

**Reprinted from  
British Tax Review  
Issue 3, 2019**

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**5 Canada Square**  
**Canary Wharf**  
**London**  
**E14 5AQ**  
***(Law Publishers)***

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# The Relevant Economic Activity Test and its Impact on the International Corporate Tax Policy Framework

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## Abstract

*A core objective of the Base Erosion and Profit Shifting (BEPS) Project was to ensure that profits are taxed where activities generating the profits take place. In this regard, international policy making organisations, such as the OECD and EU Commission, have reinforced the application of certain activity-based concepts, such as substantial activities, core commercial activity, controls over risks, economic reality and substantial economic activities, in soft and hard law instruments. If these concepts were to be consolidated it could be argued that, if the taxpayer were to comply with the relevant economic activities test, as developed in this article, then that taxpayer entity should be: 1. allocated the returns (income) from a transfer pricing perspective; 2. given access to tax treaty benefits in relation to the income it derives; 3. given access to benefits offered by EU law, in particular, the non-application of selected national anti-abuse rules (such as Controlled Foreign Company Rules) and anti-avoidance rules found in the corporate tax directives such as the Parent Subsidiary Directive and the Interest and Royalty Directive as well as the European Anti-Tax Avoidance Directive (for instance, the General Anti-Abuse Rule); and 4. the taxpayer entity should obtain access to economic activity-based preferential regimes. This article supports this proposition by taking into consideration the latest versions of the OECD Transfer Pricing Guidelines, the OECD Commentary, the case law of several courts, in particular the Court of Justice of the European Union, state practices as well as scholarly literature. Essentially, multinational enterprises (MNEs) can continue to engage in profit shifting activities post-BEPS. Furthermore, tax competition intensifies between states to attract economic activities, either through tax incentives or corporate tax rate/withholding tax rate reductions. Moreover, given that the activity-based concepts are subjective, both tax uncertainty and tax disputes will be on the rise. Interestingly, the activity-based concepts do not alter the allocation of the taxing rights framework agreed by states. Nevertheless, in light of the digital debate, there is pressure to reconsider the allocation of the taxing rights framework (Pillar I) and to find solutions to counter genuine profit shifting strategies to low tax jurisdictions/tax competition among states (Pillar II). Thus, the movement from BEPS 1.0 to BEPS 2.0 (Base Expansion and Profit*

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The authors would like to thank Professor Robert Danon (University of Lausanne, Tax Policy Center, Switzerland), Professor Luc De Broe (KU Leuven, Belgium), Professor Scott Wilkie (Osgoode Law School, Canada), Isabel Verlinden (Global Head of Transfer Pricing, PwC), Stefaan De Baets (Senior Counsel, PwC), Dr Alessandro Turina (IBFD, Managing Editor ITAXS) and Dr Marco Felder (FS+P) for commenting on the draft versions of this article. The contribution was finalised during Dr Chand's post-doctoral research and teaching stay at KU Leuven, Belgium.

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*Sharing*) is already being witnessed. The challenges raised by digitalisation will be discussed in a later article.

## 1. Introduction and scope of the article

### 1.1. The post-BEPS international corporate tax framework

A core objective of the BEPS Project was “to ensure that profits are taxed where economic activities generating the profits take place and value is created”.<sup>1</sup> In this regard, international policy making organisations, such as the OECD and EU Commission, have reinforced the application of certain activity-based concepts in the international corporate tax framework.

At the domestic tax policy level, BEPS Action 5,<sup>2</sup> which is a minimum standard, introduced the *substantial activities test*. The test provides that states can introduce/offer preferential tax incentives only when the taxpayer entity undertakes core income generating economic activities.

In relation to tax treaty policy, BEPS Action 6,<sup>3</sup> which is a minimum standard, obligated states to modify the preamble of their tax treaties to reflect that the purpose of tax treaties, in addition to the elimination of double taxation, is to prevent the creation of opportunities for tax evasion or tax avoidance (especially, treaty-shopping arrangements).<sup>4</sup> Additionally, states were required to include in their tax treaties either: 1. the Principal Purpose Test (PPT)<sup>5</sup>; 2. the PPT and the limitation on benefits (LOB) clause<sup>6</sup> (the latter being drafted in a simplified version<sup>7</sup>); 3. a detailed LOB clause and anti-abuse measures to counteract conduit arrangements.<sup>8</sup> The anti-abuse measures could stem from domestic law (such as the US conduit financing rules<sup>9</sup>) or could be treaty based (such as the anti-conduit rule contained in Article 3(1)(n) of the 2001 US–UK tax treaty<sup>10</sup>). In order to meet this minimum standard, 87 jurisdictions have signed the Multilateral Instrument<sup>11</sup> (as at 9 April 2019) and will adopt the revised preamble<sup>12</sup> and, for the

<sup>1</sup> OECD/G20 Base Erosion and Profit Shifting Project, *BEPS Project Explanatory Statement—2015 Final Reports* (Paris: OECD Publishing, 2015), 4.

<sup>2</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5—2015 Final Report (Action 5)* (Paris: OECD Publishing, 2015), available at: <http://dx.doi.org/10.1787/9789264241190-en> [Accessed 18 June 2019].

<sup>3</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report (Action 6)* (Paris: OECD Publishing, 2015).

<sup>4</sup> Action 6, above fn.3, paras 72–74.

<sup>5</sup> Action 6, above fn.3, para.26; OECD, *Model Tax Convention on Income and on Capital 2017 (Full Version)* (Paris: OECD Publishing, 2019) (OECD MC 2017), available at: <https://doi.org/10.1787/g2g972ee-en> [Accessed 13 June 2019] Art.29(9).

<sup>6</sup> OECD MC 2017, above fn.5, Art.29(1)–(7).

<sup>7</sup> Action 6, above fn.3, para.25 (Commentary in para.2); OECD MC 2017, above fn.5, Commentary on Article 29, para.2.

<sup>8</sup> Action 6, above fn.3, para.25 (Commentary in para.3); OECD MC 2017, above fn.5, Commentary on Article 29, para.3.

<sup>9</sup> See US IRC s.881 read in conjunction with US Treasury regulations, 1.881-3.

<sup>10</sup> See Art.3(1)(n), UK–US Double Taxation Convention (2001) as amended by the 2002 protocol. The provision provides for an objective and motive test.

<sup>11</sup> OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (Multilateral Convention 2016) (24 November 2016).

<sup>12</sup> See Multilateral Convention 2016, above fn.11, Art.6(1); OECD MC 2017, above fn.5, Title and Preamble.

most part, the PPT rule.<sup>13</sup> To the extent that the PPT will form part of a tax treaty, arrangements that are linked to *core commercial activity*<sup>14</sup> will be allowed to claim treaty benefits. In other words, transactions through shell companies or back-to-back arrangements that lack a commercial rationale will not be granted treaty benefits. As the PPT has already been discussed extensively, the authors will focus on its subjective and objective elements and will not undertake a critical analysis of all its elements.<sup>15</sup> Moreover, as only a few states<sup>16</sup> have opted for the LOB clause (in particular, the simplified LOB clause), this provision will also not be discussed hereinafter.

With respect to the policy surrounding the arm's length principle, BEPS Actions 8–10<sup>17</sup> were dedicated to ensuring that transfer pricing outcomes are in line with *value creation*. In this regard, the revised Transfer Pricing Guidelines,<sup>18</sup> in addition to several other changes, provide that an entity will be allocated risks (and the underlying income associated therewith) only to the extent that the entity through its personnel *controls the risks* and has the financial means, that is, the financial capacity, to assume those risks.<sup>19</sup>

Last, with respect to EU Tax Policy, the EU Commission released an anti-tax avoidance package.<sup>20</sup> Among several initiatives, the package consisted of an Anti-Tax Avoidance Directive (ATAD).<sup>21</sup> The main purpose of the ATAD,<sup>22</sup> which was adopted in July 2016, is to ensure efficient, coherent, co-ordinated and swift incorporation of BEPS measures within the EU.<sup>23</sup> Towards this end, the ATAD lays out a minimum framework (set of rules) that Member States have to transpose in to their domestic law. Essentially, Member States are required to implement a statutory General Anti-Abuse Rule (GAAR)<sup>24</sup> and controlled foreign company (CFC) rules<sup>25</sup>

<sup>13</sup> See Multilateral Convention 2016, above fn.11, Art.7(1); OECD MC 2017, above fn.5, Art.29(9).

<sup>14</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.181.

<sup>15</sup> B. Kuźniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application" (2018) 10 *World Tax Journal* 233; R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups" (2018) 72(1) *Bulletin for International Taxation* 31; R. Danon and H. Salomé, "The BEPS Multilateral Instrument — General overview and focus on treaty abuse" [2017] *IFF Forum für Steurrecht* 197, 223–235; L. De Broe and J. Luts, "BEPS Action 6: Tax Treaty Abuse" (2015) 43(2) *Intertax* 122; L. De Broe, "Tax Treaty and the EU Law aspects of the LOB and PPT provision proposed by BEPS Action 6" in R. Danon (ed.), *Base Erosion and Profit Shifting (BEPS) – Impact for European and international tax policy* (Geneva, Zurich and Basel: Schulthess, 2016); M. Lang, "BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties" (2014) 74(7) *Tax Notes International* 655.

<sup>16</sup> Namely Argentina, India, Norway and Russia.

<sup>17</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10: 2015 Final Reports* (Paris: OECD Publishing, 5 October 2015). The OECD Council approved these amendments on 23 May 2016.

<sup>18</sup> OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD, TP Guidelines 2017) (Paris: OECD Publishing, 2017).

<sup>19</sup> OECD, TP Guidelines 2017, above fn.18, paras 1.64–1.66.

<sup>20</sup> For further information, see EU Commission, *Anti Tax Avoidance Package*, available at: [https://ec.europa.eu/taxation\\_customs/business/company-tax/anti-tax-avoidance-package\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en) [Accessed 26 June 2019].

<sup>21</sup> For a general discussion on the ATAD see P. Pistone (ed.), *European Tax Integration: Law, Policy and Politics* (Amsterdam: IBFD, 2018).

<sup>22</sup> Council Directive (EU) 2016/1164/EU of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1.

<sup>23</sup> Directive 2016/1164/EU, above fn.22, 2.

<sup>24</sup> Directive 2016/1164/EU, above fn.22, Art.6.

<sup>25</sup> Directive 2016/1164/EU, above fn.22, Arts 7–8.

among other measures.<sup>26</sup> However, according to the ATAD, these anti-abuse rules may not apply if the arrangements undertaken by taxpayers are for *valid commercial reasons which reflect economic reality* or reflect *substantial economic activities* respectively.<sup>27</sup>

### 1.2. The relevant economic activity test

If one consolidates the concepts of *substantial activities*, *core commercial activity*, *controls over risks*, *economic reality* and *substantial economic activities*, it could be argued that if the taxpayer demonstrates not only the commercial rationale of the arrangement (non-fiscal purposes) but also its economic rationale, then that taxpayer should be given access to the benefits offered by the international corporate tax framework. To elaborate, from an economic standpoint, the taxpayer can demonstrate that it carries out the *relevant economic activities* (or core income generating activities) with respect to the underlying income that it receives. This would typically be the case when a taxpayer entity in a corporate group demonstrates that: 1. its personnel (board and/or operating staff to the extent relevant) make key decisions with respect to the risks associated with that entity's activities; 2. the core income generating functions of the entity are carried out by the entity's personnel; 3. the entity owns/leases the necessary office space and/or equipment to carry out its activities. In these circumstances, the taxpayer entity should be:

- allocated substantial returns (income) from a transfer pricing perspective;
- given access to tax treaty benefits for the income it derives;
- given access to benefits granted by EU law that is, selected anti-abuse rules found in the Parent-Subsidiary Directive (PSD)<sup>28</sup> and the Interest and Royalties Directive (IRD)<sup>29</sup> should not apply. Moreover, the EU ATAD GAAR and CFC Rules (within the EU) should not apply to this entity; and
- given access to substance based preferential regimes.

The next part of this article will substantiate the foregoing argument. The authors will also make certain recommendations in the form of minimum functional profile safeguards to multinational enterprises that make use of holding, financing, intellectual property (IP) and principal structures (see section 2). The issues that arise with respect to the relevant economic activities test will be discussed thereafter, specifically, issues pertaining to tax competition and tax uncertainty (see section 3). Finally, the authors conclude their analysis and discuss the way forward (see section 4).

<sup>26</sup> The other measures relate to an interest limitation rule (Directive 2016/1164/EU, above fn.22, Art.4); an immediate exit tax rule (Directive 2016/1164/EU, above fn.22, Art.5); and anti-hybrid rules (Directive 2016/1164/EU, above fn.22, Art.9). As highlighted in s.1.3, a discussion on these measures is beyond the scope of this article.

<sup>27</sup> The exclusion for CFC rules only applies to intra-EU situations. Therefore, Member States could implement the CFC rule without a carve-out for genuine activities of subsidiaries or permanent establishments outside the EU. For a criticism of this form of "fiscal protectionism", see R. Danon, "Some Observations on the Carve-Out Clause of Article 7(2)(a) of the ATAD with Regard to Third Countries" in P. Pistone and D. Weber (eds), *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (Amsterdam: IBFD, 2018), 387–407.

