

# Combating Tax Avoidance in the EU

## **EUCOTAX Series on European Taxation**

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VOLUME 61

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# Combating Tax Avoidance in the EU

## Harmonization and Cooperation in Direct Taxation

Edited by

José Manuel Almudí Cid  
Jorge A. Ferreras Gutiérrez  
Pablo A. Hernández González-Barreda

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Wolters Kluwer

*Published by:*

Kluwer Law International B.V.  
PO Box 316  
2400 AH Alphen aan den Rijn  
The Netherlands  
E-mail: [international-sales@wolterskluwer.com](mailto:international-sales@wolterskluwer.com)  
Website: [irus.wolterskluwer.com](http://irus.wolterskluwer.com)

*Sold and distributed in North, Central and South America by:*

Wolters Kluwer Legal & Regulatory U.S.  
7201 McKinney Circle  
Frederick, MD 21704  
United States of America  
Email: [customer.service@wolterskluwer.com](mailto:customer.service@wolterskluwer.com)

*Sold and distributed in all other countries by:*

Air Business Subscriptions  
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Haywards Heath  
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RH16 3DH  
United Kingdom  
Email: [international-customerservice@wolterskluwer.com](mailto:international-customerservice@wolterskluwer.com)

*Printed on acid-free paper.*

ISBN 978-94-035-0154-3

e-Book: ISBN 978-94-035-0142-0

web-PDF: ISBN 978-94-035-0151-2

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Printed in the United Kingdom.

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## CHAPTER 21

# The 2016 Communication on the Strategy on External Action and the External Dimension of the EU in Tax Matters: Balancing Internal Market and Tax Sovereignty

*Edoardo Traversa & Alejandro Zubimendi*

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### **§21.01 INTRODUCTION: EXTERNAL ACTION IN THE EU IN TAX MATTERS AND THE NEW PARADIGM IN INTERNATIONAL TAX RELATIONS**

EU action in tax matters is mainly aimed at ‘internal’ goals relating to the European Union territory. In concrete terms, the tax policy of the Union pursues two distinct objectives.<sup>1</sup> The first objective concerns the creation of an internal market without distortions, free of externalities that may present barriers to the exercise of an economic activity within the European Union. To this end, European actions are focused on securing the effectiveness of the freedoms of movement. A second goal is the consecration of an effective tax system able to prevent erosion of the Member States’ tax bases. Among the measures pursuing this aim, we can also find those actions aimed at tackling harmful tax competition practices.

In recent years, the new paradigm in international relations, based on cooperation among countries (rather than competition), has favoured the direct involvement of the European Union with respect to the elaboration and application of an external tax policy. This has emphasized even more, the existing tension between Member States’

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1. P. Pistone, *Smart Tax Competition and the Geographical Boundaries of Taxing Jurisdictions: Countering Selective Advantages Amidst Disparities*, 40 *Intertax* 2, p. 85 (2012).

tax sovereignty, enshrined in the Treaty on the Functioning of the European Union (TFEU),<sup>2</sup> and the increasing trend of the Union to expand its internal policies beyond the European territory and to strengthen the internal market.<sup>3</sup> The analysis of the legal basis justifying the external action of the European Union therefore ultimately requires a proportionality and opportunity test to be carried out with respect to the foundation goals of the Union and the new global standards in international taxation.

## §21.02 LEGAL FOUNDATIONS FOR EXTERNAL ACTION

The first matter to consider regarding external action of the European Union is the determination of the legal basis for the Union to issue legislation with repercussions on third countries. This question, beyond technicalities, may raise some doubt since the main goal of the Union is the creation of an internal market.<sup>4</sup>

EU external relations are mainly regulated by EU internal rules and international conventions. The legal foundations for the European Union to adopt internal rules in tax matters with repercussions on third countries do not set out specific problems other than analysing their compatibility with the goals of the Union and the subsidiarity principle.<sup>5</sup> Nevertheless, the EU competence to enter into treaties with third countries in the framework of direct taxation deserves special attention.<sup>6</sup>

The European Union was granted express legal personality by the Treaty of Lisbon and therefore has full legal subjectivity to conclude international agreements.<sup>7</sup> Nevertheless, over time, free trade agreements have gained complexity and nowadays they cover a broad range of subjects. These agreements therefore govern subjects that are within the exclusive competence of the European Union as well as other subject areas on which competence is shared between the Union and its Member States. The distinction between exclusive competence and shared competence areas has to be

