transactional profit method outlined by the OECD is the transactional profit split method. It focuses on highlighting how profits (and indeed losses) would have been divided within independent enterprises in comparable transactions.

[59]https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methods-examples/

By doing so, it removes any influence from "special conditions made or imposed in a controlled transaction". It starts by determining the profits from the controlled transactions that are to be split. The profits are then split between the associated enterprises according to how they would have been divided between independent enterprises in a comparable uncontrolled transaction. This method results in an appropriate Arm's Length price of controlled transactions.



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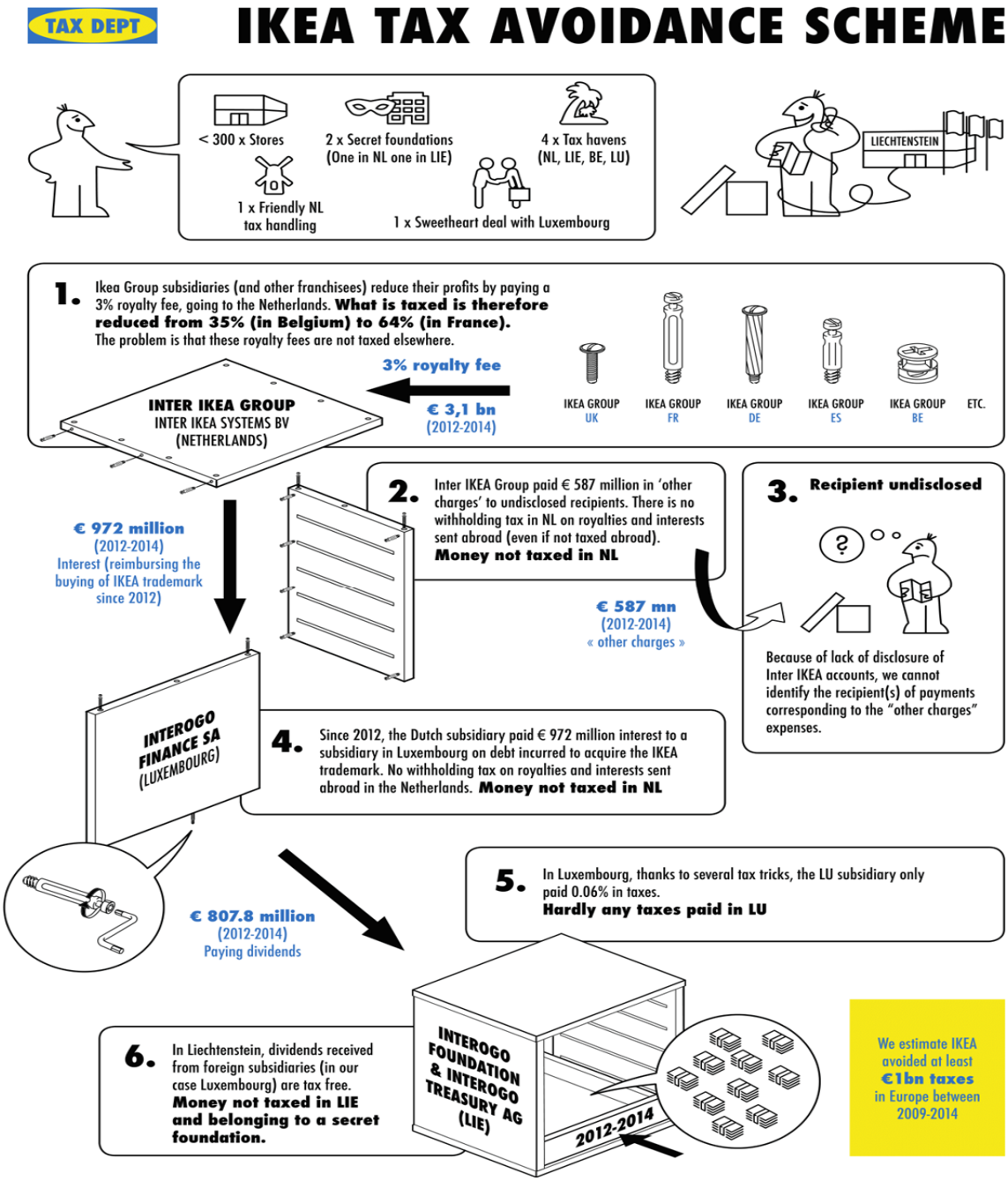
There are two main approaches that can be taken for splitting profits:

[60]https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methods-examples/

a) *Contribution analysis:* The combined profits are divided based on the relative value of the functions performed by each of the related entities within the controlled transaction (considering assets used and risks assumed).

b) *Residual analysis:* The combined profits are divided into two stages. First, each entity is allocated Arm's Length compensation for its functions and contribution to the controlled transaction. Second, any remaining profit or loss after the first stage is divided based on analysis of the facts and circumstances of the transaction[61].

[61]https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methods-examples/



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[62]https://www.retaildetail.be/en/news/furniture/greens-demand-investigation-ikeas-fiscal-tricks

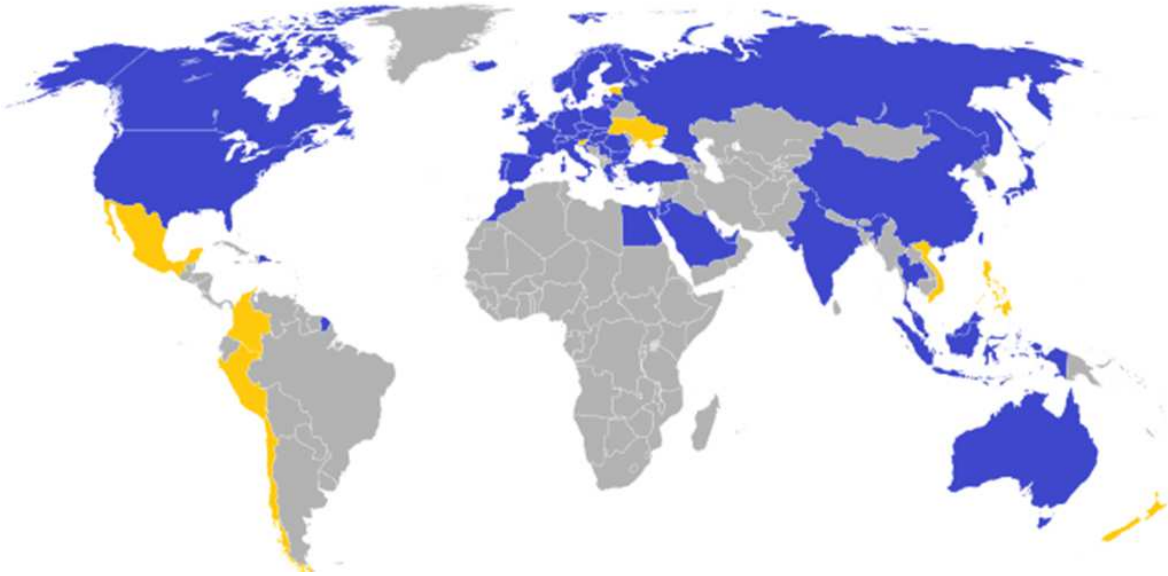
3. IKEA'S FLAT-PACK TAX AVOIDANCE SCHEME: A CORPORATE STRATEGY AS A VEHICLE OF PROFIT SHIFTING AND TAX AVOIDANCE

3.1 The Inter IKEA Group

Inter IKEA Systems BV is a Swedish-founded multinational group that designs and sells ready-to-assemble furniture, kitchen appliances and other home products. It was founded in Sweden in 1943 by a 17-year-old carpenter called Ingvar Kamprad, who was listed by Forbes in 2015 as one of the ten richest people in the world, worth more than $40 billion. The company at the time was created as a primarily mail-order sales business, indeed, it began to sell furniture only five years later. The first stores outside Sweden were opened in Norway in 1963 and Denmark in 1969. IKEA further expanded to other parts of Europe late in the 1970s and 1980s, such as Switzerland, West Germany, France, Spain, Italy, United Kingdom and Belgium. Then, realising a big picture of the business, it has fostered stores all over the world, like in Japan, Australia, Canada, Hong Kong, Singapore and the United States. The first IKEA store in Latin America was opened in 2010 in Santo Domingo, Dominican Republic. As of June 2019, 423 IKEA stores are operating in 52 different countries[63].

[63]https://www.ikea.com/

The globe's map depicts in blue the countries in which the company has broadcasted its stores, while the yellow ones are those in which IKEA has planned to establish the business in the next few years.



[64]

There are 242 stores in Europe, 56 stores in North America, 33 stores in Asia and 10 in Australia; while in Russia there are 14 stores. Nowadays, the company has implemented a strategy to get into the Chinese and Indian markets with a very positive impact. The company's name is an acronym that consists of the initials of Ingvar Kamprad (the founder), Elmtaryd (the farm where Kamprad grew up) and Agunnaryd (Kamprad's hometown in Småland, situated in southern Sweden).

[64]https://www.reddit.com/r/MapPorn/comments/dy8157/heres_an_updated_map_of_countries_with_ikea_stores/

Precisely, IKEA's vision is to create a better everyday life for the many people, hence one of the key competitive advantages of IKEA is that it has a piece of extensive knowledge about the customers. The company deeply understands the purchasing factors that affect customers' decision process to buy and as a consequence, it implements the best practices to induce them to do that[65].

Therefore, the firm has become one of the most appreciated companies worldwide. According to the 2016 Millward Brown's "Brandz Top 100 Global Brands", IKEA was the fifth most valuable retailer brand in the world, valued at over $18 billion. Unlike IKEA's major competitors, the company has smartly diversified businesses; besides its furniture products, the company operates restaurants, houses and flats. Currently, the company is known for its modern design for various types of appliances and furniture and its interior design brand is often associated with an eco-friendly simplicity. Also, the firm is renowned for its attention to cost analysis, operational details and continuous product development. Furthermore, more than 780 million customers visit IKEA stores every year and the company's website contains about 12.000 products and is the most plausible representation of the whole IKEA variety[66].

[65]https://en.wikipedia.org/wiki/IKEA
[66]https://erply.com/ikeas-growth-strategy/

Therefore, the level of customer loyalty that IKEA has built over the years is outstanding, most customers will not buy products they do not need even at low prices, therefore the company has become a synonym of quality products at reasonable prices. The company interacts with its customers to know their preferences, which serve as important input at the product design stage. For these reasons, it is also possible to state that the company is responsible for approximately 1 percent of the entire world's commercial-product wood consumption.

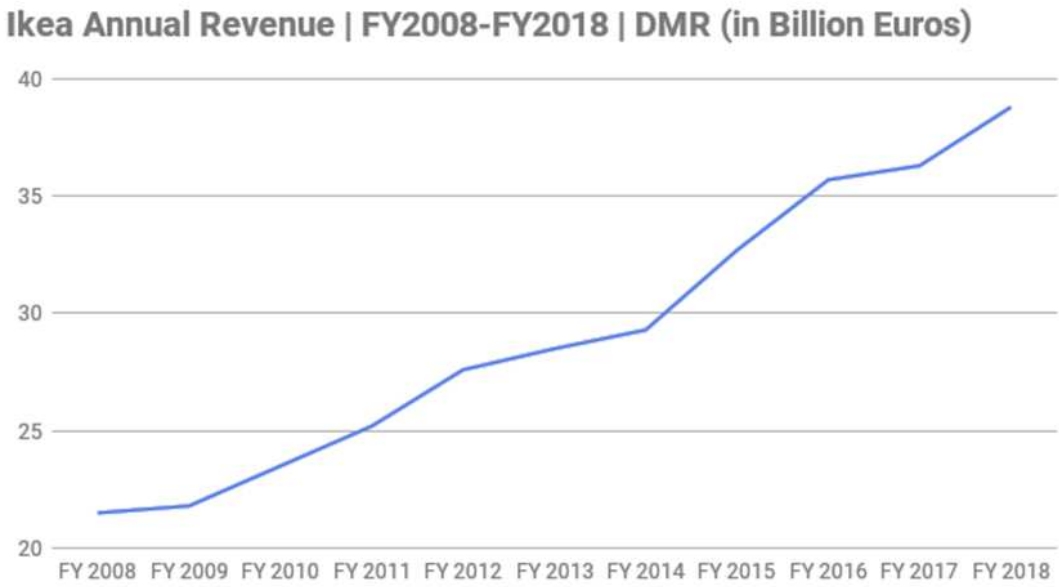
At present days, IKEA is the world's largest furniture retailer and it was awarded the 2017 Nordic Language Award for introducing Scandinavian language and culture to a global audience.

3.2 Digging In: Revenues, Production and Costs

Processing the company's annual report, IKEA's annual revenues, in the fiscal year 2018, were about €37,05 million (US$44,6 billion). The gross profit worldwide up to 2018 was about €13 million, while the net income was about €1,46 million. IKEA that has approximately 208.000 employees, has recorded a total asset for an amount of about €53 million. Although, the European market reached impressive retail sales of €22.311 million with 106.852 employees, especially thanks to the German market; North America gets great retail sales of €4.490 million totalling on 19.000 employees[67].

[67]https://newsroom.inter.ikea.com/news/inter-ikea-group-financial-summary-fy18/s/a80ce9a8-1f0a-4e91-89e0-5458e367f692

The subsequent timeline shows IKEA's revenues worldwide from 2008 to 2018 with an increasingly positive trend over the years, as a signal of the successful strategies implemented for long-term stability and prosperity.



[68]

Indeed, IKEA has reported really healthy growth in its annual sales as it plans a very ambitious expansion project which is intended to reach 3 billion people by 2025. In the Furniture & Appliances market in the United States, IKEA is ranked at number 21 with less than US$300 million in 2018, due to the lack of eCommerce net sales in this category. IKEA's sales share comes primarily from the European Union, in fact, the market share is almost 70 percent as of 2018.