<sup>28</sup> Council Directive (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2015] OJ L21/1.

<sup>29</sup> Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States [2003] OJ L157/49.

### 1.3. Further matters not discussed in this article

As this article focuses on economic activities carried out in a taxpayer entity, the authors will not include a discussion of rules relating to hybrid entities and instruments,<sup>30</sup> rules limiting interest deductions,<sup>31</sup> rules to counter artificial avoidance of the permanent establishment status<sup>32</sup> and the international corporate tax policy debate triggered by the digitalisation of the economy.<sup>33</sup> Neither will the authors include a discussion of the concept of beneficial ownership as found in Articles 10, 11 and 12 of the OECD Model<sup>34</sup> and the EU IRD.<sup>35</sup> Moreover, *with respect to EU law*, the authors will not engage in a debate on EU state aid rules.

## 2. The arguable impact of the relevant economic activities test on the international corporate tax framework

### 2.1. Risk and income allocation from a transfer pricing perspective

Article 9 of the OECD Model provides for the application of the arm's length principle for transactions among associated enterprises. Specifically, Article 9(1) discusses those situations in which the tax administration may invoke a primary adjustment. It is clear that price adjustments are permitted. Disputably, structural adjustments are also allowed.<sup>36</sup> This being said, such

<sup>30</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD Publishing, 2015).

<sup>31</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2016 Update: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2017).

<sup>32</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Paris: OECD Publishing, 2015).

<sup>33</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD Publishing, 2015); OECD, *Tax Challenges Arising from Digitalisation—Interim Report 2018* (Paris: OECD Publishing, 2018).

<sup>34</sup> For an analysis of the concept see A. Meindl-Ringler, *Beneficial Ownership in International Tax Law* (Alphen aan den Rijn: Kluwer, 2016).

<sup>35</sup> See I. Lazarov, "(Un)Tangling Tax Avoidance Under the Interest and Royalties Directive: the Opinion of AG Kokott in *N Luxembourg 1*" (2018) 46(11) *Intertax* 873.

<sup>36</sup> Transactions undertaken by the taxpayer should be respected. However, at the outset, the question arises as to whether OECD MC 2017, above fn.5, Art.9(1) allows a state to re-characterise the transaction as structured by the taxpayer (entire arrangement or a part of the arrangement) if it is not at arm's length. The OECD believes that this is indeed possible in "exceptional" cases. See OECD, *Transfer Pricing Guidelines* (1979), para.23 and OECD, *Transfer Pricing Guidelines* (2010), para.1.64. According to the 2010 Guidelines, transactions can be re-characterised when: 1. their form does not correspond to the underlying economic substance; or 2. when they are commercially irrational, and the structure of the transaction practically impedes the tax administration from determining an appropriate transfer price. See OECD, *Transfer Pricing Guidelines* (2010), para.1.65. However, the 2017 Guidelines seem to have modified the OECD's position on these two exceptions. First, the economic substance exception has been deleted. Arguably, this seems justified given that the focus of the revised guidance on accurately delineating the transaction seems to be on factual substance, that is, identifying the legal substance of the commercial or financial relations between the parties and understanding the controlled transaction by analysing all the economically relevant characteristics. See OECD, *TP Guidelines 2017*, above fn.18, paras 1.119–1.120. Also see, R. Collier and J.L. Andrus, *Transfer Pricing and the Arm's Length Principle* (Oxford: OUP, 2017), 199. Secondly, the scope of the commercially irrational exception has been redrafted. Essentially, the tax administration will have to prove that, in addition to the transaction being commercially irrational, the structure of the transaction prevents the determination of the price that would be acceptable to both parties given their respective realistically available options. The guidance on non-recognition will not apply when a comparable transaction exists. See OECD, *TP Guidelines 2017*, above fn.18, paras 1.121–1.123;

adjustments can only be made to the extent authorised by the domestic transfer pricing legislation.<sup>37</sup> On the other hand, if a state makes a price or structural adjustment under Article 9(1), the other state, to the extent that it agrees with the primary adjustment, will be required to provide, in accordance with Article 9(2), a corresponding adjustment.

The application of the arm's length principle is a two-step process. The first step involves an accurate delineation of the transaction whereas the second step involves reaching an arm's length outcome for the transaction. With respect to the first step, in order to accurately delineate a transaction or find the real deal, the post-BEPS transfer pricing guidance establishes a strong link between income (return) allocation and risk assumption.<sup>38</sup> In this regard, a detailed framework for analysing the relevant or economically significant risks is provided.<sup>39</sup> Essentially, the framework provides that the risks and returns should be allocated to the entity that "controls"<sup>40</sup> the risk and has the financial means<sup>41</sup> to bear the risk even if the intra group contracts allocate the risk to another party.<sup>42</sup>

Arguably the "control" test<sup>43</sup> is met when the entity employs relevant personnel<sup>44</sup> (directors and/or employees) and the functions of this personnel demonstrate that they not only have the capability to perform and make decisions but they also make decisions with respect to: 1. taking on, laying off or declining the key risks associated with the relevant economic activities; and 2. deciding whether and how to respond to the risks associated with their decision-making opportunity. Even if the day-to-day functions/economic activities associated with the risks are outsourced, the outcome should also be similar as long as the personnel in the entity (claiming control over risk) are able to demonstrate that they can oversee and manage the outsourced risks.<sup>45</sup> Moreover, it could be argued that the entity would have the financial means<sup>46</sup> when the entity has the appropriate access to the funding to take on or to lay off the risk, to pay for the risk

also see Collier and Andrus, above, 201–202. In the authors' opinion, the wording of Art.9 does permit structural adjustments.

<sup>37</sup> OECD MC 2017, above fn.5, Art.9(1) does not create "new" taxing rights. The provision, similar to other treaty provisions, restricts the application of domestic law provisions. Therefore, structural adjustments can be made only to the extent authorised by the domestic law. V. Chand, "Transfer Pricing Aspects of Inter company Loans in light of the BEPS Action Plan" (2016) 44(12) *Intertax* 885, 885–889.

<sup>38</sup> OECD, TP Guidelines 2017, above fn. 18, paras 1.56–1.59; UN, *Practical Manual on Transfer Pricing for Developing Countries* (UN, TP Manual (2017)) (2017), paras B.2.3.2.23–B.2.3.2.24.

<sup>39</sup> OECD, TP Guidelines 2017, above fn. 18, para. 1.60; UN, TP Manual (2017), above fn.38, para.B.2.3.2.25. It should be noted that the pre-BEPS chapter on business restructurings only indicated these requirements as potential indicators to allocate risks. See Collier and Andrus, above fn.36, 203.

<sup>40</sup> OECD, TP Guidelines 2017, above fn.18, para.1.65; UN, TP Manual (2017), above fn.38, para.B.2.3.2.35.

<sup>41</sup> OECD, TP Guidelines 2017, above fn.18, para.1.64; UN, TP Manual (2017), above fn.38, paras B.2.3.2.38–B.2.3.2.40.

<sup>42</sup> I. Verlinden, D. Ledure and M. Dessy, "The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard" (2016) 23 *International Transfer Pricing Journal* 109, 110–112.

<sup>43</sup> Also see W. Schön, "International Taxation of Risk" (2014) 68 *Bulletin for International Taxation* 280, 288–290; J. Monsenego, "The Substance Requirement in the OECD Transfer Pricing Guidelines: What Is the Substance of the Substance Requirement?" (2014) 21 *International Transfer Pricing Journal* 9, 14–15.

<sup>44</sup> Such decision makers need to have the right competence and experience to make the decisions. See OECD, TP Guidelines 2017, above fn. 18, para. 1.66; UN, TP Manual (2017), above fn.38, para.B.2.3.2.36. For a detailed discussion on this matter, see Monsenego, above fn.43, 12–13.

<sup>45</sup> OECD, TP Guidelines 2017, above fn.18, para.1.65; UN, TP Manual (2017), above fn.38, paras B.2.3.2.35–B.2.3.2.37.

<sup>46</sup> A commentator has argued that the guidance on the financial capacity test is rather limited. See Monsenego, above fn.43, 15–16.

mitigation functions (insurance or hedging) and to bear the consequences of the risk if it materialises.<sup>47</sup> Thus, if a functional analysis leads to the finding that the personnel of an entity make key decisions vis-à-vis the economically significant risks associated with the *relevant economic activities* and the entity has the financial means to assume those risks, then, from a transfer pricing perspective the risks and the underlying income connected with those risks should be allocated to that entity.<sup>48</sup> Conversely, if a functional analysis in all of the aforementioned situations leads to the finding that the key decisions vis-à-vis the economically significant risks associated with the entity's business are not made by the entity's personnel but rather the personnel of another entity in a MNE group then the tax administration of the other entity's state may initiate an assessment to accurately delineate the transaction. Essentially, an accurate delineation would reallocate the underlying income associated with those risks to the other entity.<sup>49</sup>

## 2.2. Access to tax treaty benefits

The PPT states that a treaty benefit<sup>50</sup> will be denied to the taxpayer when “one of the principal purposes” of the transaction/arrangement/structure is to obtain that benefit (subjective element<sup>51</sup>). In which case the taxpayer is given the opportunity to prove that “granting the benefit is in accordance with the object and purpose of the relevant provisions” (objective element<sup>52</sup>).

The expression “one of the principal purposes” raises questions with regard to its interpretation. It could be argued that the subjective element of the PPT is not satisfied if the taxpayer is able to demonstrate that its transaction is rational from a commercial and/or economic perspective. To illustrate this, the authors differentiate between the following two situations<sup>53</sup>: 1. genuine intermediary structures used by corporate groups that reflect commercial and economic reality (economic nexus to a state); and 2. back-to-back arrangements, which are structured through economic operators and which may not or may lack commercial rationale (these being abusive arrangements).<sup>54</sup>

With respect to the first situation, if an objective analysis of all facts and circumstances leads to the conclusion that the structure is commercially and economically rational then the taxpayer will not satisfy the subjective element and consequently the treaty benefit will be granted.<sup>55</sup> The OECD Commentary supports this position and indicates:

<sup>47</sup> OECD, TP Guidelines 2017, above fn.18, para.1.64; UN, TP Manual (2017), above fn.38, paras B.2.3.2.38–B.2.3.2.40.

<sup>48</sup> See Collier and Andrus, above fn.36, 229.

<sup>49</sup> OECD, TP Guidelines 2017, above fn.18, para.1.66; UN, TP Manual (2017), above fn.38, para.B.2.3.2.36.

<sup>50</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.175. For a detailed discussion on this matter, see V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special considerations for the BEPS project)* (Zurich: Schulthess, 2018), s.9.3.2; De Broe (2016), above fn.15, 210; Danon (2018), above fn.15, 42.

<sup>51</sup> For a critical discussion on this element, see De Broe and Luts, above fn.15, 132; De Broe (2016), above fn.15, 237–238; Chand, above fn.50, s.9.3.3.

<sup>52</sup> For a critical discussion on this element, see Chand, above fn.50, s. 9.3.4; De Broe, above fn.15, *EU Law*, 213.

<sup>53</sup> The authors restrict themselves to these two situations for the purpose of the contribution. Other fact patterns can of course also be analysed under the PPT (such as rule shopping schemes).

<sup>54</sup> Another author has recently differentiated between these two situations while analysing the PPT, see S. van Weeghel, “A Deconstruction of the Principal Purposes Test” (2019) 11 *World Tax Journal* 3.

<sup>55</sup> See, e.g. *Carrefour* decision (South Korea, 2012du16466, 2014.7.10), where the court ruled that a Dutch BV was not a conduit company as it had several subsidiaries, physical substance, discretionary authority over cash and was not established for the purpose of tax avoidance.



“[W]here an arrangement is inextricably linked to a *core commercial activity*,... it is unlikely that its principal purpose will be considered to be to obtain that benefit.” (Emphasis added).<sup>56</sup>

This conclusion can also be derived from several examples discussed in the OECD Commentary with respect to the PPT.<sup>57</sup> For instance, referring to the fact patterns that deal with intermediary companies, that are owned by third state residents, and which have been set up to carry out core economic activities:

- Example G<sup>58</sup> deals with provision of genuine intra group services. In that example, the intermediary entity (RCO) in State R is given access to treaty benefits. This is because of commercial and economic aspects. The first aspect relates to commercial reasons for selecting State R. After considering different locations, TCO chooses State R because of the availability of a skilled work force, a dependable legal system, a business friendly setting, political stability, membership of a regional block, a sophisticated banking industry and the comprehensive double taxation treaty network of State R, including its tax treaties with the five states in which TCO owns subsidiaries. The second aspect relates to the relevant economic activities carried out by the intermediary in State R. The Commentary states:

“Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded [by] State R.”<sup>59</sup>

- Example H<sup>60</sup> deals with investment activities carried out by an operating entity through debt and equity investments. In that example, the intermediary entity (RCO) in State R is given access to treaty benefits on the interest and dividend income. This is because of the following two main aspects. The first aspect relates to commercial aspects, that is, non-tax reasons for the establishment of RCO in State R and the reasons for selecting State R. The facts indicate that TCO had difficulties in conducting its international business from State T mainly because of issues related to transportation, time differences, limited availability of personnel fluent in foreign languages and the foreign location of business partners. Thus, in order to develop a base for its foreign business activities, TCO establishes RCO. Moreover, State R is selected because of its developed international trade and financial markets and abundance of highly qualified human resources. The second aspect relates to the relevant economic activities carried out by the intermediary in State R. The facts state that RCO carries on diverse business activities such as

<sup>56</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.181.

