Tax Havens and Controlled Foreign Corporations in the European Union

by

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Abstract

The subject of tax avoidance and evasion by use of tax havens has been addressed in the Organization for Economic Cooperation and Development (OECD) and G-20 industrialized nation for many years. However, taxpayers can always find the loopholes to minimize the tax payments prior to when new regulation comes out.

After the Panama Paper leaks, the European Union has emphasized that it will strongly combat the tax dodgers and a new tax regulation will be imminent.

On 12 July 2016, the Anti-Tax-Avoidance Directive finally reached an agreement, and CFC rules are one of the five particular aspects that were highlighted in the Directive.

CFC rules are the vital tool for many countries for preventing the allocation of passive income to low-taxed jurisdictions.

This paper will evaluate whether the current CFC rules are efficient at EU level to combat the multinational companies' evasion of tax payments and the future of the tax havens.

Key words: tax haven, tax avoidance, tax evasion, OECD, EU, CFC rules

Resumo

Os temas da evasão fiscal e da fraude fiscal por meio do uso de paraísos fiscais têm sido abordados na Organização para Cooperação e Desenvolvimento Económico (OCDE) e no G-20 há muitos anos. No entanto, antes que alguma regulação nova entre em vigor, os contribuintes podem encontrar lacunas na lei atual para minimizar o pagamento de impostos.

Depois da fuga dos Papéis Panamá, a União Europeia tem enfantizado a importância de combater fortemente aqueles que fogem ao fisco, criando novas regulamentações fiscais.

A 12 de julho de 2016, foi finalmente acordado uma diretica relativa ao combate à fuga fiscal. As regras relativas ao CFC constituem um dos cinco aspetos específicos desta diretiva.

As regras do CFC são uma ferramenta vital para que muitos países possam prevenir a alocação de renda passiva para as jurisdições de baixa tributação.

Este documento avaliará se as atuais regras do CFC são suficientemente eficientes a nível da UE para combater as empresas multinacionais que evitam o pagamento de impostos e também o futuro dos paraísos fiscais.

Palavras-chave: paraíso fiscal, evasão fiscal, fraude fiscal, OCDE, UE, regras do CFC

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Introduction

Due to the impact of globalization economic growth has accelerated. In response, more and more companies are choosing to start their business in multiple countries. However, the domestic taxation law varies from country to country; they are not consistent at all. This is considered as a type of international tax competition. This competition has increased rapidly from the last century due to the increased mobility of capital. And so, it gives rise to international tax planning especially for the multinational companies. Some of these multinational companies make use of this advantage to avoid or evade tax and the tax authority. There is a continuing debate over whether this kind of competition is beneficial or harmful.

The recent Panama Papers revealed how wealthy individuals and companies are able to make use of tax havens to keep their private property secretly, in order to avoid tax payments. There are several legitimate ways to hide the true owner and the origin of money for the purpose of tax avoidance and evasion, as well as money laundering. After the unexpected leak, there is an urge that the EU should put more effort on combating this issue.

The OECD issued a report titled "Harmful Tax Competition- An Emerging Global Issue" in 1998. This report defined what harmful tax competition was and the reasons supporting the argument.

Since then, the OECD has put more and more countries on the tax haven blacklist on which the countries agree to be less secretive and exchange information about the details of individuals or corporations which use the financial services there. Besides, a recent study[1] shows that the yearly losses due to the corporate tax avoidance is estimated around 50-70 billions Euros in the EU. So to support the fight

[1] Bringing transparency, coordination and convergence to corporate tax policies in the European Union - Assessment of the magnitude of aggressive corporate tax planning. Research paper by Dr Robert Dover, Dr Benjamin Ferrett, Daniel Gravino, Professor Erik Jones and Silvia Merler for the European Parliamentary, September 2015.

against the tax fraud, the EU still have to work along various axes.

Main Research Question: Can the CFC rules be efficient to combat the tax avoidance by means of tax havens?

The most common method for tax avoidance or evasion is the use of a tax haven. The Controlled foreign corporation (CFC) rules are features of an income tax system designed to limit the artificial deferral of tax by using offshore low taxed entities, for example, tax havens.

CFC rules were first introduced in the US in 1964 [2], and are now widely adopted in many EU countries in order to combat tax avoidance. In recent years, there has been an active policy debate around the CFC rules. In 2006, an influential decision was made by the European Court of Justice (ECJ) in the case of Cadbury-Schweppes (C-196/04). The ECJ tried to ban the CFC rules for affiliates that operate in the European Economic area and decided that the UK CFC rules may be in conflict with the freedom of establishment principle at EU level. This affected the development of CFC rules substantially.

This paper will examine the current CFC rules taken by the EU and the OECD to combat the tax fraud by use of tax havens. The paper will explain how controlled finance corporations make use of tax havens to avoid tax, and examine the loopholes between the current legal systems.

The Panama Paper leaks highlighted the economic significance of multinational tax evasion, and the importance of addressing these loopholes. Consequently, the EU is increasingly eager to crack down on this kind of tax fraud in order to maintain the tax system. So, how the EU adopts and improves the CFC rules to combat tax avoidance by use of tax havens, will be the main question in this paper.

In order to assist answering the main research questions, here are the two subsidiary questions that help to develop the answer.

[2] U.S. Code Subpart F – Controlled Foreign Corporations.

Subsidiary Questions:

1. ***How can CFC rules and other instruments which are adopted by EU stop corporate tax planning efficiently?***

Zucman (2015) estimated that worldwide more than $7.5 trillion was squirreled away in offshore tax havens which accounts for 8 percent of the world's financial wealth. While some of it was properly declared to world governments, about 80 percent ($6 trillion) was never taxed at all.

After the Panama Paper leaks, some scholars like Brooks (2016) suggested that tax havens should not be reformed but outlawed. He claimed that the world had been entertained by the tax haven long enough and it should be the time for tax havens to not just reform, but to end. Also from the economic view, more than 300 economists, including the former IMF chief economist Olivier Blanchard, signed a letter in May 2016 to urge the global leaders to call for an end to tax havens.

For this reason, on 21 June 2016, the European Council agreed on a draft directive addressing tax avoidance practices commonly used by large companies. CFC rules are one of the five specific fields in this new provisions of the draft directive.

Therefore, this paper will also examine the current instruments adopted by the EU to stop the aggressive corporate tax planning.

2. ***Will tax havens survive in the new international legal environment?***

In Europe, the use of tax havens started in the 1920s. It was the time when Switzerland started its offshore wealth management industry, and the German and French government began to raise the marginal income tax rates significantly.

During the period from 1920s to the 1930s, Switzerland was the only well-functioning tax haven and was mostly used by Europeans. However, in the 1980s, a number of tax havens appeared, like the Cayman Islands, Hong Kong, Singapore,

Panama, etc. Therefore, the use of the tax havens increased dramatically in the 1980s.

In 2014, base erosion and profit shifting (BEPS) was introduced by the OECD in a project. It reflects that the international tax standards, both in terms of domestic law and bilateral arrangements, have not kept pace with the developments in the global economy.

McLaren (2010) claimed that tax havens would still survive in the new legal environment since there was a demand in the market. However, time has change a lot in the legal system. This paper will aim to determine whether tax havens can survive with the introduction of new tax regimes like the Anti- Tax – Avoidance Directive in 2016.

Delimitations

This paper will mainly focus on the current legal instrument and issue about tax regimes for the tax havens adopted by the EU. Moreover, the main discussed legal instrument will consist of the CFC rules. The discussed jurisdiction is primarily focused on the EU level, including the UK.

The study period of this paper will focus predominantly on the past ten years and the future ten years, respectively. This is because several important issues related to global taxation like the introduction of the BEPS and the tax haven blacklist by the OECD, were carried out over the past ten years.

Besides, the EU's five biggest economies will join tax crackdown following the revelations of the Panama Papers. They will conduct a pilot project, under which, they will automatically exchange information on the ultimate ownership of companies in the future. So the prediction regarding tax policy on tax havens, for the next ten years, will also be vital for the research.