[68]https://annualreport.ingka.com/wpcontent/uploads/2019/02/Ingka_AR18_190206_2_3.pdf

The data presented in the following figure highlights that many of the stores belong to Germany, with more than 50 stores.

[69]

IKEA spread its stores also in Asia and Australia, obtaining an amount of €2.492 million retail sales with 14,000 employees. China as a great economic reality represents one of the fastest potential markets as well as Poland; presently India is the company's new targeted country. Concerning the production, IKEA purchased inputs from 1.074 suppliers across 55 countries.

[69]https://www.statista.com/topics/1961/ikea/

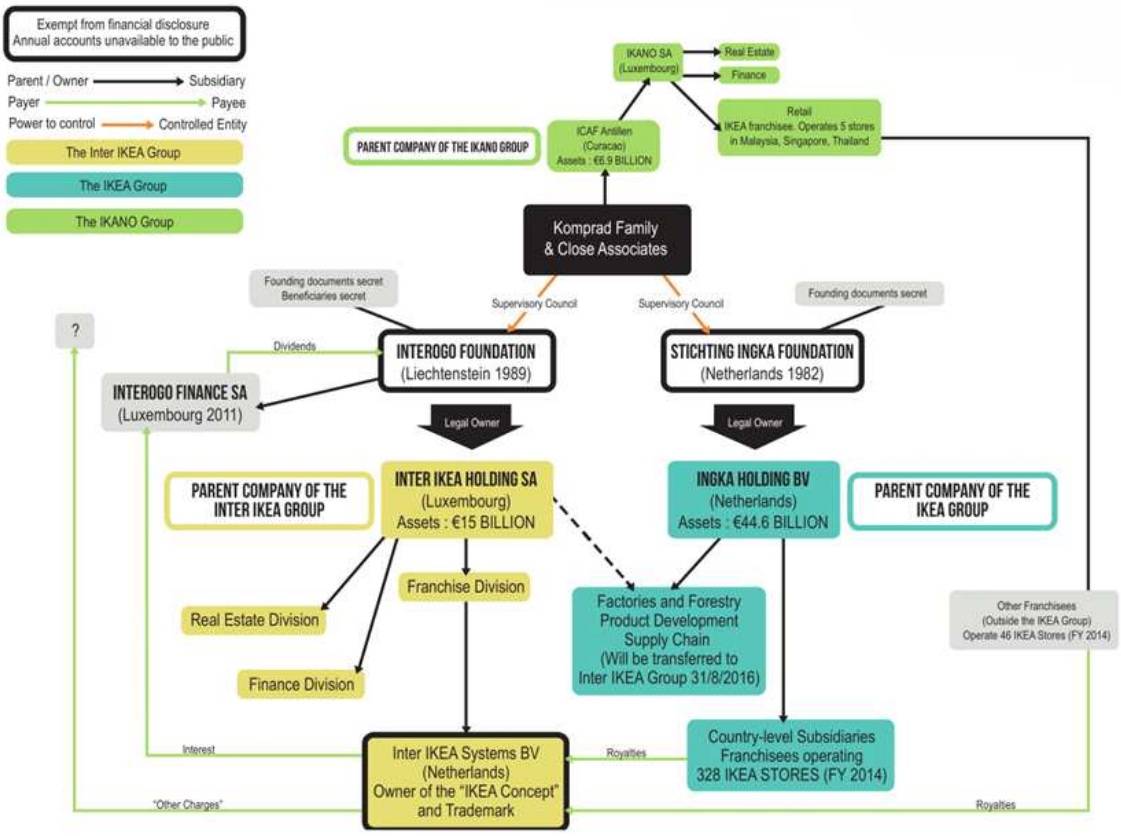
Since IKEA's main product is furniture, thus, wood products are its most important non-labor input. Currently, IKEA is the third-largest purchaser of wood products in the world. Regionally, 62 percent of inputs are sourced in Europe, 34 percent in Asia and the last 4 percent in North America. IKEA has pursued aggressive and creative sourcing strategies, showing great flexibility in changing locations of product sourcing in response to changes in the size of the product market and changes in relative attractiveness and ability of alternatives to meet the firm's needs. IKEA is known worldwide for its innovative and stylish designs, almost all products have a flat packaging. That format allows to reduce shipping costs, minimizes transport damage, increases store inventory capacity and makes it easier for customers to take the furniture home themselves, rather than needing a delivery. The household goods and furniture are designed in Sweden; however, they are mainly manufactured in developing countries with a low labor cost. In turn, the company can constantly reduce product prices as a strategic tool for growth sustenance. A combination of low product prices and high product quality became a source of competitive advantage. Swedwood, an IKEA subsidiary located in Southern Poland, deals with most of the production of the company's wood-based products[70].

[70]https://newsroom.inter.ikea.com/news/inter-ikea-group-financial-summary-fy18/s/a80ce9a8-1f0a-4e91-89e0-5458e367f692

According to the subsidiary, over 16.000 employees across fifty sites in ten different countries manufacture over 100 million pieces of furniture which are sold annually.

3.3 A Corporate Tangled Structure

Today, the IKEA multinational, as seen by the public, is a giant enterprise with an extended global supply chain and a worldwide net of stores.



[71]

[71]https://europeangreens.eu/news/ikea-report-ikea-avoided-1-billion-taxes-using-european-taxation-system-its-own-benefit

Despite its massive growth, IKEA remains a privately-owned business, controlled through a complex multinational structure as displayed in the below diagram, by Ingvar Kamprad, his three sons and their close associates.

IKEA Company is owned and administered by a complicated net of non-profit and for-profit corporations. Ingvar Kamprad, by 1982, had split IKEA into two distinct legal corporate groups:

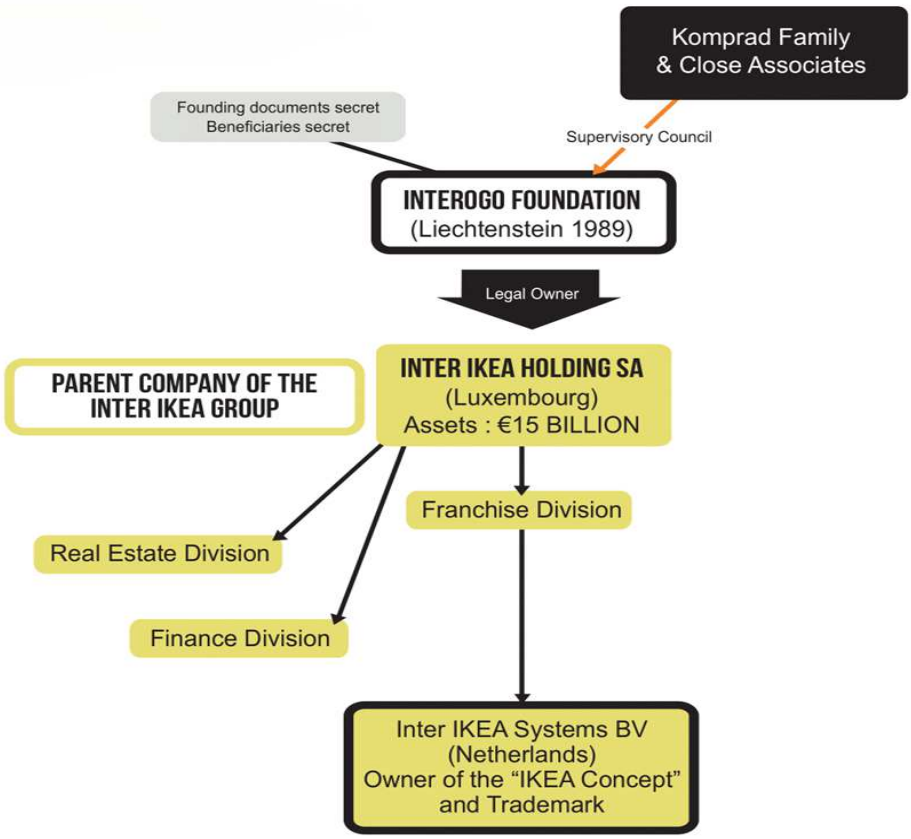
1) ***Inter IKEA Group*** was settled under a Luxembourg holding company called ***Inter IKEA Holding SA***, which has itself been placed under the ownership of the Interogo Foundation, formed in Liechtenstein in 1989.

2) ***IKEA Group*** was controlled by a Dutch parent company called ***INGKA Holding BV***. This latter has itself been placed under the ownership of a Dutch foundation, the Stichting INGKA.

Inter IKEA Systems BV was established in 1983 in the Netherlands and it is still the owner of the worldwide IKEA Franchisor. Besides, Inter IKEA Systems BV is owned by Inter IKEA Holding BV (all its subsidiaries included). Inter IKEA Holding BV located in the Netherlands, is the owner of IKEA's range and supply (IKEA of Sweden AB and IKEA Supply AG), production (IKEA Industry AB) and franchising (Inter IKEA Systems B.V.) businesses.

At the top of IKEA's dual corporate structure, two private foundations own both groups. The foundations are independent entities with legal personality and their own bodies of governance managed by members of the family.

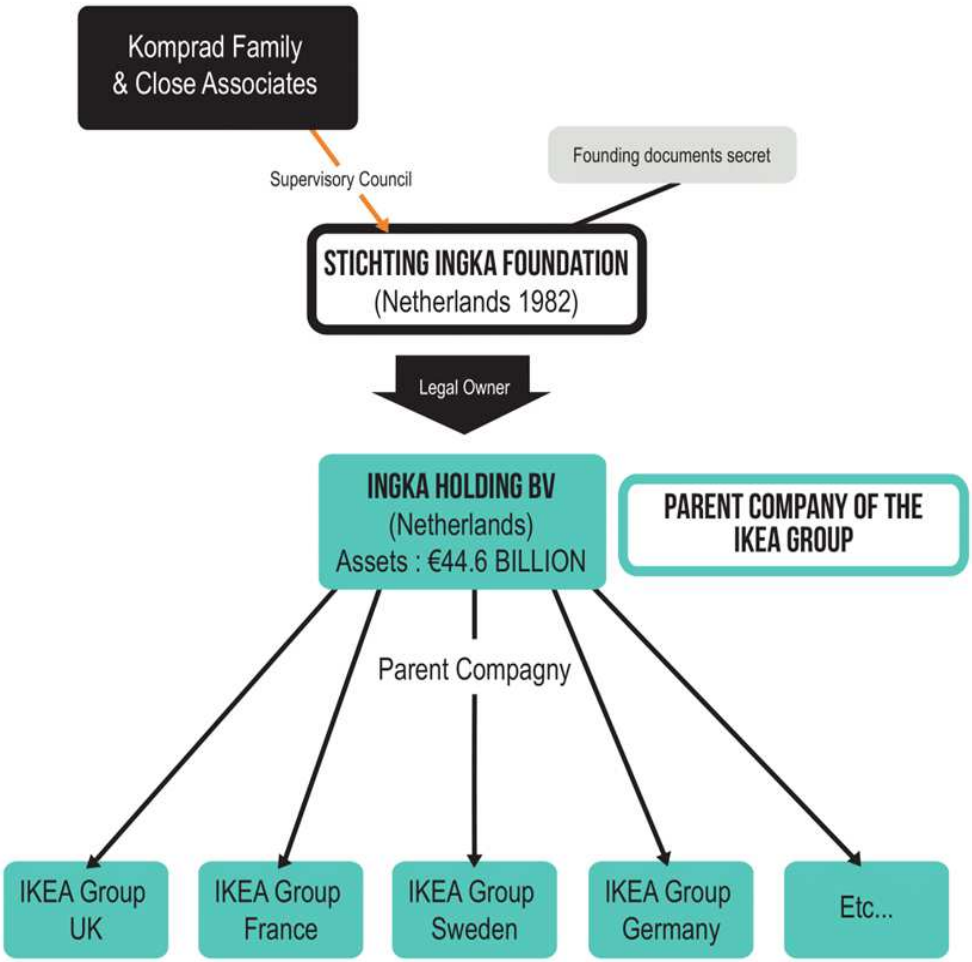
a) ***Interogo Foundation*** has two governing bodies, a Foundation Council and a Supervisory Council. However, the Kamprad family exercises indirectly a high degree of control over Interogo Foundation through their guaranteed minority representation on the Supervisory Council.



[72]

[72]https://europeangreens.eu/news/ikea-report-ikea-avoided-1-billion-taxes-using-european-taxation-system-its-own-benefit

b) ***Stichting INGKA*** is a Dutch organization but is not properly a charitable foundation. Its statute (revised in 2013), stated that the foundation's objectives are "free from any profit scope", indeed its funds may be used only to support rummage purposes or to finance the IKEA Group.