<sup>57</sup> On the importance of the OECD Commentary, see Danon (2018), above fn.15, 48–50.

<sup>58</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example G.

<sup>59</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example G.

<sup>60</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example H.

wholesaling, retailing, manufacturing, financing and domestic and international investment. RCO's employees (personnel working in areas such as legal, finance, accounting, taxation, risk management, auditing and internal control) perform these activities. Furthermore, RCO possesses the necessary financial resources to conduct its activities. Consequently, in light of these aspects, it is clear that RCO carries out genuine economic activities that may constitute an active conduct of business. Given these facts, RCO's creation in State R and its investment in SCO are not driven by the avoidance of taxes in State S. Therefore, the subjective element should not be satisfied, and the treaty benefit should be granted.

- In Example K,<sup>61</sup> the intermediary entity (RCO) that acts as a regional investment platform is given access to treaty benefits. This is because of the following two considerations. The first consideration relates to commercial reasons for selecting State R. The facts indicate that State R was selected because of the availability of knowledgeable directors with experience of regional business practices and regulations, the existence of a skilled multilingual workforce, State R's membership of a regional grouping and the extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates. The second consideration relates to the relevant economic activities carried out by the intermediary in State R. The facts state that RCO's activities are carried out by: 1. a board of directors that are comprised of a majority of State R residents (with expertise in investment management) and the members of the Fund's global management team; and 2. an experienced local management team that reviews investment recommendations from the Fund and performs various other functions such as approving and monitoring investments, carrying on treasury functions, maintaining RCO's books and records, and ensuring compliance with regulatory requirements in states where it invests. Given these facts, it is clear that RCO's creation in State R and its investment in SCO are not driven by the purpose of avoiding taxes in State S. Therefore, the subjective element should not be satisfied based on these facts and the treaty benefit should be granted.

On the contrary, if an objective analysis of all facts and circumstances leads to the conclusion that the main purpose of the arrangement was to obtain a tax benefit then the taxpayer will satisfy the subjective element.<sup>62</sup>

Similarly, with respect to the second situation, it is obvious that if a factual analysis of all facts and circumstances surrounding the transaction leads to the conclusion that the back-to-back arrangement has been entered into with the principal purpose of obtaining a tax benefit then there is no doubt that the subjective element should be satisfied. This would typically be the case when a third state resident uses an economic operator (financial institution or a related entity)

<sup>61</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example K.

<sup>62</sup> See for instance the fact patterns in *MIL (Investments) SA v Canada* [2006] 9 ITLR 25 and *Alta Energy Luxembourg SARL v R* [2018] 21 ITLR 219.

for artificial arrangements. For instance, see example A<sup>63</sup> and B<sup>64</sup> in the Commentary to the PPT as well as examples A,<sup>65</sup> C<sup>66</sup> and D<sup>67</sup> in the Commentary on anti-conduits. These arrangements are carried out with the sole purpose of obtaining tax advantages. On the other hand, if the commercial rationale of such back-to-back arrangements can be demonstrated then the subjective element should not be satisfied. For instance, refer to the fact patterns that deal with following back-to-back arrangements:

- Example E<sup>68</sup> in the Commentary on anti-conduit arrangements discusses a back-to-back licensing situation. The Commentary states that treaty benefits should be granted to the royalty income as RCO (intermediary)

“is conforming to the standard commercial organisation and behaviour of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favourable benefits”.

In this example, it seems that the treaty benefit is available as long as the taxpayer is able to demonstrate commercial reasons for setting up the licensing arrangements. Arguably, from a transfer pricing perspective the majority of the income should be allocated to the relevant subsidiary as it bears the risks associated with the development of the intellectual property.

- Example F<sup>69</sup> in the Commentary on anti-conduits discusses a back-to-back financing situation. In this case, treaty benefits are granted to the intermediary treasury (RCO)

<sup>63</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example A. The facts in this example are similar to the facts of the 1994 *Royal Dutch Oil Company/Marketmaker* judgment (Netherlands, Hoge Raad judgment of 6 June 1994, BNB 1994/217). For a detailed analysis of the judgment see L. De Broe, *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, Doctoral Series Vol.14 (Amsterdam: IBFD, 2007), 694–697.

<sup>64</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example B. The facts in this example are similar to the facts of the 2006 *Bank of Scotland* judgment. See *Ministre de l’Economie, des Finances et de l’Industrie v Société Bank of Scotland* [2006] 9 ITLR 683.

<sup>65</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example A. The example directly resembles the fact pattern contained in Example 1 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty.

<sup>66</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example C. The example directly resembles the fact pattern contained in Example 3 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty.

<sup>67</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example D. The example directly resembles the fact pattern contained in Example 4 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty. Also see Rev. Rul. 87–89, 1987–2, C.B. 195.

<sup>68</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example E. The example directly resembles the fact pattern contained in Example 5 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty. For a detailed analysis of Example E, see R. Danon, “Intellectual Property (IP) Income and Tax Treaty Abuse: Relevance of BEPS Action 5 and 8–10 for the Principal Purpose Test” in G. Maisto (ed.), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties* (Amsterdam: IBFD, 2018), 17–34.

<sup>69</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example F. The example directly resembles the fact pattern contained in Example 6 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty.

entity on the interest income it receives from State S. This is because: 1. RCO is established with the purpose of carrying out financing activities; 2. RCO carries out these activities through several employees; 3. RCO employs the relevant assets; and 4. RCO, through its personnel, assumes the financial risks associated with those activities such as interest rate and currency risks. Arguably, treaty benefits are allowed as RCO has demonstrated, through its personnel, that it takes business-related risks with respect to the underlying income.

If the taxpayer satisfies the subjective element, the question arises as to how the objective element is to be interpreted. In this regard, the authors submit that a two-stage analysis<sup>70</sup> will be required to ascertain the object and purpose of the “relevant provisions”. Under the first stage, the taxpayer has to determine the object and purpose of the “relevant provisions”<sup>71</sup> in light of the objectives pursued by the tax treaty (legal analysis). In this context, to the extent that the new preamble is incorporated in tax treaties, it could be argued that the following objectives shall be considered in the treaty interpretation process (while interpreting the PPT) as opposed to giving preference to one particular objective: 1. allocating taxing rights and eliminating double taxation with a view to promoting cross border flows (such as investments); 2. the prevention of tax evasion; and 3. prevention of tax avoidance (in particular, treaty shopping). The addition of the tax avoidance objective will ensure that

“tax conventions apply in accordance with the purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons...”.<sup>72</sup>

Thus, the object and purpose of the “relevant provisions” have to be read in light of the object and purpose of the entire tax treaty.<sup>73</sup> Thereafter, under the second stage, the taxpayer will have to demonstrate that the transaction/arrangement respects the object and purpose of the “relevant provisions” at stake (application of the legal analysis to the facts at stake).

For instance, consider a case where a resident of a third state (TCO in State T) sets up a shell entity/letterbox (RCO in State R) which then invests in shares of a subsidiary (SCO in State S). The main reason for choosing State R is its tax treaty with State S (Article 13 of the tax treaty allocates taxing rights on capital gains to the state of residence). Let us assume that the facts indicate that one of the principal purposes (or the sole purpose) for interposing RCO was to obtain a tax benefit and hence the subjective element is satisfied. With respect to the application of the objective element, under the first stage, the taxpayer will establish that: 1. the object and

<sup>70</sup> See *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601; 2005 SCC 54 (CanLII) at [44]–[62]; Chand, above fn.50, s.9.3.4.

<sup>71</sup> Arguably, the PPT becomes redundant if only the object and purpose of the “relevant provisions” are considered. This is because, in a tax avoidance scheme, a resident taxpayer always respects the formal conditions of tax treaties such as the conditions imposed by the time limit provisions (OECD MC 2017, above fn.5, Art.5(3)), ownership threshold (OECD MC 2017 Art.10(2)) or the relevant distributive rule (for instance, OECD MC 2017 Arts 10, 11, 12 and 13). Accordingly, such an approach that focuses on a literal interpretation of ordinary treaty terms should be rejected. See Chand, above fn.50, s.9.3.4.

<sup>72</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.174.

<sup>73</sup> Moreover, to the extent relevant, other treaty objectives such as elimination of tax discrimination as provided in OECD MC 2017, above fn.5, Art.24 and the establishment of a mutual agreement procedure (MAP) as per OECD MC 2017 Art.25 should be taken into consideration. See Chand, above fn.50, s.9.3.4.

purpose of Article 13 is to allocate taxing rights vis-à-vis capital gains; and 2. the object and purpose of tax treaties is to: (a) allocate taxing rights and eliminate double taxation with a view to promoting cross border investments; (b) prevent tax evasion; and (c) prevent tax avoidance. Under the second stage, RCO will be able to demonstrate that it has acted in accordance with: 1. the object and purpose of Article 13 as it has complied with its formal conditions for applying the treaty in the sense that it is a person, a resident and its income falls under the distributive rule that deals with capital gains; and 2. the object and purpose of tax treaties as: (a) it has complied with the intent of such tax treaties which is to promote cross border investment, that is, it invests in State S; and (b) the transaction does not represent a tax evasion scheme. With respect to (c) it will be difficult for RCO to prove that its transaction represents a “genuine”/“bona fide” transaction, as an objective analysis of the facts would indicate the presence of a high degree of “artificiality” (as it is a letterbox). Therefore, the PPT would apply as the taxpayer may not be able to establish that the principal purpose of seeking the tax benefit was within the object, spirit and purpose of the provisions that confer the tax benefit. This said, the analysis of the subjective and objective element will be different if the taxpayer is able to demonstrate a commercial and/or economic rationale with respect to the arrangements (for instance, as explained in examples G, H and K above).

Similarly, in back-to-back arrangements as discussed in examples A and B in the Commentary to the PPT as well as examples A and C in the Commentary on anti-conduits, it will be difficult for the taxpayer to prove that the principal purpose of seeking the tax benefit was within the object, spirit and purpose of the provisions that confer the tax benefit. This said, the analysis of the objective element will be different if the taxpayer is able to demonstrate a commercial rationale of its arrangements (for instance, as explained in examples E and F above).

### 2.3. Access to EU tax law

#### 2.3.1. Abuse of rights doctrine in EU law

It is clear from CJEU case law that a taxpayer entity (an economic operator) cannot invoke EU law (treaty freedoms) in fraudulent situations (for instance sham/simulated transactions or false declarations).<sup>74</sup> On the other hand, for transactions that are legally effective, an economic operator cannot access treaty freedoms in abusive situations. In this regard, it is argued that the CJEU

<sup>74</sup> For instance, see the following CJEU decisions: *Van Binsbergen v Bedrijfsvereniging voor de Metaalnijverheid* (C-33/74) [1974] ECR 1299 at [13]; *Alexandros Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* (C-367/96) [1998] ECR I-2843 at [20]; *Dionysios Diamantis v Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* (C-373/97) [2000] ECR I-1705 at [33]; *I/S Fini H v Skatteministeriet* (C-32/03) [2005] ECR I-1599 at [32].

has created an “abuse of rights” doctrine<sup>75</sup> and that this doctrine may be used to interpret EU law.<sup>76</sup>

With respect to the application of the doctrine in non-direct tax matters, the CJEU in *Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas*<sup>77</sup> and *Halifax plc and others v CC&E (Halifax)*<sup>78</sup> has developed a two-fold, that is, subjective and objective, test in order to determine whether or not abuse has arisen. Abuse will be determined to have arisen when the economic operator exercises its right to free movement with the sole intention (or principal, essential or predominant intention)<sup>79</sup> of obtaining benefits through artificial schemes and granting the benefits would be contrary to the object and purpose of the relevant provisions of EU law (primary or secondary law).<sup>80</sup>

Recent judgments of the CJEU in the context of the IRD<sup>81</sup> and PSD<sup>82</sup> confirm the position that this doctrine can be invoked by Member States to deny protection in harmonised areas of direct taxation within the EU.<sup>83</sup> This said, it could be argued that the doctrine should not apply to structures or arrangements that are rational from a commercial and/or economic perspective (this matter is further discussed in section 2.3.3).

<sup>75</sup> For instance, see the following CJEU case law: *J. Knoors v Staatssecretaris van Economische Zaken* (C-115/78) [1979] ECR 399; *Criminal proceedings against Marc Gaston Bouchoucha* (C-61/89) [1990] ECR I-3551; *R. v Immigration Appeal Tribunal and Surinder Singh, Ex p. Secretary of State for Home Department* (C-370/90) [1992] ECR I-4265; *Vereniging Veronica Omroep Organisatie v Commissariaat voor de Media* (C-148/91) [1993] ECR I-487; *TV10 SA v Commissariaat voor de Media* (C-23/93) [1994] ECR I-4795; *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (C-212/97) [1999] ECR I-1459.