Research Methodology

Source and Collection

This paper is a legal thesis. Thus, it is concerned about researching the existing taxation law in EU and the OECD taxation policy. Some academic papers will make a reference to the concept and idea of tax havens and CFC rules. Also, some economic analysis will make a contribution to understanding the reasons why the tax havens exist, as well as the development of tax havens. These secondary sources will be mainly collected from libraries, journals and newspapers.

Data Analysis

This paper will adopt the sociological approach, as it is suitable to look at the impact of CFC rules to the tax havens. It will examine the negative effects of tax havens in order to explain why the EU or non-tax haven countries would like to abolish them.

In addition, a descriptive method will also be used to describe the current situation the EU is facing in regards to the dangers of tax havens.

Last but not least, deep discussion on the CFC rules and current EU situation on taxation policy, like Brexit, will be carried out to lead to an informed suggestion for the future of tax havens.

Chapter I What are Tax Havens?

1.1 History of Tax havens

"*Without understanding tax havens, we will never properly understand the economic history of the modern world*," wrote Nicholas Shaxson[3].

Tax havens are believed to have been in existence for much longer than the several decades widely accepted. Some historians even proposed that tax havens existed, in the form of isolated islands, during the time of the ancient Greeks. At that time, the merchants stored their goods in the islands near Athena in order to avoid the 2% tax. Such havens were also evident in the context of the ancient Catholic Church, where the Vatican City was utilized as the private tax haven for the Pope and the papal staff.

Furthermore, the usage of tax havens has undergone several stages, especially after World War II. In Europe, the use of modern tax havens started in the 1920s. It was the time when Switzerland started its offshore wealth management industry, and the German and French started to significantly raise the marginal income tax rates to help pay for the reconstruction efforts after the Great War. From that period on till the 1950's, "Tax Havens" typically referred to individual tax avoidance.

Tax havens have successfully survived until the present day and attract increasing attention due to the sheer size of the phenomenon. The easy incorporation rules first came out from the U.S. states of New Jersey and Delaware in the late 19th century. One could buy a company "off the shell" and start the business or trading within a day. It is kind of tax haven strategy, and this concept has been developing since 1880.

Additionally, in the case of Egyptian Delta Land and Investment Co. Ltd. V. Todd. (1929), the British Courts allowed the company to incorporate in Britain without paying tax since it did not have any activities in the UK. The technique of "virtual" residencies is the second pillar of the phenomenon.

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[3] Author of 'Treasure Islands: Tax Havens and the Men who Stole the World'.

During the period from 1920s to the 1930s, Switzerland was the only well-functioning tax haven and was mostly used by Europeans. So in 1934, the Swiss amended the Bank Law[4] to protect the bank secrecy by the criminal law. Together with the virtual residencies and the above U.S. state law, the Swiss bank secrecy formulated the tax haven world.

1.2 Definition of a Tax Haven

Although there are many tax havens which have been put on the blacklist by the EU or other countries, there is not a specific definition for tax havens that is accepted worldwide. There is no application in the international law or national legal texts. The easiest way to solve this name problem would be to identify a tax haven as a jurisdiction with low tax or no tax. Many countries like Ireland and the Netherlands have introduced different laws in order to attract more foreign capital. It can eliminate the tax burden for foreign companies to the rate of zero and thus numbers of firms will decide to move their subsidiaries into these jurisdictions (Zimmer, 2009).

But in some legislative proposals, there is an adequate explanation of what a tax haven would be and thus how to combat the tax avoidance and counter the lack of information- exchange in taxation. One of the definitions of a tax haven, which is highly recognized globally, must be the one presented in the OECD's 1998 report on Harmful Tax Competition: An Emerging Global Issue. The OECD's 1998 report concluded the four key elements when identifying a tax haven should be:

(a) No or only nominal taxes and offers itself, or is perceived to offer itself, as a place to be used by nonresidents to escape tax in their country of residence.

(b) Laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction.

(c) Lack of transparency.

(d) The absence of a requirement that the activity be substantial, since it would

[4] Swiss Banking Act of 1934, Article 47

suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.[5]

When meeting only the first attribute alone is not sufficient to identify a tax haven, it is because many jurisdictions offer low tax rate for attracting more foreign investment but they are well-regulated; they are not classified as tax havens. So the second would be the most important attribute of a tax haven. Notably, most tax havens have no or minimal sharing of information with the foreign tax authorities.

Furthermore, in some cases, tax havens can be named as Offshore Financial Centres, Tax Relief Zones, Free Trade zones, etc. However, according to the OECD, there is a difference between a tax haven and an Offshore Financial Centre. Offshore Financial Centres should be "countries or jurisdictions with financial centres that contain financial institutions that deal primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy" (OECD, 2011b). This means that the mother company in the centre may then benefit from the tax advantages that cannot be available for business based outside.

On the other hand, Tax Justice Network (2007) also suggested that pure tax havens should be the jurisdictions that create the law, especially in a way that attracts companies to set up there and would be the countries' main economy. Secrecy is the main attractiveness. That includes the bank secrecy and the secrecy of legal entities. The Tax Justice Network agrees with OECD's definition of a tax haven in something that includes the low tax rates as well as special rules to non-residents.

So to conclude, there is not a single and unique definition of a tax haven or an OFC. The differences between the list of tax havens and OFC would be mainly because of the different methods and indicators that are based on when to identify such jurisdictions.

Other than those low tax and secrecy factors mentioned above, there are several socioeconomic factors like political and economic stability, lack of exchange controls,

[5] OECD's 1998 report on Harmful Tax Competition: An Emerging Global Issue (p.23).

treaties, corporate laws as well as location, that can make the low tax jurisdiction become a popular tax haven.

1.3 Tax Haven List from OECD

The OECD has developed their own list of tax havens including 35 jurisdictions according to its criteria and preferences. The list has been updated from time to time since the countries would improve their taxation standard and vice versa.

The OECD reported a list of tax havens in 2000 as shown in table 1. Thirty one jurisdictions made the formal commitments to implement the OECD's standards of transparency and exchange of information very soon, within two years after the report had been released.

However, there were still 7 jurisdictions (Andorra, Liechtenstein, Liberia, Monaco, Marshall Islands, Nauru and Vanuatu) that did not make any commitment to the OECD in April 2002 and were identified as the uncooperative tax havens by the OECD at that time. They subsequently improved the taxation standard and committed to implement the transparency and exchange of information standard. The last three jurisdictions - Andorra, Liechtenstein and Monaco were finally removed from the list of uncooperative tax havens in May 2009. Hence, there are no jurisdictions on the list currently.

Table 1.[6]

Jurisdictions that was originally identified as tax havens by OECD in 2000	
American Virgin Islands	Liechtenstein
Adderley	Man
Andorra	Marshall Islands
Anguilla	Monaco
Antigua and Barbuda	Montserrat
Aruba	Nauru
Barbados	Netherlands Antilles
Bahrain	Niue
Belize	Panama
British Virgin Islands	Seychellene
Cook Islands	St. Christopher and Nevis
Dominica	St. Lucia
Gibraltar	St. Vincent & Grenadines
Grenada	Samoa
Guernsey	Tonga
Jersey	Turks and Caicos Islands
Liberia	Vanuatu

However, the list was criticized that some developed larger countries in the OECD are held completely outside[7]. Some jurisdictions like Switzerland and Luxembourg, were not considered as tax havens by OECD but identified as tax havens by the Tax Justice Network (Tax Justice Network, 2005), which probably has the largest list of tax havens.[8] In addition, the low-tax jurisdictions could be

[6] Source from Organization for Economic Development and Cooperation (OECD), *Towards Global Tax Competition*, 2000.
[7] Tax Heavens: International Tax Avoidance and Evasion, J. Gravelle, 2015, p.4
[8] Identifying Tax Havens and Offshore Finance Centres, Tax Justice Network, 2007, P.8.

considered as a location for tax avoidance, like Iceland, Poland, the Slovak Republic and most of the eastern European countries which had tax rates below 20% were not on the list.[9]

Moreover, in 2016, the EU countries agreed on establishing a common EU system for listing non-EU jurisdictions. It is a new EU listing process and is a major step for the EU to combat the tax evasion and avoidance issue. More specifically, it can help prevent the aggressive tax planners from abusing the loopholes between divergent national systems. BEPS implementation, fair tax competition, level of taxation as well as transparency, are suggested by the Commission to be used for screening. It concerns incentives to promote a fair tax competition, as opposed to punishment if the countries are on the list.