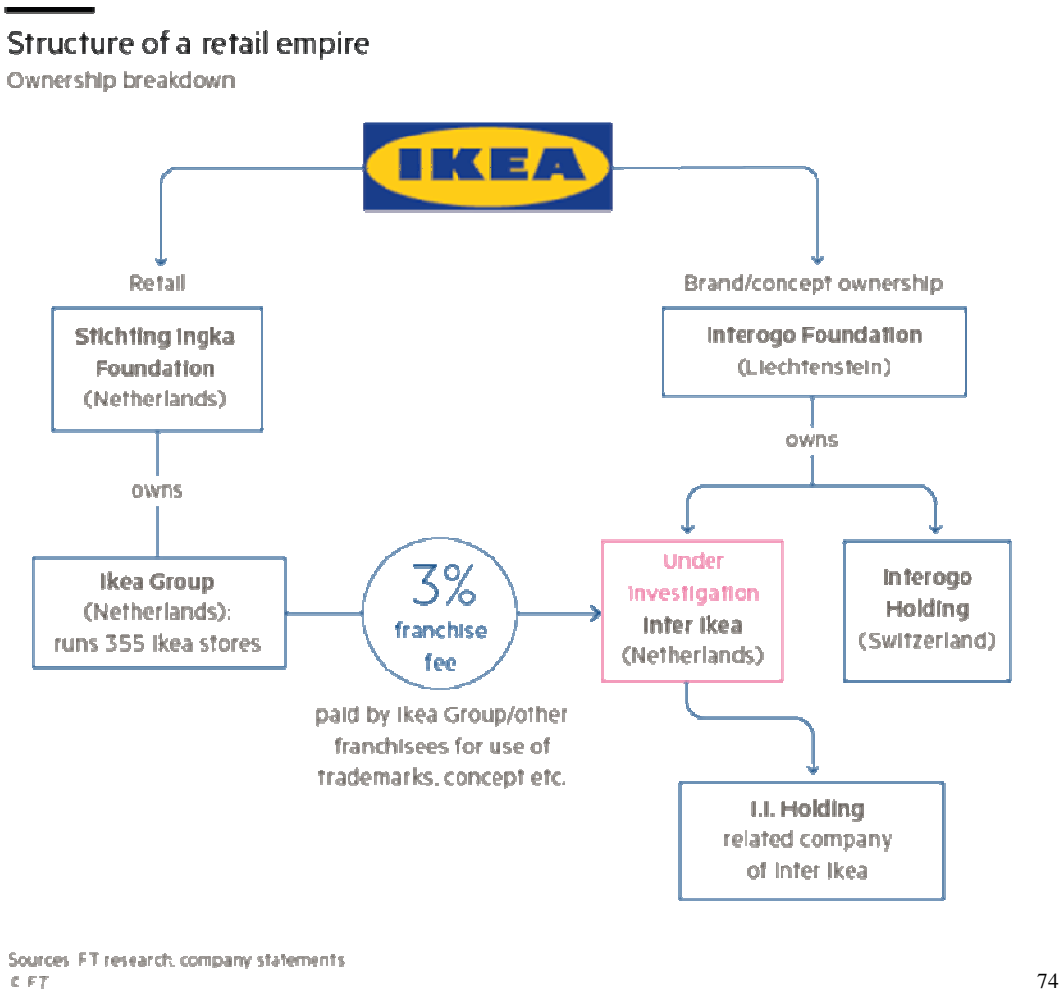
[73]

[73]https://europeangreens.eu/news/ikea-report-ikea-avoided-1-billion-taxes-using-european-taxation-system-its-own-benefit

Inter IKEA and Interogo were both created during the 1980s to secure independence and long life of the whole IKEA Concept. The company's main features are the core asset of Inter IKEA Group and its franchisor operation.

In 2016, the INGKA Holding sold its design, manufacturing and logistics subsidiaries to Inter IKEA Holding. After the 2016 corporate restructuring, Inter IKEA Holding SA no longer exists, as a result, Mathias Kamprad became a board member of the Inter IKEA Group and the Interogo Foundation. Around the globe, many companies operate under the IKEA trademarks, however, all the franchisees are independent of Inter IKEA Group and they are owned and operated by INGKA Group. In order to improve the IKEA franchise system and clarify roles, IKEA range, supply and production activities have been transferred to the new Inter IKEA Group headed by Inter IKEA Holding BV. The Inter IKEA Group is now composed of three core businesses: franchising, range & supply and industry. The three entities cooperate to forge a stronger franchise system and to build an enhanced IKEA value proposition. Franchisees operate IKEA stores under franchise agreements signed with Inter IKEA System BV a separate independent legal entity from franchisees. Undoubtedly, Ingvar Kamprad had split up IKEA and placed its two bodies under the legal ownership of foundations in the Netherlands and Liechtenstein (both for the Inter IKEA group) was mainly targeted to avoid a high amount of taxes and has been served as a tax-efficient vehicle for transferring assets.

As far as the infographic reveals, every single store from San Francisco to Shanghai, had to pay 3 percent of their turnover as a franchise fee to Inter IKEA.



[74]

[74]https://www.ft.com/content/e4ca7110-e3e8-11e7-97e2-916d4fbac0da

Inter IKEA, located in Delft (Netherlands), transfers by implication, most of the earning generated by the usage of the logo and the trademarks, to other jurisdictions without paying any tax[75].

3.4 The Flat-Pack Tax Avoidance Scheme

Although IKEA's simplicity for its ready-to-assemble flat-pack furniture lies on the surface, a complex corporate structure aimed at economizing resources from taxation is hidden below it. The above-explained structure ingeniously exploits several loopholes provided by different jurisdictions. The founder's desire for IKEA's business operations at the early stages was to focus on production efficiency and cost reduction contemporaneously. Hence, the IKEA empire arose and was then split up, with some parts located in the Netherlands, Luxembourg and Liechtenstein. The set-up of IKEA's configuration is aiming at minimizing tax and creating a charity foundation dedicated to the somewhat non-existent purpose[76]:

Step 1 - Set up a subsidiary in the Netherlands (Inter IKEA Systems BV)

Every IKEA store in the world pays 3 percent of franchise fees (or royalties) to the Inter IKEA Group.

[75]https://www.greensefa.eu/legacy/fileadmin/dam/Documents/Studies/Taxation/Report_IKEA_tax_avoidance_Feb2016.pdf

[76]https://www.forbes.com/sites/jwebb/2017/12/18/ikea-follows-apple-and-amazon-in-facing-a-eu-tax-avoidance-investigation/#31985a14b268

Throughout a company called Inter IKEA Systems BV, located in the Netherlands, IKEA is enabled to shift huge amounts of profits on a massive scale.

Step 2 – Send billions in tax-deductible royalties to a Dutch subsidiary

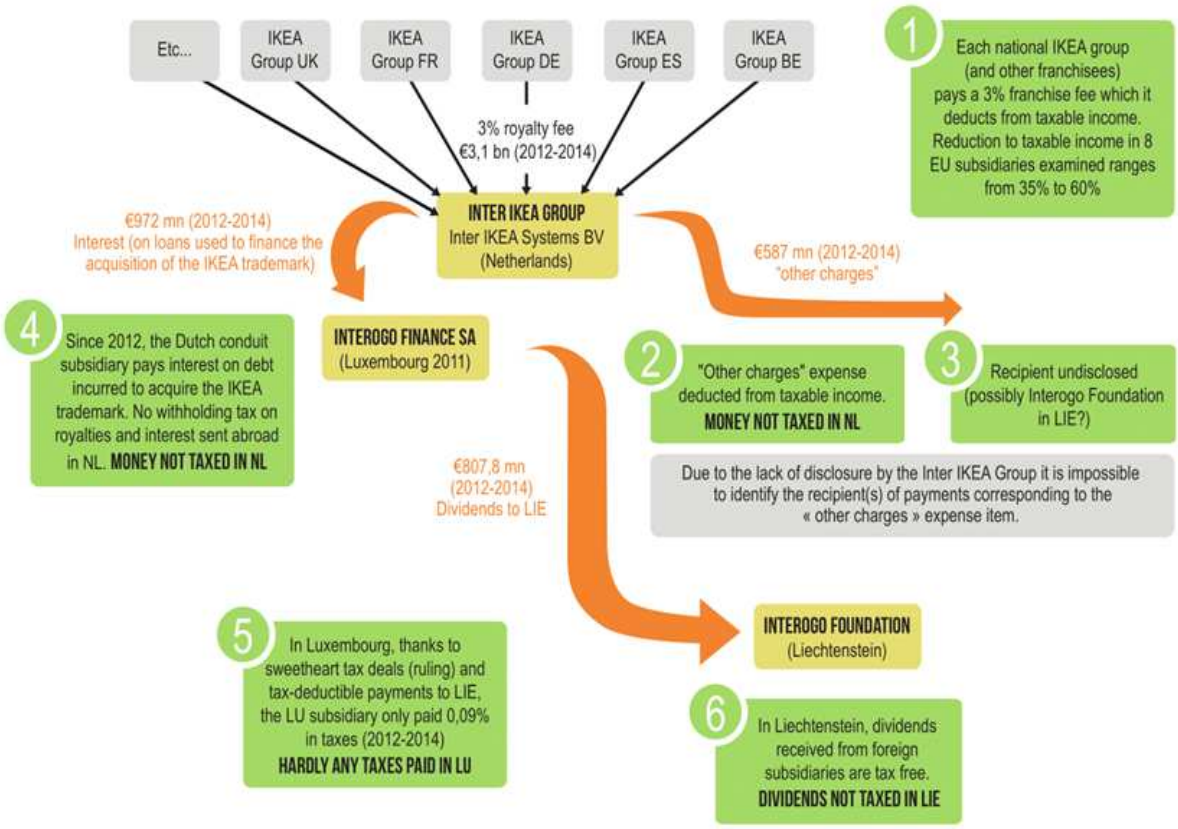
From 1991 to 2014, IKEA franchisees paid €13,6 million in tax-deductible royalties to the Inter IKEA Group. Today, they still pay to Inter IKEA more than €1 billion annually. Narrowing the focus to IKEA Group subsidiaries, especially to the European ones, it is underlined by the data that the number of profits shifted from 2009 to 2014 were more than €35 million in Germany, almost €24 million in France and €11,6 million in the UK.

Step 3 - Move royalties to Liechtenstein to remain untaxed

IKEA Group subsidiaries move a wide part of their income to Inter IKEA Systems BV in the Netherlands. Subsequently, the Inter IKEA Group guaranteed most of this income to remain untaxed by transferring it (directly or indirectly) to other entities, like the Interogo Foundation. The presented pattern is possible, by dismissing payments for interests on intracompany debt via a subsidiary in Luxembourg.

Nevertheless, it is necessary to distinguish how the Inter IKEA Group proceeded before and after the year 2012. Subsequently the 2012, the annual accounting sheets provided by Inter IKEA Holding SA (the parent company of the Inter IKEA Group in Luxembourg) revealed that, in every year since 1991, the Inter IKEA Group has supported a large expense.

This cost for an unmarked item was justified only as "other charges", which from 1991 to 2011, totalled €10,5 billion; nearly 95 percent of the income generated by franchise and license fees during that same period. Regarding the Inter IKEA Group as a whole, these unspecified "other charges" seem to be enough to almost offset the entire royalty incomes received from IKEA stores worldwide.



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[77]https://www.greensefa.eu/legacy/fileadmin/dam/Documents/Studies/Taxation/Report_IKEA_tax_avoidance_Feb2016.pdf

The overall amount of royalties has been moved in and out of the Dutch subsidiary (almost) untaxed. The entire scheme consists of Inter IKEA Systems BV being used as a royalty vent, as proved in the figure. However, the lack of accounts disclosure by Inter IKEA Systems BV (in the Netherlands) and by the Interogo Foundation (in Liechtenstein), makes it impossible to identify the entities and jurisdictions which received these payments or to determine the real objective. Yet, there are two shreds of evidence which suggest that the €10,5 billion of "other charges" payments were sent partially or entirely to the Interogo Foundation in Liechtenstein.

Firstly, someone from Inter IKEA Group has confirmed that Inter IKEA Systems BV (in the Netherlands) had been paying the Interogo Foundation for the right of the IKEA trademarks in 2012. Secondly, even though Inter IKEA Systems BV has acquired the IKEA trademark in 2012, the "other charges" expense item dropped precipitously (from an average of €864,6 million in three years to an average of €193,7 million). The information exhibited in the picture, suggests that a significant portion of this expense consisted of payments for the usage of the brand. Since 2012, the Interogo Foundation (in Liechtenstein) has sold the IKEA trademark to Inter IKEA Systems BV (in the Netherlands) for €9 billion. The above-mentioned amount of money was financed with €5,4 billion in loans from Interogo Foundation to Inter IKEA Systems BV and with €3,6 billion as share premium issued to Interogo Foundation.

Therefore, the discussed transaction created a debt of several billion for Inter IKEA Systems BV (in the Netherlands) simply by transferring legal ownership of the IKEA brand (previously belonged to Interogo in Liechtenstein) [78].

Clearly, this new "debt" was essentially manufactured out by the sale of the previously unvalued trademark. By this time, the debt allows the Inter IKEA Group to shift profits to its legal owner (Interogo Foundation) through tax-deductible interest payments. In fact, from 2012 to 2014, Inter IKEA Systems BV paid €972 million in tax-deductible interest to Interogo Finance SA (a subsidiary of the Interogo Foundation), placed in Liechtenstein. Interogo Finance SA paid taxes in Luxembourg at a rate of 0,06 percent over three years, in the meanwhile, it has sent €807,8 million in dividends to the Interogo Foundation in Liechtenstein.

Over the whole period from 1991 to 2014, Inter IKEA Group succeed in reducing its taxable income by more than €12 billion, offsetting almost all royalty income received (approximately €14,3 billion) from worldwide IKEA stores.

The impact on tax paid by the Inter IKEA Group has been massive, in the case that the "other charges" expenses and the interest paid to Interogo Foundation were included in the Group's net income for the period from 1991 to 2014, this would result in a substantially reduced tax rate of 3 percent (compared with an already reported tax rate of 12 percent).

[78]https://medium.com/@jurgeng/ikeas-tax-scheme-a-corporate-structure-designed-to-facilitate-profit-shifting-and-tax-avoidance-798caf842fb6

3.5 The Jurisdiction Loopholes

The Single Market is one of the EU's greatest achievements, however, when a country pursuit its self-interest, at the other member's expense, a loophole may occur. A loophole is a practice that allows a company to avoid the scope of a law or restriction without directly violating the law. It is often debated about taxes and their avoidance that loopholes provide ways for businesses to remove income or assets from taxable situations into ones with lower taxes or none at all. Loopholes are most prevalent in complex business deals involving tax issues, political issues and legal statutes. In this instance, the payments delivered between two companies belonging to the same group are not in line with the so-called "Arm 's Length Principle"[79]:

The Arm's Length Principle *of transfer pricing states that the amount charged by one related party of the same company to another for a given product must be the same as if the parties were not related. An Arm's-Length Price for this kind of transaction would be computed as if they are settled on the open market*[80].