- 
2. Tax competition among the Member States, protected by their tax sovereignty, has clashed with the efforts of the Community institutions to strengthen the internal market by means of coordination and harmonization of domestic tax rules.
  3. According to Avery Jones, the Economic and Monetary Union has left the Member States little scope for action apart from direct tax. J.F. Avery Jones, *Flows of Capital between the EU and Third Countries and the Consequences of Disharmony in European International Tax law*, 7 EC Tax Rev. 2, p. 95 (1998).
  4. J.A. Taha, *The External Implied Competence of the European Union and the Impact of Bilateral Treaties on the Taxation of Cross-Border Savings*, 38 Intertax 3, p. 157 (2010).
  5. Concerning EU competence in tax matters, see F. Amtenbrink & H. Raulus, *Contribution to: Fiscal Policy in the European Union Context – The Semi-detached Sovereignty of Member States in the European Union in Fiscal Sovereignty of the Member States in an Internal Market: Past and Future* pp. 13 et seq. (S.J.J.M. Jansen ed., Kluwer Law International 2011); L. Cerioni, *The European Union and Direct Taxation: A Solution for a Difficult Relationship* pp. 19 et seq. (Routledge 2015).
  6. The supremacy of Community law over domestic law (of which treaties entered into by the Member States take part) is confirmed by Case C-6/64, *Costa v. ENEL*, ECR [1964] 585, and Case C-26/62, *Van Gend*, ECR [1963]. However, this supremacy is not enforceable with respect to third countries with which the Member States sign treaties potentially incompatible with European law. In this sense, see Taha, *supra* n. 4, at pp. 160 and 161.
  7. Article 47 of the Treaty on European Union (TEU). See A.C.M. Zaidan, *The External Tax Treaty Making Powers of the Member States: Defining Limits and Obligations under the Current European Legal Order*, 41 Intertax 5, p. 275 (2013) Until the Lisbon Treaty, the subjectivity to conclude international agreements was in the hands of the European Community.

made separately for each component of the agreement negotiated by the Union. In this regard, the European Court of Justice (ECJ) has recently issued an Opinion whereby the future Free Trade Agreement between the European Union and the Republic of Singapore must be signed jointly by the Union and its Member States (in the form of a ‘mixed agreement’), although the majority of the provisions are within the scope of the common commercial policy (exclusive competence of the Union). The participation of the Member States in the conclusion of international agreements may be seen as a democratic requirement as well as a brake on the efficacy of EU external action.<sup>8</sup>

The Treaty of Lisbon also represented a great advance in the codification of ECJ doctrine on the right to conclude international agreements by the Union. The Treaty of Lisbon introduced the new Article 216 of the TFEU, which is considered as the ‘general external competence provision’.<sup>9</sup>

Article 216 of the TFEU provides that the European Union has *express* competence to conclude agreements with third countries ‘where the Treaties so provide’ or where ‘provided for in a legally binding Union act’. Therefore, EU external competences emanate directly from the exercise of its internal competences and thus the legality of the external action will be determined by the study of the appropriateness of the internal rules to achieve the Community goals. Nevertheless, Article 216 prescribes two situations of *implied* competence to conclude international agreements, thus codifying the ECJ doctrine.<sup>10</sup> The Union therefore has the right to conclude international agreements where the conclusion of an agreement is necessary to achieve one of the goals referred to in the Treaties or is likely to affect common rules or alter their scope. Article 17(2) of Council Directive 2003/48/EC (Savings Directive) provided for the extension of its measures to Andorra, Liechtenstein, Monaco, San Marino and Switzerland. Nevertheless, the agreement with Switzerland<sup>11</sup> ultimately went beyond that provision and established in its Article 15, measures equivalent to those contained in Council Directive 90/435/EEC (Parent-Subsidiary Directive) and Council Directive 2003/49/EC (Interest and Royalty Directive). Thus, the Community made use of its implied competence to conclude international agreements in matters not provided by Community law.<sup>12</sup> However, the fact that international agreements in tax matters

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8. ECJ Opinion 2/2015, ECLI:EU:C:2017:376, paras 240–244.

9. See Zaidan, *supra* n. 7, at p. 275.

10. Case C-22/70, *Commission v. Council*, ECLI:EU:C:1971:32, which concerned the European Agreement on Road Transport (AETR) and established implied external competence (AETR competence) in cases where external action of the Member States may affect the common rules already adopted by the Union. On the other hand, the ECJ Opinion 1/76, 26 Apr. 1977, ECLI:EU:C:1977:63, established an implied external competence, even in the absence of common internal legislation, whenever external action of the Union is necessary for the attainment of one of its objectives.

11. Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (26 Oct. 2004), OJ L385, 29 Dec. 2004, pp. 28–49. This Agreement was amended on 27 May 2015 to adapt it to the new standards of exchange of information (EOI) on financial accounts, OJ L333, 19 Dec. 2015, pp. 12–49.