1.4 Methods of Using Tax Havens

Not only individuals, but every company wants to maximize its profit and minimize the tax that has to be paid. Tax minimization is the fundamental motive for companies to generate profits in tax havens. Therefore, many multinational companies based in high tax countries try to have their tax planning strategies to decrease the tax payable and thus increase their profits after tax.

Tax havens are frequently used by multinational companies to shift profits. Also, there are a variety of choices which can be adopted through the use of tax havens.

1.4.1 Debt Contract

The common tool to shift profit to low tax jurisdiction is debt constructing. This is a way to finance the companies whose subsidiaries are in tax countries with high debt, whereas the other ones in low tax jurisdiction concern countries with only little debt. Since the taxable profits have to deduct the debt, the tax which has to be paid in high tax countries will be less. Then, the higher profit will be registered in the tax

[9] For tax rates see http://www.worldwide-tax.com/index.asp#partthree.

havens. This is widely used by international companies when planning their tax strategies without changing any debt exposure of the companies. Luxembourg has the beneficial tax treatment of interest income.[10]

Earnings stripping is an example of a specific practice. This refers to deducting the interest payments in order to help to escape from the high domestic taxation to a company's foreign headquarters. One example is a foreign controlled corporation that makes a loan to its subsidiary for operational expenses. Therefore, the subsidiary has to deduct the interest payments for this loan out of its overall earnings. This deduction will directly have an effect on the taxable income since the interest payments are not taxed.

1.4.2 Transfer Pricing

Shifting profits by pricing the goods and services sold between affiliates is also another common tactic that is used to avoid or evade tax. The transfer price is the amount at which an affiliate buys their parent company's product or service in order to re-sell it. According to arm's length principle, goods and services between related parties should be exchanged as the same price as between unrelated parties. However, it is difficult to set up a fair market price for the goods and services such as intellectual property, and also the royalty payment. And the companies try to use these loopholes to shift the profits. They set up a lower price of the goods and services sold in high-tax countries, raising the price of purchase. The shifting of income is achieved through this method.

The famous coffee chain store - Starbucks, is one of the companies which makes use of this method. It paid royalties to a subsidiary in the Netherlands for brand rights from 2009 – 2011 in order to achieve a 0% effective tax rate in the UK. Starbucks reported no profit and paid no income tax over those three years but on sales of 1.2 billion pounds in the UK. Also, the European Commission made the decision to hold Starbucks liable for about 30 million euros in the Netherlands because it was an

[10] Corporate Tax Avoidance by Multinational Firms, Library of the European Parliament, 2013, p.3.

artificial pricing arrangement which was unfair and created a selective advantage.[11]

1.4.3 Shell Holding Companies

"A growing fraction of the world's wealth, and particularly of the wealth in tax havens, is owned via shell companies, so it's obviously a business that is booming and is doing extremely well," says Zucman.[12]

This is mostly found in the jurisdictions with low tax rates and an extensive tax-treaty network like Ireland, the Netherlands, and Switzerland. The holding company may be just a shell company without any real trading, productivity and sales activities, but they are used in multiple ways for tax planning activities.

1.4.4 Check-the-Box, Hybrid Entities

Check-the-box is another method used by multinationals to shift profits. At first, it was used to distinguish between partnership and corporation. Later, it was developed to hybrid entities which are only recognized as a corporation by one jurisdiction, but not by the other. For instance, a parent's subsidiary in low tax jurisdiction can grant a loan to its subsidiary in a high tax jurisdiction. The interest will be deductible because the high tax jurisdiction will consider the company as a separate corporation.

In order to combat such strategies used by the multinationals to evade and escape the tax, the EU member states and international organizations have developed many anti-avoidance rules. Controlled Foreign Corporation Rules will be the rule that is discussed predominantly in this paper.

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[11] The decision was made on 28 June 2016.

[12] Author of The Hidden Wealth of Nations.

Chapter II How Can Controlled Foreign Corporation Rules Combat Tax Avoidance?

2.1 Controlled Foreign Corporation (CFC) Rules

"*To close gaps in international tax rules that allow multinational enterprises to legally but artificially shift profit to low or no-tax jurisdictions*" (OECD, 2015 c)[13].

CFC rules are employed to counteract the allocation of passive income to low-tax jurisdictions. Until 2013, 22 out of 38 reporting countries have CFC legislation[14], and there are a further number of countries that are now considering to introduce it. It is a measure to prevent profit shifting by taxing the income of the foreign affiliate, even if the profits have not been distributed as dividends or been realized in the form of capital gains. The income is taxed at the rate of the residence country of a parent company.

CFC rules are the useful legislative measure for many countries that are likely to encounter tax avoidance. It is the most direct and extensive way of combating the profit shift of passive income to low-tax jurisdictions. Other measures are sometimes considered as subordinate to CFC rules.[15] This becomes more and more important in the recent international tax policy debate.

Take one for example, if a parent country is established in a high-tax home country and it owns a subsidiary in a low-tax host country, the parent company would definitely favour taxing its income in the host country. In addition, it is important to note how the home country treats the foreign come of its residents. Exemption method, credit method and tax sparing credit are the three common methods that are adopted worldwide. With the exemption method, the home country will give an exemption of what is taxed in the host country, and in this way, the MNC will lose the tax advantage for its repatriated income.[16] In order to avoid the additional taxation in the parent country, CFC rules can help stipulate a minimum tax rate that must be

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[13] The BEPS project presents 15 Actions, where the Action 3 is entirely contributed to the recommendations on effective CFC rules.

[14] Cahiers de Droit Fiscal International, vol. 98a, 2013

[15] Cahiers de Droit Fiscal International, vol. 98a, 2013, p.24.

[16] Becker and Fuest, 2010, p.173.

levied in a host country. Therefore, CFC rules block the multinationals from shifting the valuable assets to a tax haven and override the tax-exemption method.

Many jurisdictions have CFC legislations, which are regarded in general as anti-avoidance legislation preventing the use of low tax jurisdiction. But in fact, the original objective of these rules was to prevent tax deferral which was initially proposed in the US in 1962, and followed in 1972; Germany was the second nation to establish the CFC legislation into its domestic law.[17] Since then, other European countries and also non-European countries have implemented the CFC legislation into the national law.

Central export neutrality is often discussed in relation to the CFC rules in a policy perspective. It is a key factor for the countries to choose when counteracting the routing of passive income to lower-tax jurisdictions. The choice will affect the design of the tax regimes.

CFC regimes differ across countries. However, when comparing the countries that have CFC rules, a large number of them are targeting on passive income although active income is also targeted frequently. Low taxation is a common requirement as well.

2.2 Applicability of CFC rules

There are a number of essential components of CFC rules. Most of the followings discussed are parts of the CFC legislation of the countries that implement the rules. The applicability of the rules is in accordance with the following criteria. They are generally the definition of a CFC, meaning of control or participation, nature of income as well as the meaning of "low taxation". The following criteria are mainly based on the OECD's recommendations released in 2015.[18]

[17] CFC rules in the Context of the Proposed CCCTB Directive, V.Sobotkova, 2011, p.365.
[18] See details in Designing Effective Controlled Foreign Company Rules, 2015.

2.2.1 Definition of a CFC

In general, some CFC legislations define what a CFC is, but not all. Here is a typical definition of a CFC: a foreign legal entity from the perspective of the country which applies its CFC rules.

The OECD recommends a board definition of legal entities that were covered by CFC rules in 2015. For those corporate entities that raise base erosion and profit shifting, no matter what legal forms of subsidiary, for instance, trusts, partnerships and permanent establishments, are all included in the scope of CFC legislations for many countries.

If the permanent establishments are not covered by CFC rules, there is a risk that the rules will be circumvented. Application of either territorial principle or exemption method for avoiding double taxation plays a vital role in the design of rules. Examples like French CFC rules adopted territorial principle; it targets the foreign permanent establishment of French companies. Compared to the Swedish one that amended in 2004, which also covers the foreign subsidiary that has a permanent establishment in a third country; the profits of the permanent establishment in this case will not be targeted by the French CFC rules.