Moreover, the Arm's Length Principle is adopted by OECD member countries, indeed it places both associated parties as well as independent enterprises on an equal position for tax purposes,

[79]https://www.investopedia.com/terms/l/loophole.asp
[80]https://www.investopedia.com/terms/a/armslength.asp

in order to avoid the creation of tax (dis)advantages that would distort the relative competitiveness of either type of enterprises. Corporate tax avoidance deprives public budgets of billions of euros every single year. Hence, a heavier tax burden for citizens is generated and competitive distortions affect businesses that pay their share. Nevertheless, effective taxation means that companies that generate their profits in the EU's Single Market should pay their fair share of tax, many multinational companies use aggressive tax planning practices to take advantage of mismatches in the tax rules of EU Member States.

In the international context, ***the Netherlands*** has long been a popular jurisdiction for the establishment of the "royalty conduit" companies. Since the opportunity to benefit from the combined effects of Dutch tax law with the country's wide network of tax treaties within EU jurisdiction exists. The Netherlands has also a wide network of double tax treaties that eliminate or minimize the possibility for the source country to tax royalties and interest payments sent to the Dutch region. Furthermore, the Netherlands does not impose withholding tax on royalties and interest payments sent abroad, even when the destination is a tax haven. The Dutch "Innovation Box" regime in effect since 2007, implies that taxable royalty income at a preferential tax rate of 5 percent, as compared with the statutory corporate income tax of 25 percent[81].

[81]https://tpcases.com/european-commission-vs-netherlands-ikea/

Dutch companies are covered by the EU parent-subsidiary directive, which effectively eliminates withholding taxes on payments between parents and subsidiaries within the EU.

Besides the Netherlands, also ***Belgium*** belongs to the list of European countries having a strong tradition of treasury locations (together with Luxembourg, Ireland and Switzerland). The Notional Interest Deduction regime has been conceived as a replacement for the "Coordination Centre" measure, deemed illegal by the European competition law in 2003. The new measure, entered into force in 2007, allowing all Belgian subsidiaries of multinational companies to offset income derived from providing loans or services to affiliated companies around the world. Whereas, those affiliates can deduct the expense of these loans or services from their taxable income in their respective countries. This is a classic way for big companies to shift profits to low or no-tax jurisdictions at a minimal cost. In cases where the source country imposes withholding tax on interest payments to Belgium, which in turn can generally offset that expense with a foreign tax credit[82].

Luxembourg draws the largest corporations from all around the world that are seeking asylum from large corporate taxation, specifically the country offers a corporate tax rate of 21 percent. Corporations that funnel profits through Luxembourg are charged around 1 percent.

[82]http://taxsummaries.pwc.com/ID/Belgium-Corporate-Tax-credits-and-incentives

This is a huge incentive for large corporations that have the opportunity to save billions in corporate tax bills by moving cash to the Luxemburgish region at such low rates. However, the country must be more accurate in running their intrigued arrangements, after the *"Lux Leaks Scandal"*. In an investigation launched in 2014 by the International Consortium of Investigative Journalists, tailor-made tax solutions that allowed about 350 multinationals to save billions of euros, were exposed. It has been made public no less than 550 agreements from 2002 and 2010. Each document outlines a specific tax scheme for a company that is a PwC client, and includes either a signature of a Luxembourg tax office employee or a confirmation letter written by them[83].

3.6 The Greens/EFA Investigation

In 2016 the Greens/EFA an institution of the European Parliament has compiled a report highlighting that the picture of the company's structure does not really reflect the actual scenario of artificial misconception. According to the European Commission, Inter IKEA was favoured by the Dutch Tax Authority twice. Indeed, the Commission claimed that the Dutch Tax Authority has granted two profitable tax rulings, one in 2006 and the other in 2011. A tax ruling is a tailor-made, confidential and peculiar taxation agreement between a multinational and a country's Tax Authority[84].

[83]https://www.investopedia.com/ask/answers/100115/why-luxembourg-considered-tax-haven.asp
[84]https://www.bbc.com/news/business-42396188

The written interpretation of law clarifies and confirms which part of the profits are taxed and at which rate. These arrangements have given to the company an unfair position against the competitors and they have significantly reduced Inter IKEA System BV's' taxable profits in the Netherlands, in breach of "EU State Aid" rules.

State Aid *is found in Article 107(1) TFEU and it is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities. Therefore, subsidies granted to individuals or general measures open to all enterprises are not covered by this prohibition and do not constitute State Aid*[85].

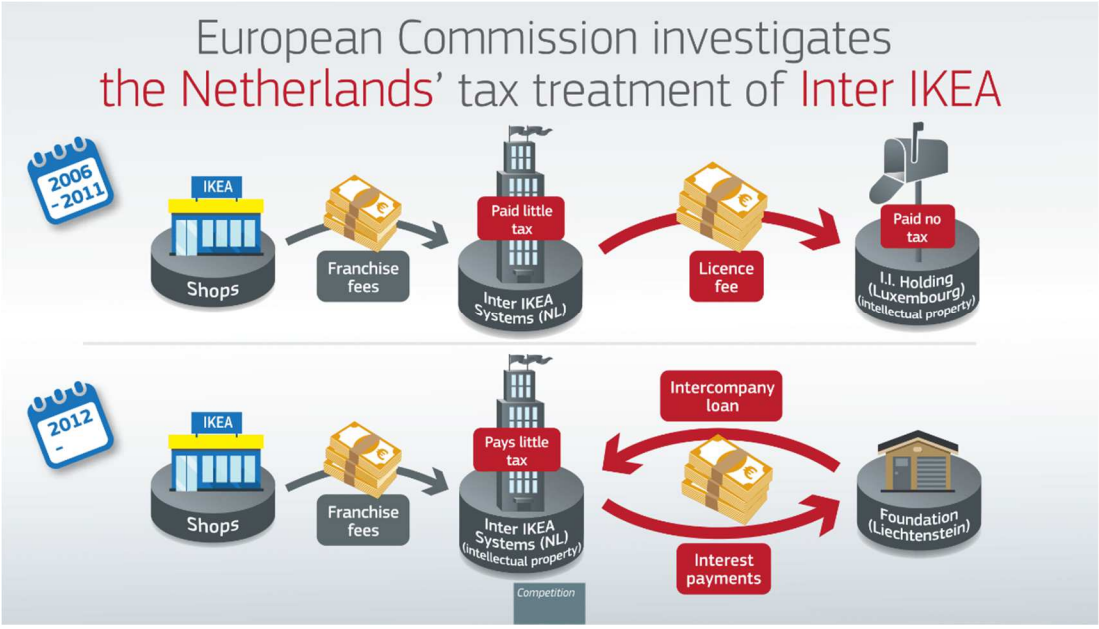
Indeed, in order to be State Aid, a measure needs to have these main features: There has been an intervention by the State or through State resources, the intervention gives the recipient an advantage on a selective basis, the competition has been or may be distorted and the intervention is likely to affect trade between the Member States. Hence, the Treaty leaves room for several policy objectives for which State Aid can be considered compatible, even if the legislation stipulates these exemptions. The role of EU State Aid control is to ensure that the Member States do not give to selected companies a customized tax treatment with respect to the competitors, via some advantageous tax rulings.

[85]https://ec.europa.eu/commission/presscorner/detail/en/IP_17_5343

More specifically, transactions between companies in a corporate group must be priced in a way that reflects economic reality. Unfortunately, the Netherlands was not the only EU member that has facilitated aggressive tax planning by IKEA. The Inter IKEA and IKEA groups have also used two other European tax havens Belgium and Luxembourg for tax avoidance operations. In the Commission's in-depth investigation, it was discovered that the IKEA's changeset toward a franchising model in the 1980s, Inter IKEA was created to handle the franchises. In the Commission's view, the franchisees pay 3 percent of their annual turnover to Inter IKEA, which gives them the right to use the IKEA trademark and the expertise to operate and exploit the concept. The revenue from all the IKEA franchisees worldwide ends up at Inter IKEA Systems, based in the Netherlands. Then in 2006, the Dutch Tax Authority signed off on a plan to shift those revenues to Luxembourg-based I.I. Holding, which controlled IKEA's intellectual property related to the franchise concept in the form of an "annual license fee." The license fee, according to the commission, was actually a large portion of the revenues paid by franchises to Inter IKEA. As a result, a significant part of Inter IKEA Systems' franchise profits was shifted to I.I. Holding in Luxembourg, where they remain untaxed. The procedure was possible because of I.I. Holding was part of a special tax scheme, so it was completely exempt from corporate taxation in Luxembourg[86].

[86]https://mnetax.com/eu-commission-publishes-decision-to-investigate-ikeas-dutch-tax-rulings-26896

Analysing the following infographic, it is highlighted that the Commission force illegal Luxembourg's special tax scheme to be expired by the end of 2010.



[87]

In turn, Inter IKEA bought the IP rights held by I.I. Holding, which has financed the transactions from an intercompany loan from its parent company based in Liechtenstein. By this moment, the Dutch Tax authority signed off on a plan to deduct the interest Inter IKEA paid on the intercompany loan from its taxable profits in the Netherlands; thereby it shifted the franchise profits to Liechtenstein.

[87] https://ec.europa.eu/commission/presscorner/detail/en/IP_17_5343

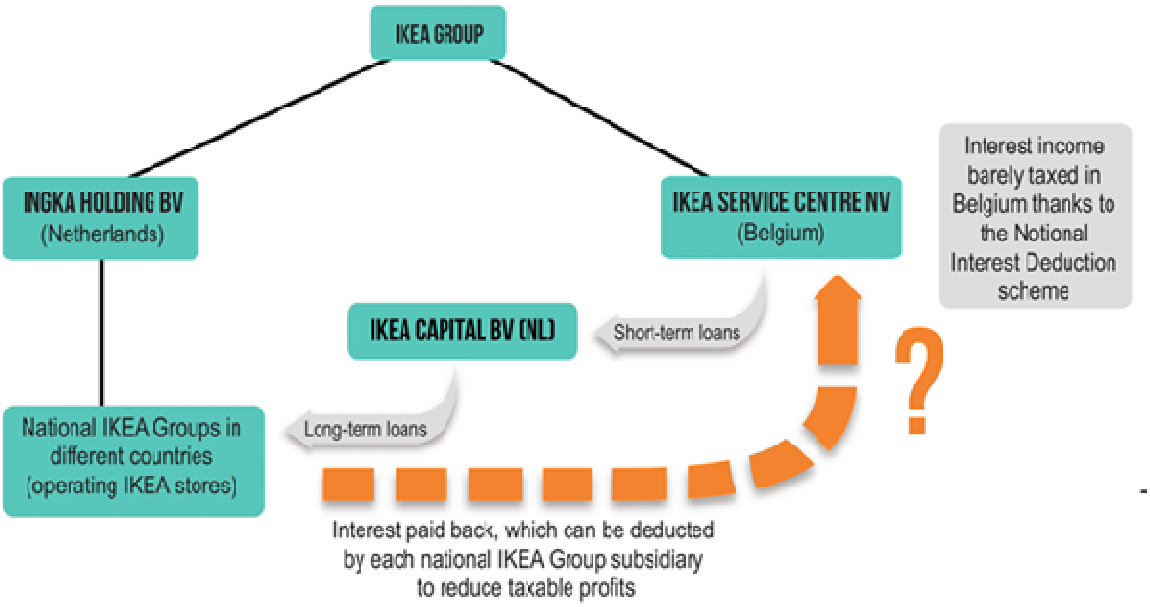
Referring to the mechanism of the overall tax avoidance system, the Greens/EFA institution went deeply into the two distorting tax agreements offered to Inter IKEA Group.

- ***The 2006 Tax Ruling "APA Settlement Agreement"***

The object of the 2006 APA is to determine "the taxable margin on the franchise, catalogue and service activities and the value of the IKEA Franchise Concept at the termination of the licence agreement between Systems and Holding.

This fiscal convention allowed to compute an annual licence fee to be paid by Inter IKEA in the Netherlands to another company of the Inter IKEA Group called I.I. Holding, based in Luxembourg. At that moment, the tax avoidance process started, because all IKEA stores pay the already mentioned 3 percent of franchise fee to Inter IKEA yearly, that in turn has been charged of another licence fee for its own use of the name "IKEA" and for the entire business model to the IKEA Holding in Luxembourg. The Holding held the intellectual property rights required for the IKEA franchise concept. Therefore, a substantial part of Inter IKEA's franchise fee profits was re-allocated without any tax charges[88].

[88]https://www.dw.com/en/eu-launches-investigation-into-ikea-tax-deals/a-41842719



[89]

Thereafter, as demonstrated by the picture, the strategy has moved to a Belgian company called Inter IKEA Treasury SA. This firm, acting as an internal financing arm for the Inter IKEA Group, has generated income from interests on loans. It has offered loans to companies belonging to the Group and paying out the interests to an unspecified Inter IKEA affiliates from whom it borrowed the money in the first place. The Inter IKEA Treasury SA functioned as "Coordination Centre" and it entitled the Group to special tax breaks in Belgium, in 2009.

[89]https://medium.com/@jurgeng/ikeas-tax-scheme-a-corporate-structure-designed-to-facilitate-profit-shifting-and-tax-avoidance-798caf842fb6

The debt flowing though Inter IKEA Treasury SA amounted to €1,2 billion and the company paid just 1,98 percent tax on €4,7 million of reported profits. The IKEA Group has also availed from the "Coordination Centre" scheme through its Belgian subsidiary, IKEA Service Centre NV, which serves as the internal treasury for the Group. From 2005 up to 2009, IKEA Service Centre NV paid just 0,04 percent in tax on €1,96 billion in profits. The benefit of the Belgian fiscal regime has accounted for a huge saving of about €647 million as compared with Belgium's statutory tax settled at a rate of 33 percent. Although, due to an order issued by the EU Tax Authorities in 2011 the Belgian "Coordination Centre" pattern was terminated, so the company was forced to shift all the activities to Luxembourg. This decision resulted in "an arrangement which guaranteed that an Inter IKEA Group subsidiary (now called Inter Finance SA) domiciled in Luxembourg would pay almost no tax. An estimation counts approximately €6 billion in loans funded by subsidiaries in Curacao and Cyprus and funnelled to affiliates through a newly established Swiss branch of Inter Finance SA. As a matter of effect, the actual rate turned to just 2,4 percent (compared with the Luxembourg statutory rate of 29,2 percent)[90].