<sup>76</sup> For a detailed analysis, see L. De Broe and D. Beckers, “The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: An Analysis Against the Wider Perspective of the European Court of Justice’s Case Law on Abuse of EU Law” (2017) 26 *EC Tax Review* 133, 136–139; R. de la Feria, “Prohibition of Abuse of (Community) Law: The Creation of a New General Principle of EC Law Through Tax” (2008) 45(2) *Common Market Law Review* 395.

<sup>77</sup> *Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas* (C-110/99) [2000] ECR I-11569 at [52]–[53].

<sup>78</sup> *Halifax plc and others v CC&E* (C-255/02) [2006] ECR I-1609 at [74]–[75].

<sup>79</sup> On such terminological differences, see C. Öner, “Is Tax Avoidance the Theory of Everything in Tax Law? A Terminological Analysis of EU Legislation and Case Law” (2018) 27(2) *EC Tax Review* 96, 105–107; De Broe and Beckers, above fn.76, 134–135.

<sup>80</sup> De Broe and Beckers, above fn.76, 133.

<sup>81</sup> *N Luxembourg 1 and others v Skatteministeriet (N Luxembourg 1 and others)* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) EU:C:2019:134 at [96]–[122].

<sup>82</sup> *Skatteministeriet v T Danmark and Y Denmark Aps (T Danmark and Y Denmark Aps)* (Joined Cases C-116/16 and C-117/16) EU:C:2019:135 at [70]–[95].

<sup>83</sup> However, whether Member States can apply this doctrine in the area of non-harmonised direct taxation is still debatable. For a detailed discussion, see: De Broe and Beckers, above fn.76, 137–139. C. Brokelind and P. Wattel in P.J. Wattel, H. Vermeulen and O. Marres (eds), *European Tax Law: Volume I (Full Edition)*, 7th edn (Alphen aan den Rijn: Kluwer Law International, 2018), 666–667.

### 2.3.2. Domestic anti-abuse measures (CFC rules) and EU law

Broadly, when the CJEU<sup>84</sup> analyses the compatibility of a domestic rule (including national anti-avoidance rules) with treaty freedoms,<sup>85</sup> as a first step, it analyses whether that national rule leads to a restriction or discrimination. In this regard, with respect to CFC rules, in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC (Cadbury Schweppes)*,<sup>86</sup> it was held that the UK CFC rules constituted a restriction on the freedom of establishment as they deterred UK companies from setting up subsidiaries overseas whereas the rules did not apply to domestic subsidiaries.

If an obstacle to free movement arises, then the CJEU analyses whether the national law measure can be justified by overriding reasons of public interest. For national direct tax law measures that amount to obstacles, the CJEU has accepted justifications<sup>87</sup> such as the need to maintain the coherence of a tax system,<sup>88</sup> the need to protect balanced allocation of taxing rights,<sup>89</sup> the need for effective fiscal supervision<sup>90</sup> and the need to prevent tax evasion and avoidance or abuse of law. With respect to the tax avoidance justification, the CJEU has held that national legislation that reduces the risk of tax avoidance could be justified, subject to the proportionality requirement.<sup>91</sup>

With respect to the proportionality test, the CJEU in the *Cadbury Schweppes* judgment held that UK CFC rules could be proportional only if they apply to wholly artificial arrangements. However, if they apply to arrangements that encompass economic reality then such rules will be contrary to the freedom of establishment provisions even though the arrangement contained tax motives. In the CJEU's verdict, "wholly artificial arrangements" exist when the CFC does not have any "premises, staff and equipment"<sup>92</sup> and can be characterised as a "letterbox".<sup>93</sup>

<sup>84</sup> *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* (C-324/00) [2002] ECR I-11779 at [26]; *Test Claimants in the Thin Cap Group Litigation v IRC (Test Claimants Thin Cap Group)* (C-524/04) [2007] ECR I-2107 at [25]; *NV Lammers & Van Cleeff v Belgische Staat (Lammers & Van Cleeff)* (C-105/07) [2008] ECR I-173 at [12]; also see Wattel, *European Tax Law*, above fn.83, 45–49; De Broe, above fn.63, 748; A. Armenia and A. Zalasinski, "EU Report" in IFA, *The taxation of foreign passive income for groups of companies, Cahiers de droit fiscal international* (2013) Vol.98a, 58.

<sup>85</sup> Armenia and Zalasinski, above fn.84, 59; Wattel, *European Tax Law*, above fn.83, 61–76.

<sup>86</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) [2006] ECR I-7995; [2006] STC 1908 at [46]. Also see *Commission v United Kingdom (Commission v UK)* (C-112/14) EU:C:2014:2369 at [20].

<sup>87</sup> Wattel, *European Tax Law*, above fn.83, 70–76.

<sup>88</sup> *Hanns-Martin Bachmann v Belgian State* (C-204/90) [1992] ECR I-249 at [21]–[28]. It should be noted that this justification has been rejected in several direct tax cases pursuant to this judgment. Wattel, *European Tax Law*, above fn.83, 73.

<sup>89</sup> *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo* (C-470/04) [2006] ECR I-7409 at [41]–[49].

<sup>90</sup> *Futura Participations and Singer v Administration des contributions* (C-250/95) [1997] ECR I-2471 at [31]–[35]; *Skatteverket v A* (C-101/05) [2007] ECR I-11531 at [54]–[55]. Also see A. Zalasinski, "Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ's Direct Tax Case Law" (2007) 35(5) *Intertax* 310, 315.

<sup>91</sup> Zalasinski, above fn.90, 315–321. It is also foreseeable that the CJEU may accept a tax avoidance justification in conjunction with other justifications. See Brokelind and Wattel, above fn.83, 667–670.

<sup>92</sup> *Cadbury Schweppes* (C-196/04), above fn.86, [2006] ECR I-7995 at [67].

<sup>93</sup> *Cadbury Schweppes* (C-196/04), above fn.86, [2006] ECR I-7995 at [68]. In line with this argument, the attribution of gain rules, as discussed in the *Commission v UK* case, was also held to violate the free movement of capital provisions as it applied in a general way and was not restricted to wholly artificial arrangements. See *Commission v UK* (C-112/14), above fn.86, EU:C:2014:2369 at [28]–[29].

Article 7 of the ATAD provides for CFC rules. However, Article 7(2)(a) carves out the application of CFC rules when the CFC carries on “substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances”. The carve-out clearly reflects the CJEU’s view expressed in the *Cadbury Schweppes* case. Accordingly, it could be argued that CFC rules are incompatible with the freedom of establishment provisions<sup>94</sup> if they apply to entities that carry out genuine economic activities,<sup>95</sup> that is, entities that are rational from a commercial and/or economic perspective. In fact, the German Federal Tax Court recently also held that the German CFC rules could not be applied to a CFC in Cyprus as the Cypriot entity carried out economic activity.<sup>96</sup> Moreover, the income inclusion rule discussed in Article 7(2)(b) ATAD should also not be applicable as long as the taxpayer satisfies the relevant economic activities test. The ATAD, on the other hand, does not preclude Member States from excluding the above carve-out from EU–third state situations. However, if a Member State applies the ATAD CFC rule to entities in third states which carry out genuine economic activities, it could be argued that such a rule, in certain situations, conflicts with the free movement of capital provisions.<sup>97</sup>

### 2.3.3. Abuse under corporate tax directives

**2.3.3.1. PSD and IRD: domestic or agreement-based measures** In order to combat abuse, Article 1(4) of the PSD<sup>98</sup> and Article 5(1) of the IRD<sup>99</sup> respectively provide that the directives “shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse”. These provisions therefore allow the application of domestic anti-avoidance

<sup>94</sup> See Öner, above fn.79, 107–110; A. Cordewener, “Anti Abuse Measures in Direct Taxation: Towards Converging Standards under Treaty Freedoms and EU Directives” (2017) 26(2) *EC Tax Review* 60, 61–63.

<sup>95</sup> In the context of interaction of domestic thin capitalisation rules with EU law, the CJEU has held that such rules could be incompatible with the freedom of establishment/free movement of capital provisions if they are not predicated on an assessment of objective and verifiable elements for the purposes of determining whether a transaction represents a “wholly artificial arrangement”. Even if the rules provide elements for determining the existence of a “wholly artificial arrangement” such rules could be found incompatible if the taxpayer is not provided with an opportunity to provide a commercial justification (without being subject to administrative hassles) and such rules make profit adjustments to the borrower that exceed the arm’s length standard. See CJEU: *Test Claimants Thin Cap Group* (C-524/04), above fn.84, [2007] ECR I-2107 at [80]–[83]; *Lammers & Van Cleeff* (C-105/07), above fn.84, [2008] ECR I-173, [28]–[29]; *Itelcar - Automóveis de Aluguer Lda v Fazenda Pública (Itelcar)* (C-282/12) EU:C:2013:629 at [37]–[38]; *Société de Gestion Industrielle SA (SGI) v Belgian State* (C-311/08) EU:C:2010:26 at [71]–[72]. Also see Öner, above fn.79, 110–111; moreover, if the outcome of applying a domestic anti-avoidance rule is not clear or is ambiguous such a rule may fail to be proportional; *Itelcar* (C-282/12), above, EU:C:2013:629 at [44]. Brokelind and Wattel, above fn.83, 679; De Broe and Beckers, above fn.76, 135.

<sup>96</sup> *Bundesfinanzhof* (Germany) judgment of 13 June 2018, I R 94/15. For the applicability of EU CFC rules to entities established outside the EU, see R. Danon, “EU Fiscal Protectionism versus Free Movement of Capital: The Case of the ATAD CFC Categorical Model” in P. Pistone (ed.), *European Tax Integration: Law, Policy and Politics* (Amsterdam: IBFD, 2018), 387–407.

<sup>97</sup> A commentator argues that the free movement of capital provisions would apply to a CFC rule that is designed on the basis of ATAD Art.7(1)(a). This is because that rule also applies to parent entities that are entitled to “receive more than 50 percent of the profits” of the CFC. Moreover, by referring to the SECIL case (*SECIL - Companhia Geral de Cal e Cimento SA v Fazenda Pública* (C-464/14) EU:C:2016:896), the commentator argues that a disproportional restriction arises when the CFC rules apply to genuine third state situations. See Danon, above fn.96, 397–407.

<sup>98</sup> Directive (EU) 2015/121.

<sup>99</sup> Directive 2003/49/EC.



rules (domestic safeguard clause hereinafter) as well as tax treaty anti-abuse rules (treaty safeguard clause hereinafter) to deny directive related benefits.

Prior to entering into a discussion on the domestic safeguard provision of the PSD and IRD, it should be noted that pursuant to Article 11(1)(a) (first sentence) of the Merger Directive (MD)<sup>100</sup> its benefits will be denied when a reorganisation “has as its principal objective or as one of its principal objectives tax evasion or tax avoidance”. It is further provided (second sentence) that

“the fact that one of the operations referred to in Article 1 is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives”.

While implementing Article 11(1)(a) of the MD into their national legislation, different Member States have adopted either domestic anti-avoidance rules of a general nature or predetermined criteria in order to deny directive related benefits. This had led tax administrations to deny benefits even in non-abusive situations. However, in several cases, such as *A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2 (Leur-Bloem)*,<sup>101</sup> *Modehuis A. Zwijnenburg BV v Staatssecretaris van Financiën (Zwijnenburg)*,<sup>102</sup> *Foggia - Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais (Foggia)*<sup>103</sup> and *Euro Park Service v Ministre des finances et des comptes publics (Europark)*,<sup>104</sup> the CJEU has held that national anti-avoidance measures that are drafted as general rules or presumptions to exclude certain categories of transactions from tax advantages to deny directive benefits could be disproportionate. Moreover, it was held in *Hans Markus Kofoed v Skatteministeriet (Kofoed)*,<sup>105</sup> by referring to the *Cadbury Schweppes* judgment, that the anti-abuse rules in Article 11(1)(a) “[reflect] the general Community law principle that abuse of rights is prohibited”. The foregoing discussion supports the premise that domestic anti-abuse rules can be applied to the extent that they are applicable to wholly artificial arrangements.

With respect to the application of domestic anti-abuse rules to the PSD, the CJEU, in *Eqiom SAS, formerly Holcim France SAS and Enka SA v Ministre des Finances et des Comptes publics (Eqiom)*<sup>106</sup> as well as the joined cases of *Deister Holding AG and Juhler Holding A/S v*

<sup>100</sup> Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States [2009] OJ L310/34. See Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States [1990] OJ L225/1 Art.11; Directive 2009/133/EC Art.15.

<sup>101</sup> *A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2* (C-28/95) EU:C:1997:369 at [48(b)].  
<sup>102</sup> *Modehuis A. Zwijnenburg BV v Staatssecretaris van Financiën* (C-352/08) EU:C:2010:282, at [44].

<sup>103</sup> *Foggia - Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais* (C-126/10) EU:C:2011:718 at [37].