2.2.2 Meaning of Control or Participation

In addition to types of control, the level of that control is also a consideration when determining whether it is a CFC. Most of the CFC rules target the companies that subject to it, and have direct or indirect ownership of the CFC, because if without the scope of indirect control, the CFC rules will be easily avoided.

The OECD defines diverse forms of control: legal control, economic control, de facto control as well as control based on consolidation.

Legal control determines the percentage of voting rights held in a subsidiary by considering a resident's holding of share capital. Since there is high flexibility in

designing share structure of a company provided by corporate law, economic control is also used by most countries. Economic control focuses more on the rights to profit, and also the capital and assets of a company. Both of them are relatively mechanical and thus limit the administrative and compliance costs. A control test should at least combine these two approaches.[19] Moreover, countries can also take either de facto test or test based on consolidation for accounting purpose to supplement these tests, although both of them increase the compliance and administrative costs.

2.2.3 Level of Control

Level of control is an important issue after conferring the existence of control. Normally, the majority of CFC rules requires more than 50% control. However, owning 50% or less than, can still allow a parent company to exert sufficient influence over an affiliate. In certain circumstances, countries are free to lower the control threshold, like the Swedish threshold which is 25%. The 50% threshold is always a straightforward way to determine the level of control. However, the "acting in concert" test is another approach when determining the minority shareholder joins together to influence the CFC. Table 2 indicates an overview of the control requirements in EU countries which have CFC legislation.

2.2.4 Nature of Income

It is necessary for the CFC rules to define the attributable income to the domestic taxpayer. The OECD refers to CFC income as the income attributed to the controlling party of the parent jurisdiction. Only part of the income that raises BEPS is also considered as CFC income in some jurisdictions. Each country is free to select its approach to define CFC income in accord to its policy objective. A balance is always struck between taxing foreign income and maintaining international competitiveness in designing CFC rules.

[19] Designing Effective Controlled Foreign Company Rules, para. 36

a. Categorical Analysis

Categorical analysis is the common approach to divide income into categories and to determine CFC income according to them. These categories can be based on legal classification, relatedness of parties and source of the income. Under legal classification, it focuses on categories such as dividends, interest, insurance income, royalties and intellectual property incomes, as well as sales and services income. In contrast, the related party test is an indicator as to whether the income earned by a related party is shifted into the CFC. The last one, the source of income approach categorises income based on where the income is earned.

Transactional Approach vs Entity Approach

It is important for the jurisdictions to determine either transactional basis or entity basis when applying the analysis regardless of which type it is.

Under the transactional approach, each stream of income is examined separately. Only the stream of income that falls within the scope of CFC income is attributed to the controlling party. It increases administrative burdens and compliance costs since it requires a detailed approach. For instance, Germany and Spain employed this approach.

Under the entity approach, it is either all or none of an entity's income to CFC rules. It reduces the administrative burdens since it does not require further analysis. However, it would be both over-inclusive and under-inclusive. An entity that earns enough CFC income will have to attribute all its income (including income that is not attributable), whereas the one that earns some income, which should be attributable, may be able to escape the rules. Finland, France, Greece and Norway are the countries that use this approach.

b. Substance Analysis

Substance analysis is a form of analysis to determine income focusing on the ability of CFC to earn the income itself. Many existing CFC rules apply this analysis.

It can apply either as a threshold test or a proportionate analysis. The latter approach is more likely to comply with EU law since it allows the CFC rules to attribute income that does not raise from genuine economic activities. However, it increases the administrative complexity and compliance of the rules.

c.Excess Profits Analysis

Excess profits analysis is the third approach mentioned by the OECD in the BEPS project, Action 3. It characterizes income in excess of "normal return" earned in low tax jurisdictions as CFC income. It is especially relevant in the context of IP income. However, no existing CFC rules feature this analysis.

2.2.5 Meaning of Low Taxation

CFC rules typically target entities subject to low taxation. There are various alternatives to identity a low-tax jurisdiction. To determine low taxation, comparing with the level of taxation in the country applying CFC rules is the most common way. The low tax rate threshold can be set either a fixed rate or a proportionate of the parent country's corporate tax rate. The second way is by a jurisdictional approach. A grey list (with potentially unacceptable tax levels) and a black list (with unacceptable tax levels) are established for references. For example, Italy, has its own black list of harmful countries that includes some specified EU territories like Luxembourg. Table 2 shows the requirement of it in EU countries applying CFC rules.

To conclude, the OECD's report on the CFC rules is not the minimum standards. However, it is the recommendations for the countries to design the CFC rules if they feel interested in implementing the new regime or modifying the existing regime.

Besides, all the CFC regimes always take the policy considerations into account. It includes their role as a deterrent measure and how they complement transfer pricing rules. The design of the regime also has to consider how to balance the effectiveness with reducing administrative and compliance burdens and the effectiveness with preventing or eliminating the double taxation.

Table 2 Controlled Foreign Corporation Legislation in EU countries

		Conditions for Application			
EU Country	**Approach**	**Control of the foreign company**	**Low Taxation Requirement**		
			Approach	**Threshold**	**Basis for the threshold**
Denmark	Entity	at least 50% of the voting rights in the subsidiary	Low taxation	100%	Home CIT rate
Finland	Entity	at least 50% of the voting rights and capital in the foreign entity	Mixed	60%	Actual tax paid/ Home CIT rate
France	Entity	Direct or indirect holding of 50% or more of the capital in a non-resident enterprise/ 5% held by French company and 50% by French or French controlled corporations	Low taxation	2/3	Actual tax paid/ Hypothetical tax
Germany	Transactional	More than 50% of the voting rights in the subsidiary	Low taxation	25%	Effective tax burden
Greece	Entity	Direct or indirect ownership of at least 50% of the voting rights in a non-resident enterprise	Mixed	50%	Actual tax paid/ Hypothetical tax

Hungary	Entity	Direct or indirect holding of 10% or more of the capital in a non-resident enterprise	Low taxation	10%	Effective tax burden
Italy	Entity	Majority of the shares and voting rights in a foreign entity	Mixed	50%	Actual tax paid/ Hypothetical tax
Lithuania	Transactional	Direct or indirect ownership of at least 50% of the voting rights in a non-resident enterprise	Mixed	75%	Foreign CIT rate/ Home CIT rate
Poland	Entity	At least 25% of capital and voting rights in a non-resident enterprise	Mixed	75%	Actual tax paid/ Home CIT rate
Portugal	Entity	Direct or indirect ownership of at least 25% of capital and voting rights in a non-resident enterprise / 10% held by a resident participator and 50% by Portuguese residents	Mixed	60%	Actual tax paid/ Hypothetical tax
Spain	Transactional	Direct or indirect ownership of at least 50% of the voting rights in a non-resident enterprise	Low taxation	75%	Actual tax paid/ Hypothetical tax
Sweden	Entity	At least 25% of the voting rights or capital in a non-resident enterprise	Mixed	5%	Actual tax paid/ Home CIT rate

United Kingdom	Transactional	Controlled by UK residents (at least 25% interest required)	Low taxation	75%	Actual tax paid/ Hypothetical tax

2.3 CFC Rules in EU level

Tackling tax abuse is one of the vital goals of the EU. The key concept in preventing it under EU law is represented by "wholly artificial" arrangements. EU law is relevant for direct taxation. Therefore, all taxation of foreign passive income of a group of companies should comply with EU law.

First, the Treaty on the functioning of the European Union (TFEU) establishes a single market in the EU, and without internal frontiers, they must ensure the freedom of the movement of goods, persons, services and capital.[20] The TFEU prohibits any discrimination and restriction on these freedom rights.[21] Member states cannot impose any less favorable rules on taxing this cross border passive income than for similar domestic profits.

However, the ECJ decided that if there is the need for preventing tax abuse, the justification could be made on the rules that target the cross border activities which may constitute restrictions on the freedom. A standing point for the CFC legislations relevance to the principle of freedom is also found in ECJ's case law. In the Cadbury Schweppes [22]case, it was the first time for the ECJ to examine the CFC rules in the light of the EC Treaty.