[90]https://www.dw.com/en/eu-launches-investigation-into-ikea-tax-deals/a-41842719

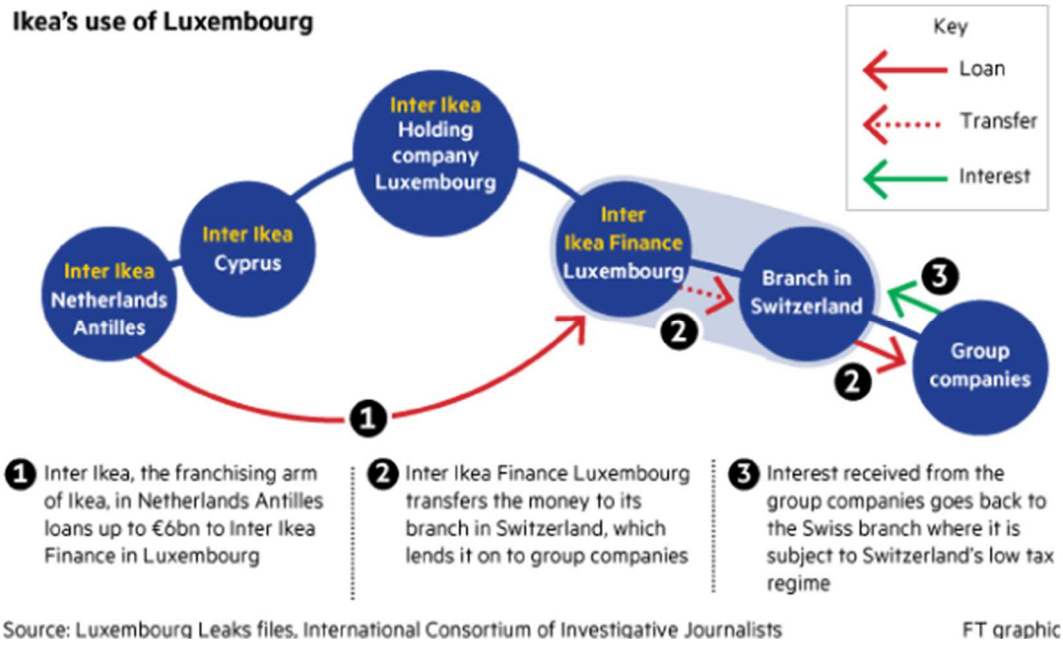
Recalling that already in 1982 Kamprad transferred legal ownership of the IKEA Group's parent company, INGKA Holding BV, to a Dutch domiciled foundation, the Stichting INGKA. The framework implemented makes its finances exempt from public disclosure under Dutch law. The Kamprad family also owns the IKANO Group, which was split off from IKEA in 1988. IKANO is controlled by Kamprad's three sons and owned through a holding company in Curacao. Kamprad also transferred legal ownership of the Inter IKEA Group to the Liechtenstein-domiciled Interogo Foundation in 1989. This foundation is nominally independent, though its ruling council included most of the Kamprad family. This council is supervised by a seven-member Supervisory Council on which the Kamprad family has up to three seats guaranteed[91].

- ***The 2011 Tax Ruling "APA Determination Agreement"***

The 2011 APA refers to the arm's length character of the value of the IKEA property rights at the time of the acquisition of those rights by Systems (it stands for Inter IKEA Systems BV). The brand-new arrangement allowed the deduction of the interest payments from Systems' taxable profits, this meant that most of Inter IKEA's franchise profits were shifted to its parent company.

[91]https://ec.europa.eu/commission/presscorner/detail/en/IP_17_5343

Firstly, the European Authorities are not convinced whether the purchased trademark rights worth really €9 billion. Secondly, the value of the loan of about €5,4 billion is simply too high in comparison with Inter IKEA's equity. The enormous sum of interest (6 percent) is unsubstantial and lending billions with no repayment obligation seemed drastically suspicious. In 2012, IKEA deployed its Liechtenstein component as an alternative for the cut-off 'Luxembourg-route', as clearly revealed in the following figure.



[92]

[92]https://www.icij.org/investigations/luxembourg-leaks/why-has-the-european-commission-not-investigated-lux-leaks-tax-deals/

Inter IKEA bought the trademark rights from the Luxembourg compound for an amount of €9 billion, to which they paid the licence fee during the last years. The focus of this deal was substantially the repayment-free loan from the Interogo Foundation in Liechtenstein. IKEA Service Centre NV provided the short-term resources which secure long-term intracompany loans made by its Dutch parent company (IKEA Capital BV) to IKEA Group subsidiaries in countries including Australia, the Netherlands, France, Norway, the US and China. The corresponding interest payments by these IKEA Group subsidiaries reduced their taxable income. That income flowed ultimately to IKEA Service Centre NV from these interest payments were charged with almost no tax thanks to the ***NID (Notional Interest Deduction),*** a Belgium norm. The so-called "notional interest deduction" is a new, innovative and powerful measure in international tax law enabling all companies subject to Belgian corporate tax to deduct from their taxable income a fictitious interest calculated based on their shareholder's equity (net assets) [93].

The main purpose of this innovative measure is to reduce the tax discrimination between debt financing and equity financing. Indeed, in the case of loan capital, the interest paid is deductible from the taxable base, while with equity capital the dividends are taxable.

[93]https://finance.belgium.be/en/ondernemingen/vennootschapsbelasting/belastingvoordelen/notionele_interestaftrek#q2

With the gradual disappearance of the special tax schedule for Belgian coordination centres, Belgium had to provide another tax schedule allowing the further development of these types of coordination activities. The *Notional Interest Deduction* is a valuable tool to maintain or even locate in Belgium activities which were previously allowed under the special tax regime of Belgian coordination centres. The norm creates a considerable tax benefit for companies that have good solvency ratios, reducing the taxable base and generating a higher return after tax. It also provides flexibility, because it is possible to carry forward any unused amount of the deduction. Moreover, the norm is a permanent incentive and not just a one-shot advantage in order to strengthen the financial position of Belgian companies and branches by encouraging them to increase their equity.

Therefore, it is an incentive to retain earnings in the Belgian entity and to use these to finance new investments. For international groups, it opens possibilities for allocating new activities to a Belgian entity such as intra-group financing, central procurement or factoring. The Belgian tax relief combines with the extensive treaty network concluded by Belgium, the tax regime for expatriates, the access to European Directives and the Belgian ruling practice. This large set of measures makes Belgium an attractive location for capital-intensive companies, equity funded headquarters and treasury centres[94].

[94]https://news.pwc.be/notional-interest-deduction-rate-for-tax-year-2019-is-0746/

As a result, Inter IKEA owed to the Foundation hundreds of millions a year in interest expenses. Indeed, the Dutch conduit subsidiary paid interests on debt incurred to acquire the IKEA trademark. Since there is no withholding tax on royalties and interests sent abroad in the Netherlands, this means that the money-flow remained untaxed. IKEA's accounts also showed an "Other charges" expense which is deducted from taxable income.

Finally, the money is not only not taxed in the Netherlands, but also in Liechtenstein, where Interogo is based, so the entire framework is intended to avoid taxation and shift billions of profits to counties in which the tax rate is exceedingly low. The dividends received from worldwide foreign subsidiaries are completely tax-free because of the Netherlands' advantageous treatment[95].

[95]https://mnetax.com/eu-commission-publishes-decision-to-investigate-ikeas-dutch-tax-rulings-26896

4. THE INTERNATIONAL LEGAL SYSTEM' S WEAKNESSES: THE TRUE COST OF TAX AVOIDANCE

4.1 The Current Status Quo

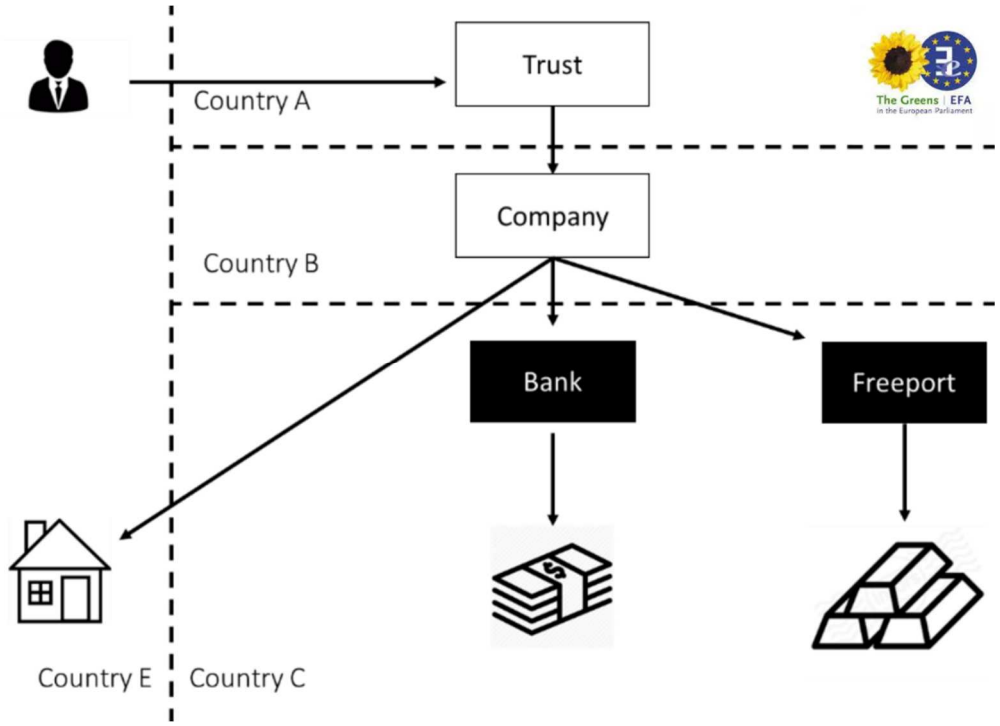
In our globalised economy, where production chains are spread across the world and highly movable, it is difficult to determine under existing rules where and how the profits of big firms should be taxed. Indeed, it is no longer possible to properly identify the countries that have both the legitimacy and ability to tax those profits. In this sense, the European Union has been making improvements to its legal frameworks relating to the collection and exchange of relevant information to help tackle illicit financial flows related to tax evasion and tax avoidance.

However, a report commissioned by the Greens/EFA Group in the European Parliament demonstrates that despite progress in recent years on closing down opportunities for tax erosion, significant loopholes for multinationals to evade paying taxes where they are based, still exist. The actual financial system is characterised not only by little regulation but especially by no transparency at all.

The lack of transparency has made it fairly easy for corporations to benefit from corruption, money laundering, tax evasion or avoidance, by hiding and mixing themselves, their assets and their transactions within legitimate uses of the global financial and tax system[96].

[96]https://ec.europa.eu/taxation_customs/publications/taxationservicespapers/taxation-papers_en

In order to address this problem, national authorities have started to cooperate more with each other at the international and European levels to update or establish financial regulations and to increase transparency requirements. Corporations engaged in tax evasion, money laundering or corruption usually adopt three main secrecy strategies in order to exploit legal loopholes and to keep information away from tax authorities. Firstly, they hold assets related to their illegal activities in places where no information about their identity has to be collected or where information is collected only at the legal owner level. This means that only the direct holder of the asset is required to be identified, but not the beneficial owner (the individual who ultimately and actually controls and benefits from the asset). Secondly, those assets are usually held through a long ownership chain, like a series of many companies or nominees, as it is shown in the scheme. Many layers of legal vehicles such as companies, trusts or partnerships are usually inserted between the asset and its real owner.



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If tax authorities identify the direct owner of an asset, they will have to overcome many other obstacles, because every layer making up the ownership chain, as a result, it is difficult to identify the beneficial owner. Lastly, assets and layers of legal vehicles will be located in as many countries as possible to make even harder for authorities to discover who is behind them. Authorities will have to pierce each layer of ownership by obtaining information from each relevant country, assuming that there is an international treaty that allows for such an exchange of information and that all countries actually collect relevant information.

[97]https://www.taxjustice.net/2018/10/15/the-european-union-tax-evasion-and-closing-loopholes-new-report/

Nowadays, the situation is increasingly concerning, because it appears that Austria, Bulgaria, Cyprus and Romania could create secrecy risks in the EU, especially regarding the lack of access to banking information. This risk is worsened by the residency and citizenship of investment schemes that many of them offer:

- ***Austria and Bulgaria*** have signed an agreement with the US, which has no obligation to send information to Austria and Bulgaria concerning their bank holdings in the American country. Austria also agreed with Liechtenstein to exempt some accounts from being reported under the automatic exchange of information procedure. Austria will also be receiving banking information from fewer countries under the CRS, compared to other EU countries.
- ***Cyprus and Romania*** will only receive information from 33 jurisdictions related to the EU, but no information from non-EU countries according to CRS.

The ***CRS (Common Reporting Standard)*** is the standard for the automatic exchange of financial account information like banking information, developed by the OECD. The ***DAC (Directive on Administrative Cooperation)*** is a European Union's Directive to address tax evasion and tax avoidance. It involves exchanges of information within the Member States[98].