<sup>104</sup> *Euro Park Service v Ministre des finances et des comptes publics* (C-14/16) EU:C:2017:177 at [57].

<sup>105</sup> *Hans Markus Kofoed v Skatteministeriet* (C-321/05) [2007] ECR I-5795 at [38].

<sup>106</sup> *Eqiom SAS, formerly Holcim France SAS and Enka SA v Ministre des Finances et des Comptes publics* (C-6/16) EU:C:2017:641.

*Bundeszentralamt für Steuern (Deister Holding and Juhler Holding)*,<sup>107</sup> held, as a starting point, that the directive provision authorising a reference to the domestic safeguard clause should be interpreted strictly.<sup>108</sup> Specifically, by referring to the *Cadbury Schweppes* decision, the CJEU held that such domestic rules can be applied pursuant to the domestic safeguard clause only if their specific objective is to “prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality”.<sup>109</sup> Moreover, the CJEU held that domestic anti-avoidance rules that are drafted as general rules or presumptions to deny PSD benefits could be disproportionate.<sup>110</sup> The CJEU then analysed the French and German domestic anti-abuse rules in light of the foregoing discussion and held that those rules were not proportional as they were based on presumptions and went beyond the wholly artificial arrangement threshold.<sup>111</sup> Thus, it could be argued that domestic anti-abuse rules should not apply to structures or arrangements that are rational from a commercial and/or economic perspective. Interestingly, in the context of discussing artificial arrangements, the CJEU in *Deister Holding and Juhler Holding* has held that

“the fact that the economic activity of a non-resident parent company consists in the management of its subsidiaries’ assets or that the income of that company results only from such management cannot per se indicate the existence of a wholly artificial arrangement which does not reflect economic reality”.<sup>112</sup>

These findings of the CJEU support the contention that holding companies cannot be systematically considered as wholly artificial arrangements under EU law.<sup>113</sup>

In line with the principles established with respect to the domestic safeguard clause, it could be argued that the application of a treaty anti-abuse rule pursuant to the treaty safeguard clause should also be interpreted strictly. This would imply that a treaty anti-abuse clause could apply if its specific objective is to *prevent wholly artificial arrangements*. For instance, the PPT can be applied only to the extent that it denies benefits vis-à-vis wholly artificial arrangements or arrangements that are not commercially rational.<sup>114</sup> In fact, the EU Commission has identified that potential frictions could arise between the PPT and the CJEU’s case law on abuse. Thus, it

<sup>107</sup> *Deister Holding AG and Juhler Holding A/S v Bundeszentralamt für Steuern* (Joined Cases C-504/16 and C-613/16) EU:C:2017:1009.

<sup>108</sup> *Egiom* (C-6/16), above fn.106, EU:C:2017:641 at [26]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [59].

<sup>109</sup> *Egiom* (C-6/16), above fn.106, EU:C:2017:641 at [30]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [60].

<sup>110</sup> *Egiom* (C-6/16), above fn.106, EU:C:2017:641 at [31]–[32]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [61]–[62].

<sup>111</sup> *Egiom* (C-6/16), above fn.106, EU:C:2017:641 at [33]–[38]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [63]–[71].

<sup>112</sup> *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [73].

<sup>113</sup> *Danon* (2018), above fn.15, 47.

<sup>114</sup> It has been argued that the PPT rule could be contrary to the proportionality principle in EU law. This is because the CJEU’s case law sets a higher threshold to determine the existences of abuse, that is, abuse arises only when the essential aim, sole aim or sole purpose of the transaction/arrangement is to obtain a tax benefit. Moreover, it is argued that the PPT rule can be challenged on the basis that it creates legal uncertainty. See De Broe (2016), above fn.15, 237–238; P. Baker, “The BEPS Action Plan in the Light of EU Law: Treaty Abuse” [2015] BTR 408, 412–414; a similar analogy should also be drawn for various provisions of the simplified or detailed LOB clause.

has recommended that Member States adopt a modified version of the PPT.<sup>115</sup> Consequently, treaty anti-abuse rules should not apply to structures or arrangements that are rational from a commercial and/or economic perspective.

**2.3.3.2. IRD, PSD and ATAD: General Anti-Abuse Rules** Article 5(2) of the IRD<sup>116</sup> states that EU Member States can deny the benefits of the IRD

“in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse” (subjective element).

The PSD also contains a GAAR.<sup>117</sup> Article 1(2) of the PSD provides that the PSD GAAR applies when an arrangement or a series of arrangements: 1. has/have been put into place for “the main purpose or one of the main purposes” of obtaining a tax advantage (subjective element); 2. that defeats the “object or purpose of this Directive” (objective element); and 3. is/are “not genuine having regard to all relevant facts and circumstances”. Article 1(3) of the PSD provides that arrangements could be regarded as not genuine to the extent they are not put into place “for valid commercial reasons which reflect economic reality”<sup>118</sup> (non-genuine element). Similar to the PSD GAAR, Article 6(1) of the ATAD states that the GAAR applies when an arrangement or a series of arrangements: 1. has/have been put into place for “the main purpose or one of the main purposes” of obtaining a tax advantage (subjective element); 2. that “defeats the object or purpose of the applicable tax law” (objective element); 3. is/are “not genuine having regard to all relevant facts and circumstances”. Article 6(2) of the ATAD provides arrangements could be regarded as not genuine to the extent they are not put into place “for valid commercial reasons which reflect economic reality” (non-genuine element).

The question arises as to how should the subjective, objective and non-genuine elements be interpreted? In this regard, it should be noted that in the Danish cases that deal with the IRD (*Z Denmark*,<sup>119</sup> *N Luxembourg*,<sup>120</sup> *X Denmark*<sup>121</sup> and *C Denmark*<sup>122</sup>) and the PSD (*T Denmark*<sup>123</sup> & *Y Denmark*<sup>124</sup>) the Advocate General (AG) has provided additional guidance on the concept of abuse, that is, criteria for determining abuse and application of those criteria to various fact patterns. In fact, while delivering her Opinion, the AG makes several references to the ATAD GAAR. Accordingly, references are made to her Opinion to understand how these elements can be interpreted in the case of directive shopping arrangements.

With respect to the criteria for determining abuse under EU law, the AG states, as a starting point, that Article 5 of the IRD and Article 1(2) of the PSD reflect the general principles of EU law (or settled case law) which provide that the application of EU law cannot be extended to

<sup>115</sup> See *Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse (notified under document C(2016) 271)* [2016] OJ L25/67, 68.

<sup>116</sup> See Directive 2003/49/EC Art.5(2).

<sup>117</sup> Directive (EU) 2015/121 Art.1(2).

<sup>118</sup> Directive (EU) 2015/121 Art.1(3).

<sup>119</sup> Opinion of AG Kokott in *Z Denmark v Skatteministeriet* (C-299/16) EU:C:2018:148 (1 March 2018).

<sup>120</sup> Opinion of AG Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16) EU:C:2018:143 (1 March 2018).

<sup>121</sup> Opinion of AG Kokott in *X Denmark A/S v Skatteministeriet* (C-118/16) EU:C:2018:146 (1 March 2018).

<sup>122</sup> Opinion of AG Kokott in *C Denmark I v Skatteministeriet* (C-119/16) EU:C:2018:147 (1 March 2018).

<sup>123</sup> Opinion of AG Kokott in *Skatteministeriet v T Denmark* (C-116/16) EU:C:2018:144 (1 March 2018).

<sup>124</sup> Opinion of AG Kokott in *Skatteministeriet v Y Denmark Aps* (C-117/16) EU:C:2018:145 (1 March 2018).

abusive transactions. As Article 5 of the IRD and Article 1(2) of the PSD do not define abuse and, thus, in order to lay out the criteria for determining abuse, the AG, first, makes a reference to Article 11(1)(a) of the MD (which provides that lack of commercial reasons could indicate abuse) and Article 6 of the ATAD (which defines abuse).<sup>125</sup> Secondly, the AG makes a reference to the CJEU's decisions in which the Court held that a taxpayer's transaction is abusive when its essential aim is to obtain a tax advantage (see section 2.3.1) or it represents a wholly artificial arrangement, which does not reflect economic reality<sup>126</sup> (see section 2.3.2). Thereafter, the AG applies the foregoing criteria to the various cases at stake.

With respect to the existence of a wholly artificial arrangement that does not reflect economic reality, the AG in the *C Danmark* case opines:

“The two intermediary Swedish companies (C Sverige II and C Sverige I) did not have any employees, any office premises of their own, any telephone numbers of their own. Their post was opened by employees of a third-party company. As a result, these companies neither incurred any staff costs nor any costs for use of the premises. Moreover, they did not generate any income of their own through the asset management activities. All of this appears very artificial. A natural person would have long since ceased its business activities under these circumstances.”<sup>127</sup>

A similar outcome is also followed in the *Y Danmark* case.<sup>128</sup> On the contrary, in the other cases, the AG opines:

“If the company has been actually validly established, if it can actually be contacted at its registered office and if it has the appropriate physical and human resources at its premises in order to meet its object..., it cannot be seen as an arrangement which does not reflect economic reality.”<sup>129</sup>

Moreover, even if the arrangement reflects economic reality, the AG, by referring to Article 6 of the EU ATAD, states that the taxpayer's transaction should have a commercial rationale, that is, non-tax reasons have to be demonstrated.<sup>130</sup> If not, the transaction could be abusive. Although the AG does not discuss commercial reasons, she nevertheless states that the fact that

<sup>125</sup> Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [61]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [62]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [62]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [62]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [50]; *Y Danmark* (C-117/16), above fn.124, EU:C:2018:145 at [49].

<sup>126</sup> Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [62]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [63]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [63]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [63]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [51]; *Y Danmark* (C-117/16), above fn.124, EU:C:2018:145 at [50].

<sup>127</sup> Opinion of AG Kokott in *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [63].

<sup>128</sup> Opinion of AG Kokott in *Y Danmark* (C-117/16), above fn.124, EU:C:2018:145 at [54].

<sup>129</sup> Opinion of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [65]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [67]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [67]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [55].

<sup>130</sup> Opinion of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [67]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [68]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [68]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [69]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [59]; *Y Danmark* (C-117/16), above fn.124, EU:C:2018:145 at [58].

the intermediary company is established in a Member State in order to take advantage of a favourable legal regime, the fact that the intermediary company is owned by third state residents or the fact that the taxpayer chose a business structure that did not lead to the highest tax burden does not in itself constitute abuse.<sup>131</sup>

The foregoing analysis, provided by the AG, may be used to interpret the subjective/non-genuine elements of the GAAR-type provisions found in the corporate tax directives. In line with the discussion put forward by the AG, it could be argued that the subjective element as well as the non-genuine elements should not be satisfied if the taxpayer is able to demonstrate that its transaction/structure/arrangement is rational from a commercial and/or an economic reality perspective. Once again the two situations need to be differentiated. That is, on the one hand: 1. genuine intermediary structures used by corporate groups that reflect commercial and economic reality; and, on the other 2. back-to-back arrangements, which are structured through economic operators and which may or may not lack a commercial rationale (see the discussion on the subjective element of the PPT in section 2.2). With respect to the economic reality or activities, the AG in the *Eqiom* case specifically stated that

“an artificial arrangement can be assumed if the company is only a fictitious establishment in the form of a ‘letterbox’ company...But even where there is a physical presence, one might conclude, in light of the financial and staffing set-up, that the arrangement is artificial. In this regard, what appears to be relevant is, *for instance, the actual authority of the company organs to take decisions, to what extent the company is endowed with own financial means and whether any commercial risk exists.*” (Emphasis added).<sup>132</sup>

This outcome is not something new as a discussion along these lines seems to have already taken place in AG Léger’s Opinion in the *Cadbury Schweppes* case.<sup>133</sup> Arguably, it becomes imperative that the personnel of the taxpayer entity make key decisions vis-à-vis the economically significant risks associated with the relevant economic activities and that the entity has the financial means to assume those risks (see section 2.1).

The AG also analyses whether the arrangement is contrary to the objective of the PSD or the IRD as implemented in Denmark. In this regard, it is stated that the taxpayers fulfilled all the requirements for applying the PSD (Article 2)<sup>134</sup> and the IRD (Article 3(a)(iii)).<sup>135</sup> The fact that Cyprus or Luxembourg do not impose withholding taxes is immaterial to the analysis as direct taxation remains largely within each Member State’s competence (which could therefore lead

<sup>131</sup> Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [69]–[74]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [70]–[75]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [70]–[75]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [70]–[74]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [61]–[65]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [61]–[65].

<sup>132</sup> Opinion of AG Kokott in *Eqiom SAS, formerly Holcim France SAS and Enka SA v Ministre des Finances et des Comptes publics* (C-6/16) EU:C:2017:34 at [57]. Also see *WebMindLicenses Kft v Nemzeti Adó- és Vámhivatal Kiemelt Adó- és Vám Főigazgatóság* (C-419/14) EU:C:2015:832 at [50].

<sup>133</sup> Opinion of AG Léger in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) EU:C:2006:278 At [110]–[114].