2.3.1 The Freedom of Establishment

The freedom of establishment is one of the four fundamental freedoms emphasized in article 49 to 55 of the TFEU. It is guaranteed that companies set up in another member state should be treated equivalently to the ones set up in the home

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[20] Treaty on the Functioning of the European Union of 25 March 1957, Official Journal2010, C83, art. 26.

[21] Treaty on the Functioning of the European Union of 25 March 1957, Official Journal2010, C83; art.45 Freedom of movement for workers, art.49 Right of establishment, art.56 Freedom to provide services and art. 63 Free movement of capital.

[22] C-196/04.

state. The home state cannot impose any conditions that constitute restrictions on such establishments less favorable, compared to an establishment in the home state. However, if the companies are set up with the only purpose to avoid or evade tax, they should not be protected by the Treaty[23].

2.4 Cadbury- Schweppes (C-196/04)

In 2006, an influential decision was made by the European Court of Justice (ECJ) in the case of Cadbury-Schweppes (C19-6/04). This affected the development of CFC rules substantially. The members of the EEA have amended the CFC rules in response to it. As mentioned above, it was the first case dealing with the compatibility of CFC rules and community law.

In this case, the concepts of abuse and freedom of establishment played a vital role in the reasoning of the Court. The UK's CFC rules were examined by the Court under the principle of freedom of establishment. As a principle, the ECJ holds that if a person covered by the EU law seeks to abuse them, they may be denied his/her EU law rights.

Cadbury Schweppes (CS) was a UK resident company and the parent company to a group of subsidiaries residing both in the UK and outside. CS established some subsidiaries in other member countries and also in third countries. Cadbury Schweppes Overseas Limited (CSO) was the head subsidiary residing in the UK. Also, two other subsidiaries were established in Dublin called Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI). Since CSTS and CSTI enjoyed the low tax regime of 10 percent in Ireland, which is less than three quarters of the amount of the UK's tax, the profits of both of the subsidiaries fell under the scope of the UK's CFC rules. However, CS and CSO appealed this decision to the Court claiming that it was contrary to the freedom of establishment.

[23] Lang (Ed) (2004), pg. 39. Schön (2001), pg. 252. Fontana (2006), pg 322.

The Court concluded that the question referred was examined in the light of the freedom of establishment. The Court examined whether the establishment of CSTS and CSTI abused this right. Regarding the earlier cases, the court concluded that the establishment with favorable tax regimes, is not considered as an abuse of the freedoms.[24]

On the other hand, the Court concluded that the UK's CFC legislation constituted a restriction on the freedom of establishment if there is a difference in treating the subsidiary established in the UK and the one established in another member countries by a shareholder.[25]

"It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carries out on national territory."[26]

The Court examined if the UK CFC legislation met the objective of only preventing the "wholly artificial arrangements" by avoiding national tax, using the motive test. It concluded that the rules cannot be applied when there are actual economic activities in the other member state regardless of the tax motive.[27]

In this case, it can be concluded that since there is no harmonization of the level of corporation tax or minimum rate agreed in the Member States, they have to accept that low taxation can be used for attracting companies to establish there, as a means of competition. The decision of the case makes clear, that it is acceptable when the companies establish in other member states with the low taxation purpose alone. That means the Court approves of certain forms of tax planning. There should not be any

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[24] C-212/97 Centros, para.27. C-167/01 Inspire Art, para.96.

[25] C-196/04 Cadbury Schweppes, para. 45.

[26] C-196/04 Cadbury Schweppes, para. 55.

[27] C-196/04 Cadbury Schweppes, para. 75.

differences in treating subsidiaries in the home state than in the other member states. So to avoid these circumstances, the Consolidation Common Corporate Tax Base (CCCTB) was introduced in 2011, which will be discussed in detail in Chapter IV.

2.5 An Overview of the Impact of CS Case (C-196/04) to National CFC Legislation

The following CFC legislations discussed are those which underwent a significant change or amendments after the decision of the CS case (C-196/04).

2.5.1 Denmark

Denmark introduced the CFC regimes in 1995 under section 32 of the Corporate Tax Act.[28] The purpose of the introduction of the regime was to prevent the erosion of the tax base caused by the Danish companies establishing subsidiaries in low-tax countries as well as moving income and assets to such entities.

Danish CFC rules have amended several times, and changed significantly in 2007 in response to the CS case. This included (1) abolishment of low-taxation test, (2) extension of CFC rules to cover also Danish, not only foreign subsidiaries, (3) inclusion of the total income of the CFC in the taxable base of the parent. It widened the scope of the application of CFC regimes to also cover the purely domestic situations. Additionally, it entailed a shift from a transactional approach towards an entity approach. Besides, the Danish CFC legislation also targeted the active business activities of subsidiaries within the financial sector like insurance and banking industries.

2.5.2 France

The CFC regimes were first introduced through the Finance Act of 1980 [29]as a tool

[28] DK: Bill L 35 of 2 November 1994 and DK: Law 312 of 17 May 1995.

[29] Article 209 B of the French Tax Code.

for taxing French shareholders on the profits of their foreign controlled companies. The primary objective of the rules was to avoid the double exemption when French shareholders invested in foreign jurisdictions.

In 1992, the legislation was changed to cover a wider scope, and especially after the 2002 Schneider Electric case, the old system was completely overhauled and new CFC regimes were established. Currently, French companies are required to include their taxable income profits made by their more than 50% owned foreign subsidiaries and branches. This 50% holding is determined by direct and indirect control of shares and voting rights.

In response to the CS case, the amended French CFC rules in 2005 only apply to artificial structures if a foreign entity resides in the EU. Moreover, the French tax authorities have published the guidelines that refer to concept of the "wholly artificial arrangement" that must be assessed.

2.5.3 Germany

The German CFC rules were first introduced in 1972[30]. The aim for it was to combat the harmful tax practices set up to avoid German taxation. Just like the UK's CFC rules, the German one likewise does not apply to partnerships or branches.

German government changed its CFC rules in 2008 in response to the CS case. When a foreign entity residing in the European Economic Area meets the following requirements, it will be exempted under the rules. The entity should carry out genuine economic activity and its passive income is derived in connection with the genuine economic activity.

Also, if the EC Mutual Assistance Directive or a similar agreement has been concluded with the European Economic Area country in question, the entity will be exempted.

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[30] DE: Foreign Transactions Tax Act (Außensteuergesetz), National Legislation IBFD.

2.5.4 Portugal

The Portuguese CFC rules entered into force in 1995[31], following the path of other European countries. Its main objective was to prevent tax avoidance through the establishment of companies in low tax jurisdictions[32].

After the CS case's decision, Portugal was one of the few member states that ignored the problem[33]. Until in the State Budget for 2012, the amendments were finally introduced, although Portugal had been alerted to the problem and noticed the changes were needed[34]. In order to make them compatible with the EU law, the amended rules included the exemption of a foreign entity that resides in the EU and the European Economic Area, if the entity is incorporated and meets the genuine business activity test; and also exempts those which carry out agricultural, commercial or industrial activities, or provide services. Lastly, the European Economic Area countries which have an exchange of tax information with Portugal, would also be exempted.

2.5.5 United Kingdom

The UK's CFC regime was first introduced through the 1984 Finance Act. It addressed that the UK's CFC legislation was under examination in the CS case, and it was not compatible with the freedom of establishment that was made clear by the

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[31] Introduced by Decree-Law no. 37/95, of 14 February.

[32] Francisco da Câmara, 'Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends - National Report (Portugal)' (2001) Cahiers de Droit Fiscal International LXXXVI (b), 777.

[33] A. Ferreira, CFC Rules in Portugal: Still Incompatible with EU Law?, European Taxation, 2012, p.1.