[98]http://extranet.greens-efa-service.eu/public/media/file/1/5729

The communication is related to bank account information, income from employment, real estate, pensions and directors' fees, cross-border tax rulings, advance price agreements and country-by-country reporting. An attempt to reinforce the legal system may be to ensure that all EU countries sign an ***IGA (Inter-Governmental Agreement) Model***, a bilateral agreement signed by the US and many other countries, that set the framework for automatic exchange of information. For example, it can be established a 30 percent of withholding tax on payments of EU sourced income, against US financial institutions until full reciprocity. Alternatively, it can be asked to the US to join the CRS or being included on the EU list of non-cooperating third country jurisdictions for tax purposes. Despite the new presented measures and directives, the new proposals and all the declarations of attempts to face the tax evasion issue, the European loopholes keep proliferating instead of been dismantled. If loopholes remain in the EU's tax regime, individuals and multinationals will seek to find ways to override paying their fair share of taxes. The only way is through concrete legislation and effective enforcement of the rules, the Authority will be able to shut down tax havens for those who wish to scam the taxman. Europe must speak with one voice and say to those currently breaching the system to either play by the rules or quit the game[99].

[99]https://www.greens-efa.eu/en/article/document/reporting-taxation/

4.2 The European Union's Countermove

In light of recent facts, a new set of norms is needed to align the tax laws in all 28 EU countries in order to fight aggressive tax practices undertaken by large companies efficiently and effectively. The European Commission has presented a new proposal during its campaign for fair, efficient and growth-friendly taxation in the entire EU, in order to tackle corporate tax avoidance.

The Anti-Tax Avoidance Package calls the Member States to take a stronger and more coordinated stance against companies that seek to avoid paying their fair share of tax and to implement the international standards against base erosion and profit shifting. The key features of the new proposal include:

- Legally-binding measures to block the most common methods used by companies to avoid paying tax
- A recommendation to the Member States on how to prevent tax treaty abuse
- A proposal for the Member States to share tax-related information on multinationals operating in the EU
- Actions to promote tax good governance internationally
- A new EU process for listing third countries that refuse to play fair[100].

[100]https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en

Moreover, the Commission's agenda for fairer taxation has then inspired the creation of three core pillars which are the basis of the package:

Ensuring Effective Taxation in the EU

The fundamental principle of corporate taxation is that companies should pay tax where they make their profits. The Package makes specific proposals to help the Member States ensure that this happens. The Commission proposes an Anti-Tax Avoidance Directive with legally-binding measures to tackle some of the most prevalent tax avoidance schemes. Its Recommendation on Tax Treaties advises the Member States on the best ways to protect their tax treaties against abuse, in a way that is compatible with EU-law.

Increasing Tax Transparency

Transparency is crucial to identifying aggressive tax planning practices by large companies and to ensuring fair tax competition. Actual's Package seeks to boost transparency on the taxes that companies are paying, through a revision of the Administrative Cooperation Directive.

Under the proposed rules, national authorities will exchange tax-related information on multinational companies' activities, on a country-by-country basis. As such, all Member States will have crucial information to identify risks of tax avoidance and to better target their tax audits[101].

[101]https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en

Securing a Level Playing Field

Since tax avoidance and harmful tax competition are global problems, actions to prevent them must extend beyond the EU's borders. As the Member States work to implement new global standards of tax transparency and fair tax competition, it is important that the EU's international partners follow the pattern. Developing countries should also be included in the international tax good governance network, so that they can benefit from the global fight against tax avoidance too. The Action Plan sets out a series of initiatives to cope with tax avoidance, secure sustainable revenues and strengthen the Single Market for businesses[102].

Moreover, the Package contains also the ***Communication on an External Strategy for Effective Taxation***. Its aim is to strengthen cooperation with international partners in fighting tax avoidance, enhance EU measures to promote fair taxation globally based on international standards and create a common approach to external threats of tax avoidance. This will help to ensure a fair and level playing field for all businesses and countries. It is accompanied by a new **Study on *Aggressive Tax Planning***, which looks at the main channels used by companies to avoid taxes. Collectively, these measures will significantly improve the corporate tax environment in the EU[103].

[102]http://www.oecd.org/about/impact/combatinginternationaltaxavoidance.htm
[103]https://www.consilium.europa.eu/en/policies/anti-tax-avoidance-package/

Through targeted key actions including a strategy to re-launch the ***Common Consolidated Corporate Tax Base (CCCTB)***, the renewed framework would ensure effective taxation where profits will be generated. The Commission is also publishing a first pan-EU list of third-country non-cooperative tax jurisdictions and launching a public consultation to assess whether companies should have to publicly disclose certain tax information. In recent days, several companies exploit loopholes and mismatches between Member States' defensive measures to shift profits out of the Single Market, untaxed. In addition, businesses face legal uncertainty and unnecessary administrative burdens, due to 28 different national policies for assessing and addressing third countries' tax systems. A coordinated EU external strategy on tax good governance is therefore essential to boost Member States' collective success in facing tax avoidance, ensure effective taxation and create a clear and stable environment for businesses in the Single Market. It seems so evident, that the European Corporate Tax Package, presented by the European Commission, does not fully address the ultimate issues. The actual system of norms allows IKEA and multiple other multinational companies to practice aggressive tax avoidance; while this package may face the "offshore dimension" of tax havens, it does not be so proactive to fix the tax competition between EU countries themselves[104].

[104]https://www.consilium.europa.eu/en/policies/anti-tax-avoidance-package/

4.3 The European Commission's Involvement

European Competition Law is the competition's system of norms in use within the European Union. It promotes the maintenance of competition within the European Single Market by regulating anti-competitive conduct by companies, in order to ensure that they do not create cartels and monopolies that would damage the interests of society. European competition law is composed mostly by articles from 101 to 109 of the ***Treaty on the Functioning of the European Union (TFEU)***, as well as a series of Regulations and Directives.

The main policy areas include:

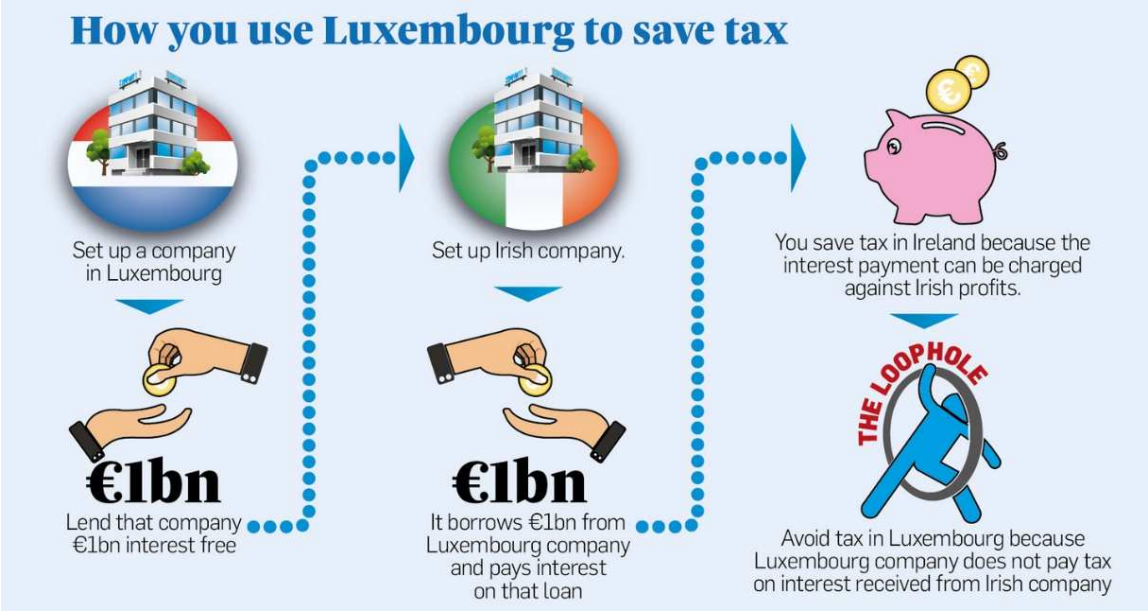
- Cartels or control of collusion and other anti-competitive practices, under article 101 TFEU
- Market dominance or preventing the abuse of firms' dominant market positions under article 102 TFEU
- Mergers, control of proposed mergers, acquisitions and joint ventures involving companies that have a certain, defined amount of turnover in the EU, according to the European Union merger law
- State aid, control of direct and indirect aid given by the Member States of the European Union to companies under TFEU article 107[105].

[105]https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12012E%2FTXT

Primary authority for applying Competition Law within the European Area rests with the European Commission: The European Commission is composed of the College of Commissioners of 28 members, including the President and Vice-Presidents. The Commissioners, one from each EU country, are the Commission's political leadership during a 5-year term. Each Commissioner is assigned responsibility for specific policy areas by the President. The President is the head of the European Commission; according to the Treaties, he decides on the organisation of the Commission, allocates portfolios to members of the Commission and can make changes at any time. The President also determines the Commission's policy agenda and defends the general European interest. The outgoing president Jean-Claude Juncker, in early November 2014, a few days after becoming head of the Commission, was hit by media disclosures deriving from a confidential tax deals discovery known as *Lux Leaks*[106]. The country of Luxembourg under his premiership had turned into a major European centre of corporate tax avoidance. Many multinational companies have transferred tax liability for several billions of euros to Luxembourg, where the income was taxed at a fraction of just 1 percent. The lack of tax agreements between the countries involved within the EU, enables these companies to avoid paying taxes in several countries at once.

[106]https://www.icij.org/investigations/luxembourg-leaks/why-has-the-european-commission-not-investigated-lux-leaks-tax-deals/

The strategies are based on a net of subsidiaries, which were settled at minimal costs, and were then be used to manage certain financial decisions taken by the parent company.



[107]

The agreements and tax rulings that the ICIJ and its journalists analysed, cover the period between **2002** and **2010**, the period when **Jean Claude Juncker** was the Prime Minister of Luxembourg. In a country of that size, it is impossible for the Prime Minister not to be aware of these sorts of secret arrangements. Juncker promised to put some morality and ethics handling this complex situation[108].

[107]https://calert.info/details.php?id=151
[108]https://www.theguardian.com/commentisfree/2017/dec/13/stop-big-corporations-dodging-tax-avoidance-paradise-paper

However, it seemed evident that a conflict of interest arose that time and the situation were not managed properly, in fact, the Juncker's involvement in the case was completely covered and overcome by the Commission. Despite the controversial leading position of the Commission, EU Antitrust and competition Commissioner Margrethe Vestager and economic and financial affairs, taxation and customs Commissioner Pierre Moscovici, start taking actions in order to face the latest decades' unpleasant condition of tax avoidance. They had begun to enforce rules focused on manage tax avoidance by multinationals actively not only in Luxembourg, but also in other avoidance-friendly EU countries such as Ireland, Belgium, Liechtenstein and the Netherlands. In Europe, these blast of news, did nothing but help Juncker, to shed his image as a friend of tax-avoiding multinationals. Though, it remains the fact that the Juncker Commission has failed to investigate a single Lux Leaks tax ruling since its revelation by ICIJ[109].

Apparently, the majority of Vestager's investigations had addressed American-headquartered multinationals, such as Nike, Apple, Facebook, Amazon, Google, Mc Donald's and Coca Cola. In reality, it is not true at all, indeed a lot of European corporations followed the same pattern of the American ones[110].

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[109]https://cafebabel.com/en/article/tax-avoidance-the-luxleaks-scandal-explained-5ae009adf723b35a145e5531/

[110]http://theconversation.com/three-strategies-to-fight-the-tax-avoidance-revealed-by-the-paradise-papers-87002

The presented case of IKEA is the perfect proof that the problem occurred inside the European Union, because the current international regulations interfere with national sovereignty. In the majority of the cases, the Tax Authorities struggle to collect the required evidence due to the confidential nature of the deal between the country and the multinational. Even worse, it happens that the country defends its position with the Commission, by helping the tax-avoiding company, instead of creating a strong system of norms able to handle correctly the topic[111].

The point is that the European countries acting as tax heavens, have too much to earn from this unstable legislation. The multinationals do not want to lose their huge capital flows from worldwide corporations, so as they do not collaborate with the institutions. The *Lux Leak Scandal* acted as a trigger and revived interest in agreeing on an EU policy to address the issue. Since that time, a change at the summits occurred, the newly elected president Ursula von der Leyen, head the Commission and several tax policies guidelines and directives were elaborated and listed but they are still at an implementing phase. Although, the tackle against unfair competition and tax avoidance mechanisms have become rough, the adequate measures appear far to be met[112].

[111]https://elpais.com/elpais/2019/02/05/inenglish/1549361631_980045.html
[112]https://www.independent.co.uk/news/business/news/ikea-tax-investigation-eu-commission-inter-margrethe-vestager-big-small-a8116321.html

4.4 The Web Tax

The Web Tax indicates the proposed law that aims, in the era of the digital economy, to regulate taxation for multinationals operating on the Internet, with the aim of guaranteeing fiscal impartiality and fair competition. These days, digital companies are taxed at 9 percent, whereas, traditional companies at 23 percent, this tax rate mismatch is no longer acceptable. The European approach is not protectionist at all, on the contrary, is imperative to protect the pure interests of Europe, indeed it is a matter of creating a level playing field. The giants of technology are growing steadily, and the tax laws are not adequate. The average annual revenue growth for the best digital companies has been around 14 percent since 2011, compared to a growth rate of 0,2 percent for other multinationals and 3 percent for companies in the telecommunications and IT sector. If for many European states the Web Tax is necessary, since it is no longer reasonable that the big web corporations such as Google, Apple, Facebook and Amazon, do business in Euro Zone by paying minimum taxes; in the opinion of others it is impossible to delimit the digital field with a law based on national borders. A Web tax should have an international strength, as it could penalize a company placed in countries that apply it, rather than the intervention of individual states[113].