<sup>134</sup> Opinions of AG Kokott in *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [69]–[70]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [68]–[69].

<sup>135</sup> Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [79]–[82]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [80]–[83]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [80]–[83]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [78]–[81].

to tax competition).<sup>136</sup> Moreover, the AG also analyses whether the entire arrangements, that is, third state investors investing into Denmark through an intermediary established in a EU Member State (Luxembourg or Cyprus) is contrary to the purpose of the law. In this regard, the AG states that the purpose of the law could be circumvented if the state of residence of the income recipients is not able to obtain information with respect to the amounts not taxed at source and assess that income for taxes. It seems that the AG analyses whether the arrangement is a tax evasion arrangement rather than an avoidance arrangement. The AG differentiates between EU–EU situations and third state–EU situations. For the former, the AG states that it may not be possible for the taxpayer to avoid declaring the income for tax purposes due to the presence of an appropriate exchange of information framework.<sup>137</sup> For the latter, the AG states that if the arrangement is structured with the purpose of ensuring that the states of residence of the investors are unable to obtain information to assess their taxpayers then an abuse of law may exist. Nevertheless, abuse will not exist if the tax related information can be provided by the taxpayer to the concerned states.<sup>138</sup>

The guidance provided by the AG may also be used to interpret the objective element of the GAAR-type provisions. Clearly, if the purpose of the transaction/structure/arrangement is to evade taxes then the transaction is fraudulent/abusive. However, in the context of tax avoidance arrangements that seek to take advantage of the PSD, it is not clear how the expression “object or purpose of this Directive” should be interpreted. The AG seems to indicate that PSD benefits should be granted as long as: 1. the distributing entity is subject to corporate taxes; and 2. the recipient company is subject to unlimited tax liability.<sup>139</sup> Such formal conditions are usually satisfied in tax avoidance structures. Accordingly, there is a risk that transactions, which have been executed with the sole purpose of obtaining directive benefits, could be “saved” from the application of the PSD GAAR. This said, if the CJEU considers the prevention of tax avoidance as an “object or purpose of this Directive” transactions that are “artificial” (or wholly artificial arrangements) may not be able to get access to directive related benefits (see the discussion on the objective element of the PPT in section 2.2). A similar approach could also be upheld for interpreting the objective element of the ATAD GAAR.

**2.3.3.3. IRD and PSD: abuse of rights doctrine** In February 2019, the CJEU issued its verdict on the Danish cases discussed in the previous section. The Court held that the abuse of rights doctrine can be invoked by a Member State to deny directive benefits (IRD/PSD) even if that state does

<sup>136</sup> Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [83]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [84]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [84]; *C Denmark* (C-119/16), above fn.122, EU:C:2018:147 at [82]; *T Denmark* (C-116/16), above fn.123, EU:C:2018:144 at [71]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [70].

<sup>137</sup> Opinions of AG Kokott, *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [84]–[85]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [85]–[86]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [85]–[86]; *C Denmark* (C-119/16), above fn.122, EU:C:2018:147 at [83]–[84]; *T Denmark* (C-116/16), above fn.123, EU:C:2018:144 at [72]–[73]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [72]–[73].

<sup>138</sup> Opinions of AG Kokott, *Z Denmark*, (C-299/16), above fn.119, EU:C:2018:148 at [86]–[88]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [87]–[89]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [87]–[89]; *C Denmark* (C-119/16), above fn.122, EU:C:2018:147 at [85]–[87]; *T Denmark* (C-116/16), above fn.123, EU:C:2018:144 at [74]–[76]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [74]–[76].

<sup>139</sup> *T Denmark* (C-116/16), above fn.123, EU:C:2018:144 at [69]–[70]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [68]–[69].

not have appropriate anti-abuse rules in place to combat abusive transactions (for example, directive shopping). Thereafter, the CJEU lays out certain indicators of abuse, that is, situations wherein the arrangements of the taxpayer could be considered to be artificial. According to the Court, an artificial arrangement exists when the taxpayer (entity in a MNE group) is an artificial entity or an entity that does not reflect economic reality or a conduit entity. Essentially, this would be the case when the entity does not carry out any relevant economic activities.<sup>140</sup> Another factor that indicates the presence of an artificial arrangement is when the entity plays a conduit role, that is, the entity passes on income (dividends or interest), as soon as it receives it, to taxpayers (or beneficial owners) that are not eligible for the directive related benefits. This would be the case even if the conduit entity makes a small taxable profit.<sup>141</sup> Although this is not particularly clear, it seems that an artificial arrangement could also exist when back-to-back arrangements are structured through genuine economic operators.<sup>142</sup> In the authors' opinion, it can be argued that the doctrine should not apply to structures or arrangements that are rational from a commercial and/or economic perspective (see discussion on the subjective element of the PPT in section 2.2 and the subjective/non-genuine elements of the GAAR-type provisions found in the corporate tax directives in section 2.3.3.2).

#### 2.4. Access to preferential regimes

In December 1977, the EU Code of Conduct for Business Taxation established five criteria to assess whether a national tax measure (legislative or regulatory or administrative) was potentially harmful. One criterion looked into whether the tax advantage was granted without any “real economic activity and substantial economic presence”.<sup>143</sup> Similarly, in the 1998 *Harmful Tax Competition* report, the OECD laid out four primary and eight supplementary criteria to assess whether a measure was potentially harmful. One of the supplementary criteria pertained to looking at whether the tax measure provided for “substantial activities”.<sup>144</sup> Since then the Code of Conduct and the OECD's Forum on Harmful Tax Practices (FHTP) have analysed several regimes of different states to assess whether they were harmful or not.<sup>145</sup> However, neither the

<sup>140</sup> The Court states that “the absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has”. See *N Luxembourg 1 and others* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.81, EU:C:2019:134 at [127] and [131]; *T Danmark and Y Denmark Aps* (Joined Cases C-116/16 and C-117/16), above fn.82, EU:C:2019:135 at [100] and [104].

<sup>141</sup> See *N Luxembourg 1 and others* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.81, EU:C:2019:134 at [127]–[130]; *T Danmark and Y Denmark Aps* (Joined Cases C-116/16 and C-117/16), above fn.82, EU:C:2019:135 at [100]–[103].

<sup>142</sup> See *N Luxembourg 1 and others* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.81, EU:C:2019:134 at [132]; *T Danmark and Y Denmark Aps* (Joined Cases C-116/16 and C-117/16), above fn.82, EU:C:2019:135 at [105].

<sup>143</sup> See Council of the European Union, *Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy - Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation - Taxation of saving* [1998] OJ C2/1, 1–4.

<sup>144</sup> OECD, *Harmful Tax Competition, An Emerging Global Issue* (Paris: OECD Publishing, 1998), 34.

<sup>145</sup> See Council of European Union, *Report: Code of Conduct (Business Taxation)*, SN 4901/99 (Brussels: 23 November 1999); OECD, *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting And Recommendations By The Committee On Fiscal Affairs, Progress in Identifying and Eliminating Harmful Tax Practices*

work of the EU nor that of the OECD provided guidance on how the substantial activity criterion was to be interpreted.<sup>146</sup>

The BEPS Project reignited the debate on harmful tax competition. Action 5 of the BEPS Plan mandated the FHTP “to revamp the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime”.<sup>147</sup> As a result, the substantial activity criterion was elevated to a primary criterion.<sup>148</sup> The final report discusses the applicability of the substantial activity criterion in the context of IP regimes (such as IP boxes) and non-IP regimes.

In the context of IP regimes, the nexus approach was adopted.<sup>149</sup> Under the nexus approach, profits made by a taxpayer utilising an IP box regime are exempt only to the extent the taxpayer itself incurs the qualifying research and development (R&D) expenses that gave rise to the IP income. The idea behind the requirement is that taxpayers should actually carry out the activity and incur the related expenses in order to benefit from the regimes. Importantly, it should be noted that Action 5 rejected the transfer pricing (TP) approach.<sup>150</sup> Arguably, under the TP approach only high level decision-making substance in the entity was required to be demonstrated. The day-to-day activities associated with developing the IP could be outsourced to related parties. However, such outsourcing is not possible under the nexus approach.<sup>151</sup> Accordingly, it is reasonable to state that the substance requirements for an entity adopting the nexus approach are high.<sup>152</sup> In other words, merely demonstrating “control over risks” is insufficient. Post-BEPS, several states have either amended their existing regimes to reflect the nexus approach or have implemented nexus compliant IP boxes in their domestic tax law.<sup>153</sup>

In the context of non-IP regimes, the Action 5 final report states that the principles applied in the nexus approach should continue to apply. Accordingly, the taxpayer can access preferential regimes “to the extent those taxpayers undertook the core income generating activities required to produce the type of business income covered by the preferential regime”.<sup>154</sup> In the follow up report, it is indicated that “[c]ore income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities”.<sup>155</sup>

In the context of headquarter regimes, the core income generating activities could

(2000); OECD, *The OECDs Project on Harmful Tax Practices: 2004 Progress Report* (2004); OECD, *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries* (2006).

<sup>146</sup> For a detailed discussion, see A.C. dos Santos, “What is Substantial Economic Activity for Tax Purposes in the Context of the European Union and the OECD Initiatives against Harmful Tax Competition?” (2015) 24(3) *EC Tax Review* 166, 166–171.

<sup>147</sup> Action 5, above fn.2, para.23.

<sup>148</sup> Action 5, above fn.2, paras 24–25.

<sup>149</sup> Action 5, above fn.2, para.27. See R. Danon, “General Report” in IFA, *Tax Incentives on Research and Development (R&D)*, *Cahiers de droit fiscal international* (2015) Vol.100a, 43–54.

<sup>150</sup> Action 5, above fn.2, para.27.

<sup>151</sup> Action 5, above fn.2, paras 49–51.

<sup>152</sup> Danon, above fn.68, 25.

<sup>153</sup> See OECD/G20 Base Erosion and Profit Shifting Project, *Harmful Tax Practices – 2017 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5 (Harmful Tax Practices 2017 Progress Report)* (Paris: OECD Publishing, 2017), 15–18.

<sup>154</sup> Action 5, above fn.2, paras 70–73.

<sup>155</sup> See OECD/G20, *Harmful Tax Practices 2017 Progress Report*, above fn.153, 40.



“include the key activities giving rise to the particular type of...income received by the company. For example, they could include taking relevant management decisions, incurring expenditures on behalf of group entities, and co-ordinating group activities.”<sup>156</sup>

For instance, a reference can be made to the Global Headquarters Administration regime (GHA) available in Mauritius<sup>157</sup> and Singapore’s Pioneer Certificate Incentive (PC) and Development and Expansion Incentive (DEI).<sup>158</sup> These regimes, which have been approved by the FHTP,<sup>159</sup> grant an eight year tax holding/reduction of corporate tax rates respectively to qualifying taxpayers. To avail itself of the benefit of the GHA, the taxpayer must employ at least 10 professionals, with at least two at managerial level, and incur an annual expenditure of MUR 5 million.<sup>160</sup> On the other hand, to avail itself of the benefit of the PC/DEI initiative, the taxpayer must employ skilled staff and incur substantial expenditure<sup>161</sup> (the number of employees and expenditure amounts are unspecified).

With respect to financing regimes, the core income generating activities could “include agreeing funding terms;...setting the terms and duration of any financing...;monitoring and revising any agreements; and managing any risks”.<sup>162</sup> Once again, a reference can be made to the Global Treasury Activities regime (GTA) available in Mauritius<sup>163</sup> and Singapore’s Finance and Treasury Centre Incentive (FTC).<sup>164</sup> These regimes, which have been approved by the FHTP,<sup>165</sup> grant a five year tax holding/reduction of corporate tax rates respectively to qualifying taxpayers. To avail itself of the benefit of the GTA, the taxpayer should employ at least four professionals, with at least one at managerial level, and incur annual expenditure of MUR 2 million.<sup>166</sup> On the other hand, to avail itself of the benefit of the FTC, the taxpayer must employ skilled staff (at least 10 personnel) and incur expenditure of SGD 3.5 million.<sup>167</sup>

Nevertheless, for holding companies that only own and manage participations, the Action 5 final report notes that such entities “may not in fact require much substance in order to exercise their main activity of holding and managing equity participations”.<sup>168</sup> This being said, the Report provides that such entities should

<sup>156</sup> Action 5, above fn.2, paras 74–75.

<sup>157</sup> See Financial Services Commission, Mauritius, *Circular Letter CL29012018* (29 January 2018), available at: <https://www.fscmauritius.org/media/4268/tax-holiday-cl-02-feb-18-270416.pdf> [Accessed 18 June 2019].

<sup>158</sup> See Singapore Economic Development Board, *Pioneer Certificate Incentive and Development and Expansion Incentive* (2016), available at: <https://www.edb.gov.sg/content/dam/edb/edbsite/downloads/brochures/PC%20and%20DEI%20Brochure.PDF> [Accessed 18 June 2019].

<sup>159</sup> OECD/G20, *Harmful Tax Practices 2017 Progress Report*, above fn.153, 18 and 42–43.