[34] The need to amend the domestic rules was mentioned as early as 2009 in a report promoted by the State Secretary of Finance and drafted by a group of tax scholars and experts (see A. Santos and A. Martins (coords.), Relatório do grupo para o estudo de política fiscal, competitividade, eficiência e justiça do sistema fiscal da Secretaria de Estado dos Assuntos Fiscais do Ministério das Finanças e da Administração Pública, 3 Oct. 2009, available at http://info.portaldasfinancas.gov.pt/NR/rdonlyres/8AFAA047-5AB4-4295-AA08-E09731F29B0A/0/GPFRelatorioGlobal_VFinal.pdf.

ECJ[35].

Therefore, after the decision, the CFC rules were amended to not apply to that part of the profit of a CFC established in an European Economic Area country. Also, following the case Vodafone 2 v Commissioners for Revenue and Customs (2009), the UK's CFC rules were amended to exempt a foreign entity that is established in an European Economic Area country and carries out genuine economic activity.

Interestingly, the most changes introduced in the Finance Act 2012 have undertaken a complete overhaul of its CFC rules. The new rules are only aimed at taxing foreign profits artificially diverted from the UK[36].

2.6 Limitations of CFC Rules

CFC rules help to combat the issue of tax avoidance. The rules have made MNCs less motivated to establish subsidiaries into tax havens[37]. However, different member states have their own tax regimes to attract businesses. From the CS case, we can notice that most of them have different policies for the CFC rules and were not compatible with the EU law. When the rules applied to an actual establishment, they always easily infringe the freedom of establishment or override the tax treaty applied.[38] The countries had to make amendments after the court's decision. Here, there is always a burden of proof for the genuine establishment at national level. Therefore, it incurs a question, whether a harmonization of the tax base at the EU level, would be a better solution to the international tax avoidance since different CFC regimes from countries are not efficient to combat the tax avoidance.

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[35] C-196/04 Cadbury Schweppes, para. 45.

[36] The New UK Controlled Foreign Company Rules, Buzzacott, 2012.

[37] See the results in CESIFO working paper no. 5850, Optimal Policies against Profit Shifting, the Role of Controlled Foreign Company Rules, A. Haufler, 2016. It suggests that the MNCs are sensitive to the changes in CFC rules.

[38] CFC-legislation, the Freedom of Establishment and Tax Treaties- A Comparative Study in the Light of the Cadbury-Schweppes judgement, C. Billgren, 2008.

Chapter III Will Tax Havens Survive in the New EU Legal Environment?

Since the financial crisis in 2007-2009, the G-20 and the OECD have tried to apply much more effort to combat harmful tax practice. After the Panama Paper leaks, the European Union has emphasized even more that it will strongly combat the tax dodgers, and new tax regulation will be implemented imminently. These financial crises and economic scandals have drawn the public attention that the world has to promote and ensure the fairness, as well as transparency, in the tax systems.

Combating tax evasion has been an issue within the European Union for many years. Many directives and regimes concerning this issue have been adopted, like the latest one -- EU Action Plan (2015). There are five key areas in the Action Plan. The first one is the re-launch of the Common Consolidated Corporate Tax Base which will be discussed later. Secondly, it concerns ensuring fair taxation where profits are generated. Thirdly, it refers to creating a better business environment as well as improving EU coordination and increasing transparency[39].

Besides, the OECD has also introduced the international taxation standard. For instance, it requires the countries compliance to exchange the tax information when the domestic country requests for the administration and enforcement of tax law, which helps improve the transparency of the information and prevent particular tax evasion. The OECD also proposes the recommendations for countries to adopt the CFC rules and develop the methods to record and analyze BEPS data and counter measures.

3.1 Do We Need Tax Havens?

The existence of tax havens is a controversial issue in the world. Although tax havens are always considered as a danger to higher-tax jurisdictions, somehow, they encourage investments in other countries as well. This is because the transfer of income to the tax havens would improve the desirability to invest again in high-tax jurisdictions[40]. The less money the corporates pay for the tax, the more money they

[39] A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, European Commission, 2015.

[40] Fiscal Paradise: Foreign Tax Havens and American Business, Hines and Rice, 1990.

can invest again. Companies that have shifted income through the set up in tax havens are most likely the ones with growing activities in high-tax jurisdictions (Dharmapala, Desai 2006).

Tax havens play a vital role in the world. They facilitate the allocation of the economic world, they offer the low-tax platform for the financial activities and they accumulate the capital. Also, the low or no tax rate from tax havens partially drives the tax competition. As a result, the high-tax jurisdictions have to reform or amend their tax law to be more competitive.

On the other hand, the OECD also reports that "`lowering statutory corporate tax rates and rates on personal capital income in countries where these are particularly high, may increase the domestic tax base as there are less incentives to shift taxable profits and capital income abroad". It suggests that when the tax rates are lower, there will be more people who report their income to the authority instead of hiding it. In regards to this, the decrease in tax rate will result in an increase in tax revenue (Leibfritz 1997).

3.2 Why Do We Combat Tax Havens?

Although tax havens provide a low-tax platform for the taxpayers, it also creates an uneven playing field. Only numbers of multinational corporations can make use and take advantages of tax havens; small businesses and less wealthy parts of society do not have the capacity to do this.

The biggest cost of the tax havens is the large scale of tax revenue loss around the world because of the tax avoidance and evasion. It is no doubt that tax evasion has a detrimental impact on the development of society; tax revenue is essential to offer the public services. Governments which are affected by tax havens do not have enough money to spend on the public service, and thus, it widens the gap between the rich and the poor, worsening the state of inequality simultaneously. The International Monetary Fund estimates that the total loss in tax revenue is due to the misuse of tax havens, at approximately $600 billion globally in 2015.

Moreover, the bank secrecy provided by the tax havens gives rise to corruption, money laundering, the hiding of political conflicts of interest and the manipulation of markets. This undermines the democracy and increases instability. They also help the officials and wealthy people from developed countries to hide their wealth and avoid paying tax. Therefore, tax havens hurt the governance of developed countries.

Last but not least, the issue of bank secrecy also mitigates the risk in financial markets. This is exemplified in the financial crisis that took place in 2007, where many researchers found out that bank secrecy was a contributory factor to it. Financial secrecy leads to economic inequality and to less well-functioning and competitive markets. They are corrupting the global markets and as a result, there is an urge worldwide for governments to combat tax havens.

3.3 Against "Harmful" Tax Practices

"*Let there be no illusion: tax evaders steal from the pockets of ordinary citizens and deprive Member States of much-needed revenue. If we want fair and efficient tax systems, we must stamp out this activity.*", as stated by Algirdas Semeta[41], the Commissioner responsible for tax affairs when presenting a Commission report on measures to fight tax fraud and tax evasion in June 2012.

Since the mid-1900s, the number of policies related to the international tax practices have been targeted at the "harmful" tax practices which distort investment and trade flow. The European Parliament Research Service has estimated that the EU lost between 50 billion euros and 70 billion euros in the tax revenue in a year[42]. That is the reason why the European Commission is trying its hardest to convince the 28 members to unite together to combat the tax dodgers. The main aim of the anti-tax avoidance legislation is not to increase marginal corporate taxation revenue, but rather to protect a fair tax base for the countries.[43]

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[41] IP/12/697 VOM 27.6.2012.

[42] IP/16/1349 VOM 12.04.2016.

[43] OECD, 2015a, p.13.

Besides the controlled foreign company (CFC) rules, thin-capitalization rules, and transfer pricing rules are the three most common anti-avoidance measures adopted worldwide (Egger and Wamser,2015).

3.3.1 Thin-Capitalization Rules

The capital structure of a company affects its taxable profit and thus the amount of tax payable as well. "Thin- capitalization" means that the company is financed through a relatively high level of debt compared to equity; the interest that the company pays according to the level of debt in it. So in this case, if the debt level is higher, and thus the higher the amount of interest, the taxable profit will be lower. With respect to this, debt is always better than equity in the tax efficient method of finance.

In order to protect the domestic tax base, thin capitalization rules are designed to limit cross-border profit shifting by financing excessive debt.[44] The introduction of these rules tends to reduce the leverage and the capital stock of affiliates located in the jurisdictions imposing it.[45] Until 2015, there are 30 European counties who have imposed these rules.

Thin capitalization rules are adopted to restrict the amount of debt for which the interest is tax deductible. The definitions of debt measures in the numerator of the ratio and of assets or equity in its denominator vary widely across jurisdictions.