[113]https://www.theitaliantimes.it/economia/web-tax-italia-cos-e-come-funziona-imposta-sulle-transazioni-digitali_030919/

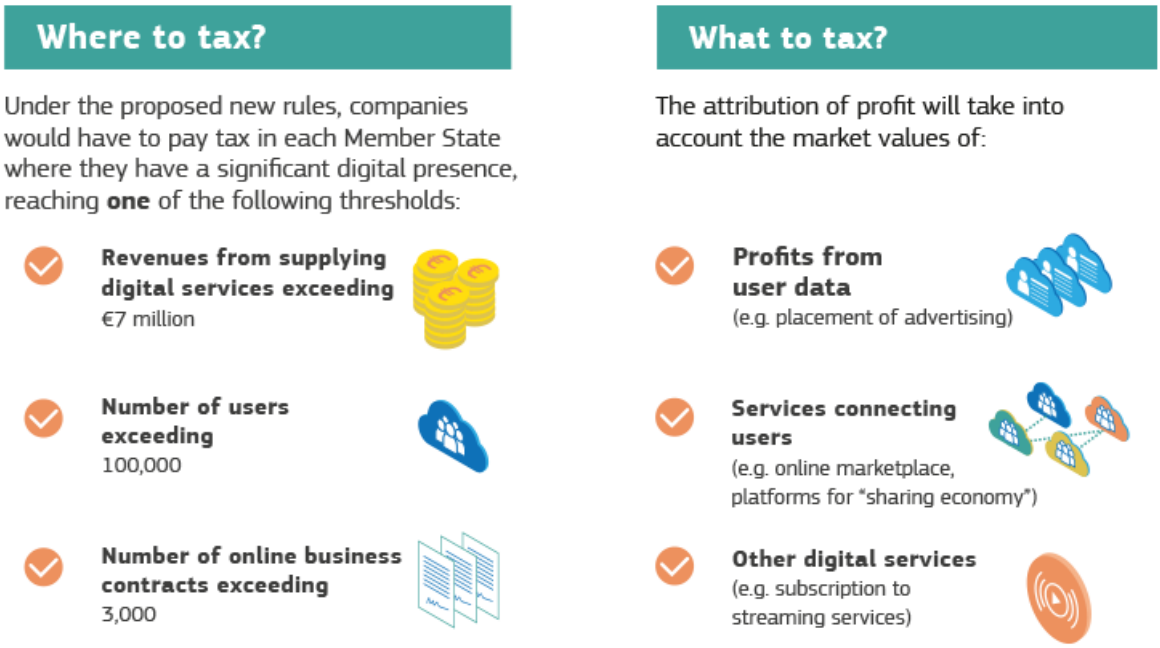
Today's international corporate tax rules are not fit for the realities of the modern global economy and do not capture business models that can make a profit from digital services in a country without being physically present. Current tax rules also fail to recognise the new ways in which profits are created in the digital world, in particular, the role that users play in generating value for digital companies. As a result, there is a 'mismatch' between where value is created and where taxes are paid. The Commission has made two legislative proposals:

- The first initiative aims to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. This forms the Commission's preferred long-term solution.
- The second proposal responds to calls from the several Member States for an interim tax which covers the main digital activities that currently escape tax altogether in the EU[114].

The above-mentioned proposal would enable the Member States to tax profits that are generated in their territory, even if a company does not have a physical presence there. The new rules would ensure that online businesses contribute to public finances at the same level as traditional 'brick-and-mortar' companies.

[114]https://www.debatingeurope.eu/2013/07/01/is-tax-evasion-making-the-crisis-worse/#.XieEmWieQ2x

The new rules will also change how profits are allocated to the Member States in a way that better reflects how companies can create value online. Ultimately, as the infographic reveals, the new system secures a real link between where digital profits are made and where they are taxed.

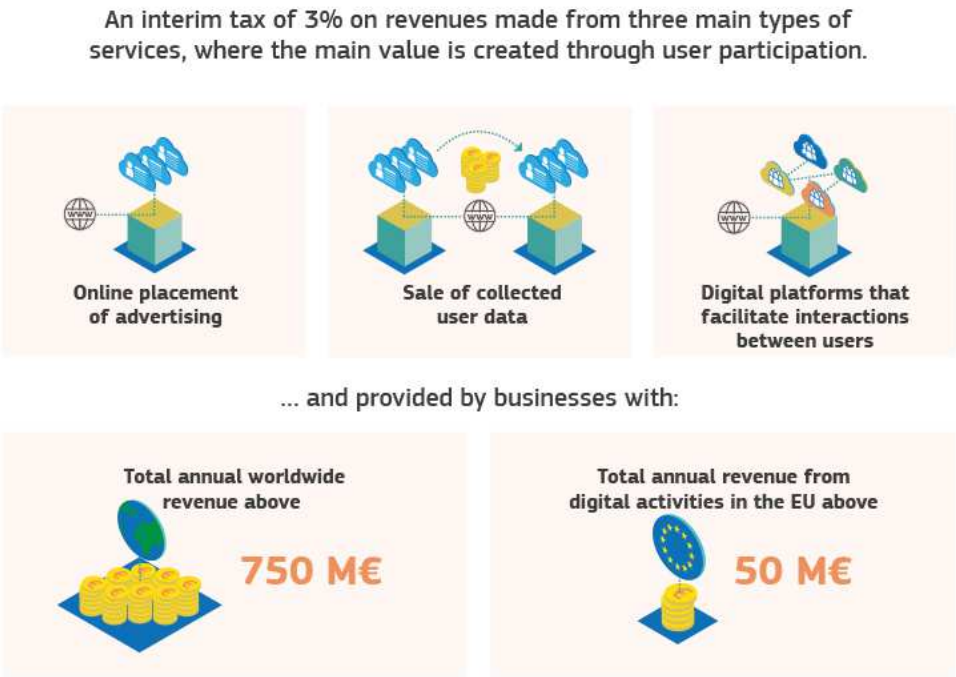


[115]

The interim tax ensures that those activities which are currently not effectively taxed would begin to generate immediate revenues for the Member States.

[115]https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

It would also help to avoid unilateral measures to tax digital activities in the certain Member States which could lead to a patchwork of national responses which would be damaging for our Single Market. Unlike the common EU reform of the underlying tax rules, this indirect tax would apply to revenues created from certain digital activities that escape the current tax framework entirely. This system will apply only as an interim measure, until the comprehensive reform has been implemented and has inbuilt mechanisms to alleviate the possibility of double taxation.



[116]

[116]https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

The fee which is about the 3 percent, will be levied on revenues generated from advertising spaces (like Google's publicity slots), sale of personal data and information to third parties (like Facebook did for the last decades) and intermediary activities between users and businesses (like Uber does). As a result, the tax would erase the never-ending status of tax heaven that the current taxation legislation allows. Unfortunately, the transition to this digital/global taxation, makes the double taxation of profits, the distribution of losses and the identification of the subject required to pay taxes issue arises again. In the further step of the new rules, the minimum taxation of corporate profits would provide a minimum rate of income received anywhere produced, called income inclusion rule. Besides, the possibility for the state of residence of the company to pass from the tax credit exemption to the tax credit method (switch overrule); still exists. Moreover, the reformed legislation allows the taxation of income not subject to tax in the state of residence, subject to tax rule. In this new picture, by denying the deductibility or introducing a withholding tax on payments to related parties that are not subject to at least a certain level of taxation in the country of residence of the related parties (undertaxed payment rule). The proposal presents both advantages and disadvantages, counting that some aspects are still to be refined[117].

[117]https://www.consilium.europa.eu/en/policies/digital-taxation/

However, it does not matter, because, among the signatory countries, some are still reluctant to take part in the proposal. Undoubtedly, Ireland and Luxembourg are strongly against a kind of norm that will wear away their illicit affairs. So, they start preventing the new duty from being implemented in the European system of regulations. However, Estonia is also opposed to the Web Tax, because it claims that it is just a short-term measure which not address completely the embedded issue. By now, the proposal is stuck in the Commission's intentions, without unanimous approval the norm cannot be integrated. Once more, the willingness of the European Union is bounded by the resistance of a few countries.

Taxation is at the core of countries' sovereignty, but the interaction of domestic tax rules in some cases leads to gaps and frictions, according to the Action Plan on Base Erosion and Profit Sharing (BEPS). One of the most dangerous weaknesses of the EU, is that the Member State has an excessive discretionary power on the taxation field. Thus, the institutions had not implemented an effective system of regulations and sanctions yet, so the gaps remain[118].

4.5 The Downside of Tax Erosion

As new technology changes business models, lifestyles and working practices, it is important that the tax system also adapts.

[118]https://taxfoundation.org/eu-digital-tax-criticisms/

The government is committed to ensuring that businesses and individuals pay the taxes that they owe. Currently, the increase in expenditure is determined by the increasing costs of maintaining public services, pensions and increasing the number of people who depend on the State. In the current economic environment, increased levels of taxation are harder to maintain because, despite the economic development, individuals and companies are gaining greater freedom to take advantage of economic opportunities abroad. High levels of taxation cause large economic losses under capital mobility and international tax competition is becoming increasingly harsh as mobility of labour and capital is increased[119].

Tax fraud has serious consequences for Member States ' budgets and on the system of own resources of the EU. Governments either have to cut back on these services or make up the shortfall by collecting higher taxes from everyone else; both options see the poorest people lose out and the inequality gap grows. The tax system must keep pace with modern ways of working and the government should continue to act, through reforms such as Making Tax Digital, to make it as easy and simple as possible for taxpayers to get their tax right first time. The tax administration framework has to be continuously reviewed in order to make sure it effectively supports a modern, trusted tax system, which brings in revenue for our public services, while making sure there are appropriate safeguards for the taxpayer.

[119]https://www.sciencedirect.com/science/article/pii/S1877042812035057

The domestic economic policy alone does not solve the problem of the growth of a country, there is a need to act simultaneously at an international level and close all tax havens and dismiss their huge business. More and more frequent, violations of the principle of fair and transparent taxation occurs, as well as distortions of competition and thus, significantly affect the functioning of the internal market.

Honest companies experiencing competitive disadvantages of order, due to tax fraud and tax revenue losses, finally they are covered by the European taxpayer through other forms of taxation. When multinational corporations dodge paying their taxes in the countries where they do business and where they make their money, they deprive governments of the resources needed to provide vital public services and infrastructures like schools, hospitals and roads, and to tackle poverty and inequality. Since 2014, a huge number of documents have been revealed in order to demonstrate how powerful corporations and super-rich individuals are exploiting a weak global system. As a result, they were allowed to avoid paying their fair share of tax and it is the world's poorest people who pay the price[120].

As shown in the figure, tax avoidance by companies cost EU countries €185 billion in lost revenue in 2019, in fact, multinationals are still allowed to salt their profits away in ultra-low-tax jurisdictions.

[120]https://link.springer.com/article/10.1007/s11156-019-00795-7

Yet, the gap between rich and poor becomes wider, with a massive increase in wealth at the top, while the total wealth owned by those at the bottom is falling. Such extreme economic inequality is being exaggerated by an epidemic of tax evasion and avoidance that has reached an unprecedented scale. Those who should be paying the greater share of taxes instead maximize their profits by making countries compete to provide tax breaks, exemptions and lower rates and paying little tax as possible. While millions across the world live in poverty, rich individuals and companies, exploiting the secrecy provided by tax havens, are continuing to dodge their taxes, depriving the poorest countries of being able to provide vital services[121]. Recalling that Cyprus, Bulgaria and Latvia that tie up the very first part of the table, have already implemented some measures in order to enable tax avoidance behaviour. Through a complex and loosely regulated tax system, multinational companies actively seek to increase their profits by storing them offshore and avoiding paying taxes in their countries. Indeed, 9 out of 10 of the world's top 200 companies have a presence in tax havens. Furthermore, the figure highlights both corporate tax rates and respective tax income by each member state[122].

[121]https://www.worldfinance.com/strategy/the-true-costs-of-tax-avoidance
[122]https://www.thestar.com/opinion/editorials/2018/02/05/the-real-cost-of-tax-avoidance.html

CORPORATE TAXATION

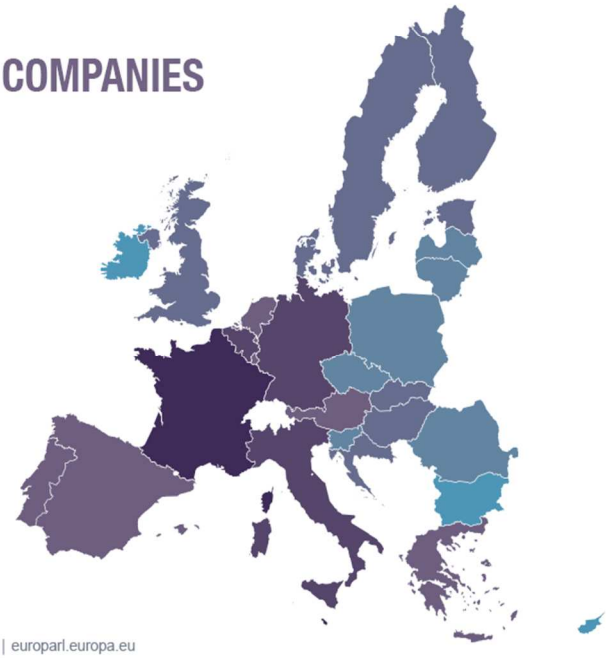
€160-190 billion
Estimated annual revenue losses for EU countries due to tax avoidance by companies

TAX AVOIDANCE
Using legally permitted measures to pay the lowest amount of tax possible

TAX EVASION
Resorting to illegal and deliberate acts to pay fewer taxes or even no taxes at all

MAXIMUM TAX RATE FOR COMPANIES

10.0% Bulgaria	**22.0%** Slovakia
12.5% Cyprus	**22.0%** Sweden
12.5% Ireland	**23.5%** Denmark
15.0% Latvia	**25.0%** Austria
15.0% Lithuania	**25.0%** Netherlands
16.0% Romania	**28.0%** Spain
17.0% Slovenia	**29.0%** Greece
19.0% Czech Republic	**29.2%** Luxembourg
19.0% Poland	**29.5%** Portugal
20.0% Croatia	**30.2%** Germany
20.0% Estonia	**31.4%** Italy
20.0% Finland	**34.0%** Belgium
20.0% United Kingdom	**35.0%** Malta
20.6% Hungary	**38.0%** France



Source: European Parliament, European Commission, Eurostat | europarl.europa.eu

[123]

[123]https://epnetwork.tumblr.com/post/158885264282/week-of-27-march-this-is-a-selection-of-the

Therefore, the competition among jurisdictions to provide the best ways to avoid taxes is today's engine of the offshore system, disclosure and financial regulation. Traditionally, such a race to the bottom is framed as a collective action problem requiring collaborative, multilateral solutions. Notwithstanding, cooperative approaches have flaws, indeed, some jurisdictions are more likely to cheat as they seek to attract mobile capital. A new and growing research conducted by the IMF, the Bank for International Settlements, suggests that financial sector growth is beneficial up to an optimal point, after which it starts to harm economic growth. Most advanced economies, including the United States, the United Kingdom, and other major tax havens, passed that point long ago. Therefore, shrinking the financial sector to remove harmful financial activities should boost prosperity. Financial flows seeking secrecy or fleeing corporate taxes seem to be exactly those that exacerbate the finance curse, worsening inequality, increasing vulnerability. Yet it seems that for many economies hosting an offshore financial center is a lose-lose proposition: it not only transmits harm outward to other countries, but inward, to the host. Countries that recognize this danger can act unilaterally to rein in their offshore financial center, simply stepping out of the race to the bottom and curbing tax haven activity while also improving their own citizens' well-being. This is a powerful, winning formula[124].