<sup>160</sup> See Financial Services Commission, Mauritius, *Circular Letter CL1-121018* (12 October 2018), available at: <https://labeledheim.com/wp-content/uploads/2018/10/cl-on-substance-gb.pdf> [Accessed 18 June 2019].

<sup>161</sup> See Singapore Economic Development Board, above fn.158.

<sup>162</sup> Action 5, above fn.2, paras 78–79.

<sup>163</sup> See Financial Services Commission, Mauritius, *Circular Letter CL29012018*, above fn.157.

<sup>164</sup> See Singapore Economic Development Board, *Finance and Treasury Centre Incentive* (2016), available at: <https://www.edb.gov.sg/content/dam/edb/edbsite/downloads/brochures/FTC%20Brochure.PDF> [Accessed 18 June 2019].

<sup>165</sup> See OECD/G20, *Harmful Tax Practices 2017 Progress Report*, above fn.153, 19 and 42–43.

<sup>166</sup> See Financial Services Commission, Mauritius, *Circular Letter CL1-121018*, above fn.160.

<sup>167</sup> See Singapore Economic Development Board, *Finance and Treasury Centre Incentive*, above fn.164.

<sup>168</sup> Action 5, above fn.2, para.87.

“respect all applicable corporate law filing requirements and have the substance necessary to engage in holding and managing equity participations (for example, by showing that they have both the people and the premises necessary for these activities)”<sup>169</sup>.

More recently, several jurisdictions have adopted substance requirements in their legislation and provided additional guidance thereto on core income generating activities. These requirements are similar to those suggested in BEPS Action 5.<sup>170</sup> In light of the foregoing analysis, it is reasonable to conclude that if the relevant economic activities exist in an entity then that entity should be given access to a preferential regime.

### 2.5. *Synthesis and minimum safeguards for entities in a MNE*

A high degree of convergence exists between the post-BEPS concepts<sup>171</sup> of *substantial activities*, *core commercial activity*, *controls over risks*, *economic reality* and *substantial economic activities*. Specifically, these concepts require the presence of personnel (directors and/or employees) who can contribute meaningfully towards the creation of value or the production of the core income that the entity receives.<sup>172</sup> However, divergences also exist. The exact personnel threshold for fulfilling each of these concepts seems to be different. Accordingly, an objective answer cannot be given to the question “how much substance is required” to gain access to the international corporate tax framework. The answer would indeed depend on the facts and circumstances of each case. This said, from an economic activity perspective, a taxpayer entity which takes a specific role within a multinational group should at a minimum perform the following activities/bear the relevant risks with respect to the underlying income it generates (besides documenting the commercial reasons for its existence and activities):

- Holding Entity that receives dividend income or capital gains: the core functions of such an entity relate typically to management activities that are important for monitoring and protecting the investments.<sup>173</sup> The key risks relate to investment risks to which the entity is exposed.

<sup>169</sup> Action 5, above fn.2, para.88.

<sup>170</sup> See States of Guernsey, *Guidance on aspects in relation to the economic substance requirements as issued by Guernsey, Isle of Man and Jersey* (issued 26 April 2019) available at: <https://www.gov.gg/economicssubstance> [Accessed 18 June 2019], 19 and United Arab Emirates, Cabinet of Ministers Resolution No. 31 of 2019 Concerning Economic Substance Regulations, available at: <https://www.mof.gov.ae/en/lawsAndPolitics/CabinetResolutions/Pages/312019.aspx> [Accessed 26 June 2019].

<sup>171</sup> On this matter, see S. Wilkie, “New Rules of Engagement? Corporate Personality and the Allocation of “International Income” and Taxing Rights” in B.J. Arnold (ed.), *Tax Treaties After the BEPS Project: a tribute to Jacques Sasseville* (Toronto: Canadian Tax Foundation, 2018), 365–371. The author argues that the BEPS recommendations lift the corporate veil when intermediation is unwarranted.

<sup>172</sup> On this matter, see S. Wilkie, “Transfer Pricing Aspects of Intangibles: The License Model” in M. Lang, A. Storck and R. Petruzzi (eds), *Transfer Pricing in a post BEPS World* (Alphen aan den Rijn: Kluwer Law International, 2016), 94–95.

<sup>173</sup> For instance, the personnel of the holding entity, among several activities, could provide non-binding advise to the management of the subsidiaries to improve their performance. It is arguable whether such an activity could be considered to confer a benefit on the subsidiary in order to justify a charge for a service fee from an arm’s length perspective. See OECD, *Transfer Pricing Guidelines* (1979), para.154; OECD, *Three Taxation Issues—Transfer Pricing* (1984), paras 38–39; OECD, *TP Guidelines 2017*, above fn.18, para.7.4 and para.7.10; UN, *TP Manual* (2017), above fn.38, para.B.4.2.14.

- Financing Entity that receives interest income: the core functions of such an entity are that it is engaged in the business of providing intra group loans which relate typically to activities associated with creating<sup>174</sup> and managing loans.<sup>175</sup> The key risks relate to financial risks<sup>176</sup> associated with activities such as the credit risk, interest rate risk and possibly the exchange rate risk.<sup>177</sup>
- Intellectual Property (IP) Entities that derive royalty income or capital gains: the core functions of an entity that is engaged in the business of licensing (or selling) intangibles<sup>178</sup> typically relate to activities associated with development (nexus approach) or acquisition of intangibles, enhancement, maintenance, protection and exploitation of intangibles (DEMPE activities).<sup>179</sup> The key risks<sup>180</sup> relate to: 1. the development risk or acquisition risk associated with the intangible; 2. risks associated with technology obsolescence and loss of the intangible value; 3. risks associated with infringement of the intangible; 4. product liability risks occurring from the use of intangibles; and 5. risks associated with intangible exploitation.<sup>181</sup>

<sup>174</sup> For instance, the personnel of the financing entity could engage in the following loan creation activities (inclusive list): 1. negotiating the terms and conditions of the loans; 2. evaluating the various financial risks associated with the loan; 3. analysing the credit worthiness of the borrower; 4. undertaking the steps to price a loan; 5. deciding on whether collateral or securities are required; 6. undertaking steps to formalise the loans, etc.; OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (Attribution Report) (2010), available at: <https://www.oecd.org/ctp/transfer-pricing/45689524.pdf> [Accessed 26 June 2019], 65–66; Chand, above fn.37, 896–898.

<sup>175</sup> For instance, the personnel of the financing entity could engage in the following loan management activities (inclusive list): 1. undertaking loan support functions such as collecting the interest, monitoring repayments, determining the value of collaterals; 2. monitoring the financial risks on an ongoing basis by reviewing the credit worthiness of the borrower, analysing market interest movements, analysing the profitability of the loan; 3. undertaking necessary steps to hedge risks associated with the loan; 4. deciding on whether refinancing the loan is required or not, etc. See OECD, Attribution Report, above fn.174, 65; Chand, above fn.37, 896–898.

<sup>176</sup> In the context of cash boxes, the revised guidance has made it clear that, if an entity does not control the financial risks over the debt funding but simply acts on the direction of other members of the MNE group, then: 1. that entity will not be attributed the profits linked to the financial risks and therefore will be entitled to no more than a risk-free return or; 2. less than a risk-free return if, for instance, the transaction is not commercially justified and therefore the non-recognition rules apply. See OECD, TP Guidelines 2017, above fn.18, paras 1.85 and 1.103; UN, TP Manual (2017), above fn.38, para.B.5.3.35; also see OECD, TP Guidelines 2017, above fn.18, paras 6.61–6.64. Moreover see, OECD, TP Guidelines 2017, above fn.18, Example 6 in Annex to Ch.VI. Moreover, see OECD, *Public Discussion Draft BEPS Action 8–10, Financial transactions, 3 July–7 September 2018*, paras 12–21.

<sup>177</sup> For a discussion on these risks, see OECD, Attribution Report, above fn.174, 68; OECD, TP Guidelines 2017, above fn.18, para.1.72(c); UN, TP Manual (2017), above fn.38, 89–90, Table B.2.4.

<sup>178</sup> For a definition and list of common categories intangibles see OECD, TP Guidelines 2017, above fn.18, paras 6.15–6.31; UN, TP Manual (2017), above fn.38, paras B.5.2.5–B.5.2.38.

<sup>179</sup> See OECD, TP Guidelines 2017, above fn.18, para.6.12; UN, TP Manual (2017), above fn.38, paras B.5.3.13–B.5.3.20.

<sup>180</sup> See OECD, TP Guidelines 2017, above fn.18, Examples 4, 5, 14 in Annex to Ch.VI. On the other hand, in several examples it is illustrated that the royalty income (or capital gains) would be re-allocated from the legal owner to the entity that controlled the DEMPE risks. See Examples 1, 2, 3, 15 and 17 in Annex to Ch.VI; also see, UN, TP Manual (2017), above fn.38, para.B.5.3.12 and para.B.5.3.20. Furthermore, see Collier and Andrus, above fn.36, 214–215; for a detailed analysis of the ownership requirement of the intangibles see S. Wilkie, “The Definition and Ownership of Intangibles: Inside the Box? Outside the Box? What is the Box?” (2012) 4(3) *World Tax Journal* 222.

<sup>181</sup> OECD, TP Guidelines 2017, above fn.18, paras 6.65–6.68; UN, TP Manual (2017), above fn.38, para.B.5.3.22.

- Principal Entities<sup>182</sup> that receive business income: a principal entity (or the entrepreneurial entity), for example, that is engaged in the business of selling physical goods usually operates with the support of “assisting” entities<sup>183</sup> such as procurement entities<sup>184</sup> that assist in sourcing/buying raw materials, contract or toll manufactures<sup>185</sup> that assist in processing the raw material as well as limited risk distributors or commissionaires<sup>186</sup> that assist in selling the finished product. Generally, the core functions of a principal entity typically relate to key decision-making activities associated with the purchase, manufacture as well as sale of products. The other “assisting” entities usually perform their activities under the supervision and guidance of the principal. The key risks are risks pertaining to its value chain, that is, risks relevant to purchasing, processing and selling of the products.<sup>187</sup>

Taxpayers within a corporate group should also pay special attention to back-to-back arrangements that are structured through economic operators (such as other operating members of the group or financial institutions). The issue with respect to these transactions may not be the degree of nexus to a state but rather the commercial rationality of such arrangements. If the taxpayer is able to demonstrate that its arrangements are commercially and/or economically sound, then that taxpayer should obtain access to tax treaty or EU law related benefits.

### 3. The key issues in connection with the relevant economic activity test

#### 3.1. *The rise in tax uncertainty*

It is obvious that if the degree of subjectivity is high in the interpretation process then the chances of the tax outcome being uncertain are also high. Consequently, the chances of tax disputes arising together with the risk of double or multiple taxation all increase. This proposition clearly holds true once the structures adopted by taxpayers become transparent to the tax administrations through the Master File (which requires the taxpayer to explain its value chain), Country-by-Country reporting<sup>188</sup> as well as spontaneous exchange of rulings.<sup>189</sup>

<sup>182</sup> For a discussion on the principal structure, see OECD, TP Guidelines 2017, above fn.18, para.9.51. In this contribution, it is assumed that the principal entity does not own intangibles. Nevertheless, the principal entity licenses the relevant trade or marketing intangibles from another IP entity of the MNE for its business.

<sup>183</sup> It should be noted that in the post-BEPS world, these “assisting” entities could trigger a permanent establishment for the principal entity pursuant to the recommendations made by BEPS Action 7.

<sup>184</sup> OECD, TP Guidelines 2017, above fn.18, paras 1.169 and 9.2; C. Finnerty, P. Merks, M. Petriccione and R. Russo, *Fundamentals of International Tax Planning* (Amsterdam: IBFD, 2007), 201–202.

<sup>185</sup> OECD, TP Guidelines 2017, above fn.18, paras 2.60, 7.40 and 9.2; Finnerty, Merks, Petriccione and Russo, above fn.184, 184–185; M. Cotrut and L. Ambagtsheer-Pakarinen, “Business Restructurings: The Toolkit for Tackling Abusive International Tax Structures” in M. Cotrut (ed.), *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures* (Amsterdam: IBFD, 2015), 190–194.

<sup>186</sup> OECD, TP Guidelines 2017, above fn.18, para.9.2; Finnerty, Merks, Petriccione and Russo, above fn.184, 194–198; Cotrut and Ambagtsheer-Pakarinen, above fn.185, 194–198.

<sup>187</sup> For a discussion on the risks that a MNE could be exposed towards see UN, TP Manual (2017), above fn.38, 89–90, Table B.2.4.

<sup>188</sup> OECD/G20 Base Erosion and Profit Shifting Project, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD Publishing, 2015).

<sup>189</sup> Action 5, above fn.2, para.89.