Safe-harbour rules and earnings stripping rules are the two common ways for defining this regime by OECD.[46]

Under the first approach, the maximum amount of debt is determined by two different methods: "arm's length" approach or "ratio" approach. The amount of tax deductible interest will be only up to this specific amount.

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[44] Thin Capitalisation Legislation ,OECD,2012,p.7

[45] The Impact of Thin- Capitalization Rules on Multinational's Financing and Investment Decisions, p.24.

[46] Thin Capitalisation Legislation ,OECD,2012,p.8

Under the second one, which sometimes refers to the "earnings stripping" approach, limits the amount of interest that is deductible relative to another variable, e.g. an interest to EBITDA ratio.

3.3.2 Transfer Pricing Rules

"*Transfer pricing is the leading edge of what is wrong with international tax,*" Lee Sheppard[47] said.

Transfer pricing is a significant issue for the multinational companies when they want to ensure that each party in the group earns a fair share of profits. So in itself, is not illegal or necessarily abusive. The one which is illegal or abusive is called transfer mispricing.

"Arm's length" principle is always endorsed in transfer pricing rules. It requires that the transfer prices of intra-firm transactions should be the same as if the two unrelated companies are negotiating in a normal market.

The first draft of the current OECD's Transfer Pricing Guidelines was released in 1995. It recommends various methods to determine the practice of transfer pricing, the latest one of which, was revised in 2015. It is formally followed by many European Union countries with little or no amendments. The most common method that is adopted to evaluate arm's length interest rates on the loan in groups, is the internal or external comparable uncontrolled price (CUP) method. On the other hand, the CUP method and the benefit method is the most common methods that are adopted to evaluate the arm's length nature of guarantee fees.

Currently, over 60 countries have adopted these rules. The introduction or tightening of transfer pricing rules can reduce the multinational profit shifting activities significantly.[48]

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[47] Tax analyst, one of the world's top experts in international tax.

[48] Theresa Lohse and Nadine Riedl, 2013, p.16.

To conclude, countries introduce different anti-avoidance measures in their tax regimes with only one aim, which is to limit the profit shifting to low tax jurisdictions by MNCs. Especially over the recent years, the number of countries that have adopted the above rules has grown considerably. This means that to limit BEPS has become the key intention of tax regimes for many countries and international organizations. In May 2016, more than 300 economists, including the former IMF chief economist Olivier Blanchard, signed a letter to urge the global leaders to call for an end to tax havens. They proposed that tax havens should not be reformed but outlawed.[49] Furthermore, in the present day it is widely accepted that it is the time for tax havens to not just reform but to end, as they will not survive in the new legal environment.

[49] Suggested by Richard Brooks, the author of The Great Tax Robbery.

Chapter IV Are CFC Rules Sufficient to Combat Tax Havens?

4.1 Anti-Tax Avoidance Directive

As of 2015, 13 out of 28 EU member states have enforced CFC rules. Due to the recommendations of BEPS Action 3, more and more countries are inclined to implement the rules and even now, the recommendations have a high influence to the existing CFC rules.

The Anti-Tax – Avoidance Directive[50] finally reached an agreement by the Ministers of Finance of the Member States to the EU on 20 June 2016 and was formally adopted on 12 July 2016. It consists of five vital legally binding anti-abuse provisions which all member states should adopt to crack down the common forms of aggressive tax planning. These measures should all be adopted from the 1 January 2019.

4.1.1 CFC Rule

CFC rules are one of the five specific fields that are emphasized in the Directive. It is the regime that is adopted by many countries to prevent the profit shifting from one company's home country to another low-tax jurisdiction, so as to protect the national corporate tax bases.[51] It applies to both EU and non-EU CFCs. This also extends to the permanent establishments. The CFC's income would be taxable in home jurisdictions if certain requirements are met, such as 50% ownership.

4.1.2 Exit Taxation

Exit taxes have the function of preventing companies from avoiding when re-locating assets. It applies to certain relocating assets or residence within the EU or to the third countries. It can also help clarify the transfers of assets between a parent company and its subsidiaries falling outside the scope of the envisaged rule on the

[50] the Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

[51] the Directive (EU) 2016/1164, (12).

exit taxation.[52] It broadly reflects EU case law.

4.1.3 Hybrid Mismatches

Hybrid Mismatches occur when there is a difference in the legal characterization of payments between the legal systems of two jurisdictions. This usually causes a deduction of the income in one state without inclusion in the tax base of the other or a double deduction. So the rules should be laid down in order to minimize this effect. The Directive only covers hybrid entities and instruments related in the EU situations[53].

4.1.4 Interest Limitation Rule

The rules are designed to discourage taxpayers to use artificial tax payment to avoid tax payments. The rules should apply to the taxpayer's exceeding borrowing of costs regardless of the origin of the debt (nationally, cross border within EU, or with the third parities).[54] It will occupy the form of an earnings stripping rule; which requires that interest cannot exceed 30% of EBITDA.

4.1.5 General Anti-Abuse Rule

This is the rule that fills in the gap that other rules cannot fulfil when countering the aggressive tax planning. It features in tax systems to tackle tax practices.[55]

Although there are numbers of EU countries that have the rules in their national laws, approximately half of the member states do not want to follow this rule because of the economic structure since the rules will impact the attractiveness of foreign capital to flow in. However, all the member states should transpose it into

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[52] the Directive (EU) 2016/1164, (10).

[53] the Directive (EU) 2016/1164, (13).

[54] the Directive (EU) 2016/1164, (7).

[55] the Directive (EU) 2016/1164, (11).

their national laws and regulations until 31 December 2018, as agreed with the Directive.

The Directive is a common EU approach to combat the corporate tax avoidance. It will ensure that the OECD anti-BEPS measures are carried out in a coordinated manner in the EU. It can offer an immediate and effective solution to combat tax avoidance, raise tax transparency and ensure a fair tax competition[56].

Also, three areas of the directive adopt the OECD recommendations, namely interest limitation rules, CFC rules and rules on hybrid mismatches. On the other hand, the remaining two deal with the anti-avoidance aspects of a 2011 proposal for an EU common consolidated corporate tax base (which will be discussed in the following).

4.2 Common Consolidated Corporate Tax Base (CCCTB)

In March 2011, the European Commission launched a proposal carrying out a common system for the calculation of the tax base of businesses and companies operating within the European Union. This system is called the Common Consolidated Corporate Tax Base (CCCTB)[57]. It provides a set of single rules for how the EU businesses calculate for their tax base, but not for harmonizing the tax rate among the member states. The member states still have their sovereignty to decide the tax rate.

However, the proposal has been stalled by strong opponents like the UK and Ireland. They fiercely opposed to the proposal since they believe that it would weaken their ability to tailor its tax system to attract investments. Finally in June 2015, the European Commission announced that re-launch of the CCCTB would occur in 2016.

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[56] Fact sheet of Anti-Tax Avoidance Package,2016.

[57] Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM (2011) 121/4.

4.2.1 How does the CCCTB work?

The CCCTB provides a uniform rule for the companies or groups of companies operating in different Member States to calculate the tax base. It does concern harmonizing the tax rate, but instead, tries to impose a higher transparency on the effective rate of each Member State. The profits for each member of the group of companies can be added up and consolidated at the level of the parent company. A specific formula known as the Formula Apportionment is adopted to allocate the group income to the Member States where companies are located. Also, the allocated profit will then be taxed according to the national tax rate.

Under the Directive, the calculation of Formula Apportionment includes factors of production (labor and capital) and the companies' economic performance (sales), in equal proportions (1/3). Besides, the number of employees in addition to payroll have an equal contribution in the labor factor[58].

4.2.2 Benefits of the CCCTB

a. Cross Border Loss Compensation and Less Compliance Costs

Companies that cooperated across the borders can benefit from the cross border loss compensation introduced by the CCCTB Directive. The CCCTB can also lower the compliance costs incurred by the complexity of the 28 different sets of rules. In addition, the consolidation of profits and loss can help prevent the transfer pricing system that currently take place for intra-group sales[59].

b. More Foreign Direct Investment

The scope of the CCCTB does not only include the companies in the EU, but also benefits the EU-located branches of the third-country companies. The companies

[58] See details in Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM (2011) 121/4.