[124]https://www.taxpolicycenter.org/briefing-book/how-do-taxes-affect-economy-long-run

4.6 A Call to Action

The most shocking feature of today's corporate-tax-avoidance schemes is that they are legal. When multinationals create subsidiaries, those entities are in theory legally independent firms. A parent company can then set the prices of transactions between its subsidiaries to register its profits in low-tax countries, rather than where the original economic activity actually occurred. The previously presented BEPS program has proved to be insufficient, particularly from developing countries' perspective, because it failed to address the core problem: the transfer-pricing system. Recently, it has been discussed that the fairest and most effective way to allocate and tax corporate profits is to treat multinationals as single firms doing business across international borders. Thus, a firm's total global profits would be taxed according to factors such as sales, employment, and resource usage; all of which reflect real economic activity in each jurisdiction. To be sure, under such a system, countries would still compete for investment and corporate operations by lowering their corporate tax rates. In the meantime, developing countries should be included, they will have to force change, starting with agreed minimum corporate-tax rates at the regional level. For instance, they can try to implement some strategies and take advantage of already-existing systems[125].

[125]https://www.oxfam.org/en/inequality-and-poverty-hidden-costs-tax-dodging

One of them is to establish a minimum taxable income for local corporate affiliates, based on the gross margins of different types of transactions. Only a truly global cooperative effort can fix a broken system and end the destructive race to the bottom on taxes once and for all. On one hand, there has been a multiplication of anti-avoidance rules and initiatives, at national and international levels, to prevent companies from shifting profits between countries. On the other hand, there has been an intensification of tax competition, with countries offering ever-lower rates of corporate income tax in order to foster investment, thus incentivising that same corporate mobility. In the current process, it has given to multinationals massive bargaining power, the power to pit countries against each other. If taxes are charged at the destination, or sales endpoint, there would be no benefit in moving headquarters or patent registrations to a lower-tax country. Since customers are relatively immobile, a destination-based tax would remove mobility from the equation. At a single stroke, it may be possible to completely eliminate tax competition and avoidance. Although, international cooperation would make that more effective, it could still work if only one country unilaterally moved towards a destination-based corporate income tax. Once the country of destination was identified, corporate income tax would be applied to sales made in that country[126].

[126]https://www.fnlondon.com/articles/a-simple-solution-to-corporate-tax-avoidance-20180309

If international cooperation could be achieved, even within a small group of countries, they could delegate tax collection to each other. This would mean companies could concentrate all the compliance for tax regulation in their country of residence, a one-stop-shop. More importantly, the end of tax competition would end the pressure of the race to the bottom felt by developing countries and they could freely establish their tax rates. The alternative to a destination-based corporate income tax is not a perfectly functioning international tax system for developing countries, by contrary it is a system that at present is fundamentally rigged against them. Besides, some relevant actions have to be taken in order to reinforce the reformed system[127]:

Require Public Disclosure of Tax Affairs

The first strategy is to require the public disclosure of country by country reporting of company tax affairs (CBCR). It would increase tax transparency by requiring corporations to make specific disclosures on the tax paid in different countries, by project and region. Doing so, would allow any interested party to observe and understand how corporations transfer profits from high to low tax jurisdictions. Collecting such specific information, it would make more difficult for companies to hide their tax affairs and provide impetus and justification for the public to pressure tax avoiders.

[127]https://www.taxjustice.net/solutions/

Create a Register of Beneficiaries

The next idea comes from the G20, it is to set up a public register of beneficial ownership (in other words, who owns the companies). As a result, improving transparency around who owns, controls, and benefits from companies will assist with preventing the misuse of companies for illicit activities including tax evasion, money laundering, bribery, corruption, and terrorism financing.

The Unitary Tax

Under the unitary tax approach, governments treat a multinational corporation as a unique entity made up of all its local subsidiaries. Whereas the traditional method treats each local subsidiary as an entity separated from the global chain. As a result, the profits that the multinational corporation declares as a whole are then attributed to each country where it operates, based on how much of its real economic activity took place in that country. The root of the problem is the way international corporate income is taxed, indeed, the current system is based on an approach elaborated almost a century ago, when the corporate organization as operating today did not exist. Today, individual entities that make up a corporate company run separate accounts as if they were independent companies, however, the multinational optimises its tax liabilities as a whole[128].

[128]https://www.opendemocracy.net/en/oureconomy/unitary-taxation-multinationals-what-it-and-why-it-matters/

Different proposals for unitary taxation schemes define this tax base in various ways. The five factors most often considered are: location of headquarters, sales, payroll, employee headcount and assets. Regarding the most genuine business activity a corporation carries out, for instance, the more is worker's participation in the value chain, the greater the share of the corporation's global profits get apportioned to a certain country. In this direction, each country is free to exercise its sovereign tax rights, by taxing its share of the global profits at its preferred rate. However, three main obstacles to unitary taxation exist[129]:

- *Path dependency*. The "arm's length" approach is how the international tax system has emerged, and there will be great institutional resistance to change established practices. Still, the alternative of unitary taxation is not an all-or-nothing approach requiring everyone to adopt it at once. It could be adopted by some states and not others, or hybrid versions between Unitary Taxation and the Arm's Length approach could be adopted as interim steps.
- *Vested interests*. Multinationals are more likely to have the leeway to manipulate transfer pricing. The interest to maintain the status quo is very strong, as a consequence, it would be extremely complex to establish the new system.
- *Technical issues*. Potentially important technical complexities in designing an appropriate formula may occur.

[129]https://www.taxjustice.net/solutions/

Firstly, to establish a fair tax rate that will satisfy all members, then member states should be willing to cooperate.

All these criteria could be adapted to fit a formula under unitary taxation, for instance, country-by-country reporting would also disclose if there was deliberate material mispricing of goods or services across international borders. Even without unitary taxation, Country by country reporting would be extremely valuable in order to try to determine whether arm's length principles are being complied with. Corporation tax is an especially precious part of any tax system, particularly for developing countries in which alternative revenue sources are thin. Corporate taxes are very progressive, and they raise significant sums of money for public services.

However, in the end, the failure to cut down on tax avoidance is not due to a lack of proposals. The failure of tackling the issue is because of these proposals' feeds into the distrust of all governments as they do not appear to be doing a very good job at limiting tax avoidance. Changing the fundamentals of the current tax system would present a short-term challenge. As in every tax reform, there would be winners and losers, although the mid to long-term rewards of such a move could be extremely significant[130].

[130]https://www.europarl.europa.eu/news/en/headlines/economy/20160530STO29669/corporate-taxation-the-fight-against-tax-avoidance

Citizens lose out either by having to foot the bill through higher taxes for services that would otherwise have been funded by corporate income tax revenues or going without those services.

CONCLUSIONS

As it was designed, the tax system is established in order to stimulate economic growth, to enhance investments in a specific industry or for a particular asset, but most of the cases it allows to achieve social objectives. Moreover, it is important to bear in mind that even in federalist states, like the United States, it is hard to achieve an across-boarder harmonised corporate tax. A harmonised tax rate across the EU may face other hurdles, therefore, it is well known that businesses regularly pass the tax on to consumers and workers. Corporate taxes are necessary but denying states the right to decide how they attract and retain foreign investment could impact their ability to compete. Leaders have often debated in order to finalise work on the modernisation of international tax laws and introduce a common reporting standard in either 2017 and 2018. Although, the main issue is that if a universal tax regime were introduced, the compliance costs would likely fall outside the remit of most low-income countries, therefore, the rewards make their way only to mature economies. Recognising the issue and actually remedying are very different challenges, so by forming partnerships with low-income countries it would be proper means of redressing the imbalance. The international tax system is rigged in favour of multinational enterprises, at the expense of smaller companies and other taxpayers.

Multinational corporations exist primarily to make profits, the relevant part of earnings is the after-tax profits, as only this part is intended to reward the shareholders by paying a great share of dividends. Tax advisers say an important way for companies to shift profits out of a country is to sell intellectual property, like brands or patents, to a subsidiary in a foreign country. In this paper, it was largely explained that such profits are not taxed in the origin's country and have that unit license the intellectual property to other overseas affiliates. Base erosion refers to the reduction of the amount of profits that a country can tax. The tax base of a country is defined as people and the profits that a country allows to tax. When a company moves its residence to different countries, then the capability of the original country to collect corporate taxes will be diminished. Various international initiatives have tried to address the problems, the most notable is OECD's Base Erosion and Profit Shifting (BEPS) programme, which has targeted corporate tax avoidance practices. Despite, BEPS was precisely designed for the issue, it is widely considered to have failed. The international tax system was set up around a century ago notwithstanding, it does no longer fit for the modern age. In the presented scenario of changing societies and the digital economy, the legal system has to adapt its features in order to survive. The competition within Eurozone has become heavy to sustain, mostly because the intention of attracting new investments from some of the Members, has been carried out at the others' expenses.

Increasingly, jurisdictions compete to provide customized tax deals to big corporations, as a result, the European legal framework results segmented and weak in the presence of aggressive tax planning. For instance, Ireland has denied claims by the European Parliament that it behaves like a tax haven. The country was accused in March of displaying traits of a tax haven and facilitate aggressive tax planning alongside Belgium, Cyprus, Liechtenstein, Luxembourg and The Netherlands. Ireland's economy has flourished in recent decades in fields such that technology, finance and pharmaceutical companies with aggressive tax policies and lower costs than other European countries. Luxembourg, whose tiny economy has benefited from providing a European base for multinational companies then, rejecting the findings and avoid providing disclosure. IKEA' highlighted case is the perfect example of how this European country has started to benefit from the tailored tax regimes in favour of the corporate multinationals. The current behaviour is a blind mentality, because the consequences enlarge the difference between developed and developing countries. The burden of Tax Avoidance is backed up to taxpayers, that see the service provision and welfare policies be gradually dismissed. Maybe by the time in which the European Members will be no longer able to finance their policies due to the fact that the resources have been eroded by Tax Avoidance; they will understand the urgency of the issue.

Several solutions have been displayed, but the starting point is the political willpower of facing the problem as an integrated entity as the European Union was originally established. There is a need to reconsider the fundamental philosophical underpinnings of the international tax system and push for a radical change. Indeed, a reform should move away from the current fiction that multinationals are merely loose collections of separate entities trading with each other at “Arm’s Length Prices,” under a country which tax the multinational’s profit recorded in that jurisdiction. This is the previous approach that has led multinationals to shift their earnings into tax havens, where the effective tax rate is very low or even zero. A radical alternative, which is called "Unitary Tax," treats each multinational as a single global entity. Its global gains are then allocated out to the countries where it does business, in proportion to the amount of genuine economic activity that is carried out in each location. Then, the country can tax its share of global profits at whatever rate it prefers. Those profits would be allocated according to a formula, which may be based, for example on that corporation’s sales and employees in each place. Under this system, it wouldn’t matter if a corporation runs a one-person booking office in Luxembourg: under this formula, only a minimum portion of its global profits would be allocated to Luxembourg, so it would not matter if its tax rate was 0,2 percent or zero. This alternative, if applied widely, would effectively cut corporate tax havens out of the international tax system.

Such a framework contains many restrictions and complexities, in addition, many political obstacles to implementation may arise, given the vested interests that benefit from the current unworkable system. In the meanwhile, one shorter-term approach is to try and limit the losses under the existing pattern. Our Corporate Tax Heaven Index provides a road map for tackling the leakage, in the many areas in which it occurs. Each of the indicators provides practical policies to improve the taxation of corporations in the source countries (that is where their activities take place and the profits are generated, as opposed to where the headquarter is registered). A farsighted methodology should require the public disclosure of country by country reporting of company tax affairs, in order to promote tax transparency by binding corporations to make specific disclosures on their tax activities in different countries, by project and region. Furthermore, another step may be to set up a public register of beneficial ownership, so basically, who actually owns the companies.

None of the presented proposals are prompt to be implemented as well as easy to be accepted. The best European's strength is diversity, so obviously, the process will be delayed, however, the nexus is the willpower of acting as a one as the European's fondant principles require. It is no longer acceptable for each member to act for its own interests, the consequences will be disruptive for the entire Eurozone by keeping away the European Union from the real future's challenges.

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