With respect to transfer pricing rules, prior to the BEPS Project the OECD Transfer Pricing Guidelines, recognised that it might be difficult to apply the arm's length principle in practice.<sup>190</sup> Since the BEPS Project, commentators have opined that the BEPS guidance has made the transfer pricing process more complex.<sup>191</sup> For instance, the "control" over risk requirement has received a great deal of criticism. First, it is argued that this particular requirement can be met easily by having the right people doing the right job. This could lead to the shifting of taxable bases from high tax states to low tax states. Thus, the arm's length principle promotes tax competition.<sup>192</sup> Secondly, the guidelines state that in situations where multiple associated enterprises control the risks, the risk should be allocated to the associated enterprise that demonstrates "most control".<sup>193</sup> The demonstration of this requirement could indeed be challenging from a practical perspective, especially, in MNEs where management boards are similar/spread across various entities and where consensus based decision-making takes place.<sup>194</sup> Thirdly, a few commentators have argued that the control test goes beyond the boundaries of the arm's length standard. It is stated that several situations exist among independent enterprises where the incidence of risk is separate from the control over risk requirement. In other words, enterprises bear risks that they do not control. Accordingly, courts may deviate from the control requirement if this is proven.<sup>195</sup> Fourthly, it is argued that the level of factual detail that is required to understand which party controls the risks is substantially high. Accordingly, it could be burdensome for the taxpayers and the tax administrations to undertake this analysis.<sup>196</sup> Fifthly, there is no clarity as regards whether the concept of control over risk for the purpose of Article 9 of the OECD Model and the significant people functions with respect to risk assumption under Article 7 of the OECD Model are similar or different. The OECD does not provide an answer to this issue. Accordingly, the approach adopted in an Article 9 and an Article 7 analysis could be different.<sup>197</sup>

With respect to the PPT, the authors have argued that the subjective element should not be satisfied if the transaction/arrangement/structure is rational from a commercial and/or an economic perspective. However, if a judge interprets the phrase "one of the principal purposes" in a literal manner then the subjective element may be satisfied as long as a tax benefit exists.<sup>198</sup> This would also be the case if a judge takes into consideration the LOB clause (and its related Commentary) to interpret the "substance" requirements for the PPT. Therefore, the level of tax certainty with respect to the test seems to be low (in other words, high tax uncertainty). In fact, the OECD has identified this issue and in a recent report on tax certainty states:

"To increase tax certainty in the application of the PPT, the OECD has formed an informal group of interested delegates that would explore various areas where more tax certainty

<sup>190</sup> OECD, TP Guidelines 2017, above fn.18, paras 1.9–1.13.

<sup>191</sup> See Collier and Andrus, above fn.36, 246.

<sup>192</sup> See Collier and Andrus, above fn.36, 230.

<sup>193</sup> OECD, TP Guidelines 2017, above fn.18, para.1.98.

<sup>194</sup> See Collier and Andrus, above fn.36, 230–231.

<sup>195</sup> See Collier and Andrus, above fn.36, 231–232.

<sup>196</sup> See Collier and Andrus, above fn.36, 246–247.

<sup>197</sup> See L. Spinosa and V. Chand, "A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?" (2018) 46(6/7) *Intertax* 476.

<sup>198</sup> R. Kok, "The Principal Purpose Test in Tax Treaties under BEPS 6" (2016) 44(5) *Intertax* 406, 408–409.

could be provided in the PPT, including best practices in the area of the general anti-avoidance rules and would report back with recommendations.”<sup>199</sup>

The Commentary to the PPT currently analyses the impact of the PPT on 13 fact patterns.<sup>200</sup> Moreover, the six additional fact patterns, which are discussed in the context of conduit arrangements, are also analysed in light of the PPT.<sup>201</sup> Out of these 19 examples, only five deal with situations where the PPT is applied to deny the treaty benefit. Therefore, the OECD would be advised to expand the Commentary by enhancing the negative list of examples. Reference could be made to the fact patterns of the following court judgments wherein the denial of a treaty benefit was heavily debated vis-à-vis holding entities: in Austria: *N AG v Regional Tax Office for Upper Austria*<sup>202</sup>; in Canada: *MIL (Investments) SA v Canada*<sup>203</sup> and the *Prévost* cases, *Prévost Car Inc v The Queen*<sup>204</sup>; in India: *Azadi Bacho Andolan v Union of India and another*<sup>205</sup>; in Israel: *Yanko-Weiss Holdings Ltd v Holon Assessing Office*<sup>206</sup>; and in Switzerland: *A Holding ApS v Federal Tax Administration*.<sup>207</sup> Furthermore, to enhance certainty, it could also be clarified that taxpayers which avail themselves of substance based preferential regimes should be entitled to treaty benefits for the underlying income. For instance, taxpayers that avail themselves of a nexus compliant IP box regime should be entitled to the treaty benefits on royalty related income.<sup>208</sup>

In relation to EU law, the authors have argued that if the taxpayer is able to demonstrate that its transaction/arrangement/structure is rational from a commercial and/or an economic perspective then the subjective and non-genuine elements of the PSD and ATAD GAAR-type provisions should not be satisfied. However, in line with the aforementioned discussion with respect to the PPT, the analysis is subjective. Essentially, the question arises as to how will the CJEU interpret the GAAR provisions? Will the Court interpret the phrases “the main purpose or one of the main purposes” and “for valid commercial reasons which reflect economic reality” in light of its established case law or will the Court depart from established case law and broaden the scope of abuse? Also, a similar question arises in relation to how the CJEU will interpret the phrase “substantive economic activity” in the context of the ATAD CFC rules. It seems that this threshold exceeds the wholly artificial arrangement threshold created by the CJEU.<sup>209</sup> Therefore, from a tax certainty perspective, it would be advisable if the EU Commission were to provide some clarification as regards the interpretation of these provisions.

Finally, the notion of *substantial activity* in relation to IP box regimes seems to be uniform among states. States forming part of the Inclusive Framework have adopted the nexus approach.

<sup>199</sup> See IMF/OECD, *Update on Tax Certainty: IMF/OECD Report for the G20 Finance Ministers and Central Bank Governors* (July 2018), 12.

<sup>200</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.182.

<sup>201</sup> OECD MC 2017, above fn.5, Commentary on Article 29, para.187.

<sup>202</sup> *N AG v Regional Tax Office for Upper Austria* [2000] 2 ITLR 884.

<sup>203</sup> *MIL (Investments) SA v Canada*, above fn.62, [2006] 9 ITLR 25.

<sup>204</sup> *Prévost Car Inc v The Queen* [2008] 10 ITLR 736 at 736–758.

<sup>205</sup> *Azadi Bacho Andolan v Union of India and another* [2002] 4 ITLR 878.

<sup>206</sup> *Yanko-Weiss Holdings Ltd v Holon Assessing Office* [2007] 10 ITLR 524.

<sup>207</sup> *A Holding ApS v Federal Tax Administration* [2005] 8 ITLR 536.

<sup>208</sup> Danon, above fn.68, 33.

<sup>209</sup> J. Schönfeld Bonn, “CFC Rules and the Anti-Tax Avoidance Directive” (2017) 26(3) *EC Tax Review* 145, 150; G. Ginevra, “The EU Anti-Tax Avoidance Directive and the Base Erosion and Profit Shifting (BEPS) Action Plan: Necessity and Adequacy of the Measures at EU level” (2017) 45(2) *Intertax* 120, 129–130.

However, the notion of *substantial activity* in relation to non-IP box regimes seems to have been implemented differently. For example, compare the activity requirements in the financing incentives offered by Mauritius and Singapore. Non-uniform implementation of such incentives will lead to tax competition as discussed below.

### 3.2. *The increase in tax competition for attracting economic activities*

Although the BEPS Project has achieved a high degree of international tax co-ordination/co-operation by ensuring that states adopt a common set of tax related rules, it has at the same time enhanced international tax competition.<sup>210</sup> Essentially, states compete by reducing fiscal burdens to attract investment/activities into their jurisdiction or discourage the outflow of investment/activities from their jurisdiction.<sup>211</sup> As argued in this article, a taxpayer should be given access to the entire international corporate tax framework as long as it satisfies the economic activity test (also commercial rationale requirement). Consequently, the authors expect that states will compete to attract economic activities, that is, people functions.<sup>212</sup> Such competition will either take the form of a reduction in corporate tax rates (as well as withholding taxes) or an increase in tax incentives, among others, preferential regimes that attract mobile tax bases.<sup>213</sup> In fact, the recent OECD report, *Tax Policy Reforms 2018: OECD and Selected Partner Economies* (the OECD Report) confirms this point of view.<sup>214</sup>

With respect to a reduction in corporate taxes, the OECD Report confirms that corporate tax rate cuts have accelerated.<sup>215</sup> Several states such as Argentina, Belgium, France, Japan, Luxembourg, Norway, Sweden and the US have reduced their corporate tax rates in 2018.<sup>216</sup> Moreover, several states such as the UK, Australia and Greece have announced corporate tax rate cuts for future years.<sup>217</sup> Although not mentioned in the OECD Report, Switzerland has adopted a corporate tax reform, expected to enter into force on 1 January 2020, alongside which some cantons will be dropping their corporate tax rates. The effective corporate tax rates in Switzerland, depending on the cantons, will range roughly from 13 per cent to 18 per cent.<sup>218</sup> The OECD Report highlights that

<sup>210</sup> P. Piantavigna, “Tax Competition and Tax Coordination in Aggressive Tax Planning: A False Dichotomy” (2017) 9(4) *World Tax Journal* 477, 477–496.

<sup>211</sup> For a detailed discussion on the merits and demerits of tax competition, see W. Schön, “Tax competition in Europe – the legal perspective” (2000) 9(2) *EC Tax Review* 89, 91–95.

<sup>212</sup> EY, *The outlook for global tax policy in 2018* (2018), 2–5; M.P. Devereux and J. Vella, “Implications of Digitalization for International Corporate Tax Reform” (2018) 46(6/7) *Intertax* 550, 551–552.

<sup>213</sup> M.J. Graetz, *Follow the money: essays on international taxation* (Yale: Lillian Goldman Law Library, 2016), 276–277; M. Keen, “Competition, Coordination and Avoidance in International Taxation” (2018) 72(4/5) *Bulletin for International Taxation* 220, 224.

<sup>214</sup> See OECD, *Tax Policy Reforms 2018: OECD and Selected Partner Economies* (Paris: OECD Publishing, 2018), available at: <https://doi.org/10.1787/9789264304468-en> [Accessed 18 June 2019].

<sup>215</sup> See the OECD Report, above fn.214, 65 and A.P. Dourado, “Taxes and Competitiveness: How Much Competitive Is European Tax Competition?” (2018) 46(12) *Intertax* 942.

<sup>216</sup> See the OECD Report, above fn.214, 66–67.

<sup>217</sup> See the OECD Report, above fn.214, 67.

<sup>218</sup> Swiss Federal Council, *Message concernant la loi fédérale sur le Projet fiscal 17*, 21 March 2018, Federal Gazette 2018 2565, 2679.

“countries appear to be engaged in a ‘race to the average’ rather than in a ‘race to the bottom’, with their recent corporate tax rate cuts now placing them in the middle of the pack”.<sup>219</sup>

With respect to a reduction of withholding taxes, the most notable reform pertains to the Netherlands, which has increased the scope of its dividend withholding tax exemption to third state treaty residents.<sup>220</sup>

The OECD Report also confirms that states have also increased tax incentives in order to support investment. The tax incentives pertain to research and development incentives (input incentives in the form of expensing R&D expenses and output incentives in the form of patent boxes<sup>221</sup>), special economic zones schemes, accelerated depreciation provisions, capital investment expensing provisions, small and medium enterprises tax base related changes and so on.<sup>222</sup> Moreover, in light of the various BEPS Actions, several states have issued guidelines with respect to minimum substance requirements for accessing preferential tax regimes, such as the practice adopted by Singapore, Mauritius and more recently the British Crown Dependencies as well as the UAE (section 2.4).

#### **4. The next stage: from Base Erosion and Profit Shifting to Base Expansion and Profit Sharing**

This article has argued that the taxpayer entity should be given access to the benefits offered by the international corporate tax framework if that taxpayer satisfies the relevant economic activity test. Accordingly, in the post-BEPS environment, MNEs can still engage in profit shifting activities by having the appropriate people functions in low tax jurisdictions. On the other hand, tax competition between states is intensifying in order to attract people functions. Interestingly, the activity-based concepts discussed in section 2 do not alter the allocation of taxing rights framework agreed between states. However, in light of the digitalisation of the economy,<sup>223</sup> there is pressure to reconsider the allocation of taxing rights framework (Pillar I) and find solutions to counter genuine profit shifting strategies to low tax jurisdictions/tax competition between states (Pillar II). Thus, we have already started to witness the movement from BEPS 1.0 to BEPS 2.0 (Base Expansion and Profit Sharing). The “core” challenges raised by digitalisation will be discussed in another article. <sup>Ⓔ</sup>

<sup>219</sup> See the OECD Report, above fn.214, 9–10.

<sup>220</sup> See the OECD Report, above fn.214, 74.

<sup>221</sup> EY, above fn.212, 3–4.

<sup>222</sup> See the OECD Report, above fn.214, 7, 4–77.

<sup>223</sup> See OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digitalisation of the Economy, Public Consultation Document, 13 February–6 March 2019* (2019), available at: <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> [Accessed 18 June 2019].

<sup>Ⓔ</sup> Abuse of rights; Base erosion and profit shifting; EU law; General anti-abuse rule; International tax planning; Multinational companies; Tax policy