[59] COM (2016) 683 Final. P.130.

in third countries can deal with one single systems instead of 28 different sets of rules. The one-stop-shop system for filing tax returns would facilitate the administration and lowers costs. It can make the EU be a more attractive market for the foreign investors[60].

c. ***Benefits to MNEs and SMEs***

The CCCTB will be available for all sizes of companies. MNEs can get relief from certain obstacles within the Single Market whereas the SMEs can benefit from a lower compliance cost when they want to expand cross border.[61]

d. ***Encourage R&D and Innovative Companies***

Under the CCCTB, R&D expenses are treated by the generous and innovation friendly rules. It provides a better environment for the R&D than the current rules of most of the Member States[62].

e. ***Combating Tax Avoidance***

Under the CCCTB, all Member States would have to apply the same rules for calculating the taxable profits of cross-border companies. It can help eliminate the mismatches and loopholes among the national systems. The CCCTB helps to defend the Single Market against the profit shifting and base erosion. It would be also a solid framework for Member States to carry out many new international tax standards that agreed in the OECD and BEPS. And there have been introduced a specific anti-abuse provisions, such as the CFC rules in the CCCTB.

"The CCCTB will make it easier, cheaper and more convenient to do business in the EU. It will also open doors for SMEs looking to grow beyond their domestic market.

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[60] COM (2016) 683 Final. P.66

[61] COM (2016) 683 Final. P.66

[62] COM (2016) 683 Final. P.62.

Today's proposal is good for business and good for the EU's global competitiveness." [63]

Moreover, there are significant statistics to highlight that the CCCTB can help regulation and growth of the Single Market more fairly and competitively by using the harmonization of tax base[64].

4.2.3 Opponents to the CCCTB (2011)

After the introduction of the proposal of the CCCTB (2011), there have been numerous controversies among the EU members. Although the Commission saw the key benefits of the CCCTB, the proposal has stuck for almost 4 years. Some Member States that were against the system including Ireland, the UK, the Netherlands, Bulgaria, Sweden, Poland, Malta and Romania.

Ireland and the UK are the two countries that are most hostile to this proposal. They argued that the harmonization of tax base would sooner dilute their national sovereignty and thus lose their competitiveness in the global market. They pointed out that the CCCTB in somehow violates the fundamental freedom principle of the Single Market.

Besides, Slovakia also fears that the CCCTB could be narrower than the current tax base tied to the country's flat tax, and the subset of the opponents like the Baltic States feared that it would be a mechanism to harmonize the company tax rate in the future. Some critics have also figured out that the CCCTB disadvantages the less developed countries by reducing the corporate income tax revenue[65], and the Formulary Apportionment under the CCCTB is not a convincing alternative to separate accounts and arm's length pricing[66].

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[63] Šemeta declared when unveiling the original CCCTB proposals in March 2011

[64] To see more details. European Commission (2011), "Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)," Communication COM(2011) 121/3.

[65] Pîrvu, D. (2013). Why CCCTB Disadvantages less Developed Countries of the European Union. *Practical Application of Science*, *1*(1), 1.

[66] Röder, E. (2012). Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment. *World tax journal*, *4*(2), 125-150.

4.2.4 Re-Launch of the CCCTB (2016)

After four years of discussion in the Council without agreement, the conclusion finally comes out that the original CCCTB was too ambitious by intending to adopt all in one single step. Despite this, in 2015 the Commission decided to re-launch the CCCTB in regards to the important benefits that the CCCTB will bring. The re-launch of the CCCTB has two major features that differ from the original one.

a. Mandatory CCCTB

CCCTB is optional in most cases. Companies can feel free to choose this harmonized system for the tax base to opt-in. On the other hand, they also can choose to remain to work with the national system as usual. This is because not every company has the intention to expand their business outside their residence or beyond the national borders. And so, they do not have to shift to a new tax system while they only deal with one single system. On the other hand, for the companies from different Member States, the CCCTB offers an excellent opportunity for them to lower the compliance costs, administrative burdens and complex re-adjustments which incurred higher with the 28 different rulebooks.

As mentioned above, the CCCTB is optional in most cases. The revised CCCTB boasts a significant change from the previous one. A mandatory CCCTB will be proposed to at least the multinational companies. Its aim is to simplify the tax environment in the Single Market, also to prevent tax avoidance. It will push the large companies that are unlikely to opt in since they benefit from the current loopholes in this system.

b. Step-by-Step Approach

As the original CCCTB was too ambitious to adopt all in one single step, the Commission breaks the original one into small pieces in order to make it more acceptable for Member States. Under the CCCTB Directive (2011), it allowed the companies to consolidate the profits and loss at EU level. It would facilitate the cross-

border activities of the business as well as avoid the over taxation. But in fact, it is difficult to carry out and has been the most difficult element in negotiations so far.

Röder (2012) suggested that an enhanced CCCTB without consolidation and Formulary Apportionment would be an alternative. Therefore, consolidation will be postponed in the second step. Once the common base is secured, consolidation will be introduced as the second one.

4.3 Conclusion

There is an alert in the world that combating tax haven is an urgent issue. They do not only affect our financial markets in many different ways, but also the political and social aspects like corruption problems and decreased tax revenue to governments. Tax avoidance and the lack of transparency in tax havens contribute to large instability in financial markets. The increasing use of tax avoidance instruments through tax havens and lack of financial regulation have a negative impact on financial markets also. This leads to asymmetric information failures and unfair competition.

Currently, there are more than 15 European countries that have implemented CFC regulations. This includes the Anti-Tax-Avoidance Directive comprised of the interest limitation rules, exit taxation rules, general anti-abuse rule, CFC rules and rules on hybrid mismatches. CFC rules are one of the five specific fields that are emphasized in the Directive. Many literature researches show that CFC regimes are effective in limiting profit shifting activities by European companies. The financial and real decisions taken by multinational companies are sensitive to changes in CFC rules[67].

However, only the CFC rules are not sufficient to combat tax havens, other anti-tax avoidance tools such as thin-capitalization rules and transfer pricing rules should be implemented. Also, as I discussed in the previous chapter, the applicability of CFC

[67] L. Mozule and L. Rezevska, Development and Effectiveness of Controlled Foreign Company Ruls,2016 ,p.85.

rules is not so wide. Most of the CFC rules only apply to the passive income. The Cadbury-Schweppes case has had a great influence on the development of CFC regimes at EU level; we can notice that most of the CFC rules easily infringe the principle of freedom of movement and the tax treaty. As every member state has its own CFC regimes, it will be a burden for the taxpayer to prove integrity when meeting certain requirements. On the other hand, there are loopholes between the differences in the regimes. Therefore, it points out that somehow harmonization may be the better way to tackle the tax avoidance among countries. In relation to this, the EU relaunched the project - Common Consolidated Corporate Tax Base initiative in late 2016.

The CCCTB provides a uniform rule for the companies or groups of companies who operate in different Member States to calculate the tax base. It does not concern harmonizing the tax rate, but in contrast, it tries to impose a higher transparency on the effective rate of each Member State. The profits for each member of the group of the companies can be added up and consolidated at the level of the parent company. The CCCTB apparently highly contributes for the economic growth, co-operation, competitiveness and fairness which is always emphasized in the Four Freedoms of the Single Market. The European Commission also seems very confident that the CCCTB will happen soon. After four years of discussion, the Commission amended the CCCTB to be a better mechanism. However, it always emphasizes that it is not a harmonization of the tax rate. Most of the data supports the notion that what the CCCTB brings, could benefit the Member States. Although there are some technical problems dealing with the aspect of consolidation, it can be foreseen that CCCTB can enhance the Single Market's attractiveness in general.

Last but not least, the CCCTB should not only be concerned about the harmonization of the tax base but also the harmonization of the anti-abusive provisions. The CFC regimes in the context of the CCCTB are believed to enhance the efficiency of cracking down the tax havens. Lastly, the CCCTB could be a vital instrument to combat tax avoidance in the future years.

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