12. The fact that the agreement with Switzerland was expressly provided for in the Savings Directive, with the exception of Art. 15 of the agreement, means that this was the exercise of express external competence according to Art. 216 of the TFEU (‘provided for in a legally binding Union act’), and consequently it does not imply any attribution problem (see the principle of

concluded by the Union must be authorized by unanimity in the Council (Article 218(8) of the TFEU) makes irrelevant, from a practical point of view, the determination of the source, express or implied, of the external competence in tax matters. Analysis of the existence of such external competence (express or implied) therefore leads us, as a last resort, to the principle of subsidiarity and the necessity of establishing measures relating to third countries in matters affecting the internal market.<sup>13</sup>

The most important question is determining whether a matter on which there is implied external competence could be a matter within the exclusive competence of the Union and thus prevent the Member States from concluding agreements in tax matters with third countries, i.e., whether the nature of the implied external powers of the Union is exclusive or shared with its Member States.<sup>14</sup> In this regard, Article 3(2) of the TFEU reflects the ECJ doctrine, establishing that the Union shall have exclusive competence to conclude an international agreement when ‘its conclusion ... is necessary to enable the Union to exercise its internal competence, or in so far as its conclusion may affect common rules or alter their scope’.

With regard to the first type of situation, the implied external competence arising from a *necessity ratio* (competence deriving from ECJ Opinion 1/76)<sup>15</sup> only exists as long as the Union has not yet exercised its competence, otherwise we would be before an AETR competence. In the field of the fundamental freedoms (the field which usually affects matters of direct taxation), there is no exclusivity because it is a shared competence (Article 4 of the TFEU). Consequently, there is no exclusivity in taxation where the competence is exercised by reason of the ‘necessity to enable the Union to exercise its internal competence’. The ECJ has settled that in regard to the fundamental freedoms, only the competence due to the *affect ratio* (AETR competence) may give rise to exclusivity.<sup>16</sup>

Once the European Union exercises its competences, whether express or implied, and establishes a common policy on a certain matter, it acquires an implied external competence based on the *affect ratio* (AETR competence). The ECJ has established that this type of implied competence is always exclusive for the Union. Nevertheless, the existence of several tax directives does not mean that the Union has a settled common tax policy with respect to third countries. Hence, we cannot conclude that the Union has exclusive powers to conclude tax agreements with third countries. The cases known as the ‘*Open Skies*’ decisions of the ECJ suggest that distortions in the internal

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attribution enshrined in Art. 5(2) of the TEU). Nevertheless, the internal Community law from which this express competence derives (i.e., the Savings Directive) is the measure that should be subjected to control according to the principle of subsidiarity (Art. 5(3) of the TEU) that governs the shared competences (such as taxation). See sec. 24.3. for an analysis concerning the suitability of the external actions of the European Union in tax matters in the light of the subsidiarity principle. In this regard, see Taha, *supra* n. 4, at p. 158.

13. See sec. 24.3.

14. See R. Holdgaard, *External Relations Law of the European Community: Legal Reasoning and Legal Discourses* p. 54 (Kluwer Law International 2008). According to the first part of Art. 3(2) of the TFEU, the express external competence (expressly ‘provided for in a legislative act of the Union’) shall always be exclusive competence of the Union, in coherence with the application of the principle of primacy of EU law.

15. ECJ Opinion 1/76, *supra* n. 10.

16. ECJ Opinion 1/94, 15 Nov. 1994, ECLI:EU:C:1994:384, paras 86–88.

market produced by agreements concluded between the Member States and third countries do not affect the EU common rules adopted in tax matters and consequently they cannot not give rise to implied external competence based on an *affect ratio* (and to exclusive competence).<sup>17</sup> Although it is true that conclusion of tax agreements by the Member States might hinder the goals of an internal market, this effect is not intense enough to interfere with the scope of a tax directive (of an intra-Community scope). This is the reason why the competence of the Member States to conclude their own tax agreements with third countries remains intact.<sup>18</sup> However, this non-harmonization constitutes a source of tax competition between the Member States, favouring the phenomenon of tax base erosion (referred to as ‘channelling’).<sup>19</sup>

### **§21.03 TAX BASE EROSION AND INTERNATIONAL TAX COMPETITION WITH RESPECT TO THIRD COUNTRIES**

#### **[A] Tax Base Erosion: Taxation Where ‘Value Is Generated’ as a New Paradigm to Achieve a Global Level-Playing Field**

It is necessary to contextualize the current external strategy of the Union in tax matters. The recent Communication on an External Strategy for Effective Taxation<sup>20</sup> is inserted into the framework of the Anti-Tax Avoidance (ATA) Package.<sup>21</sup> The external tax policy of the Union therefore requires not only that harmful tax competition from third countries is analysed, but also that the ATA Package is analysed from a more global perspective. Only in this way is it possible to build a coherent framework of external relations and to assess the legitimacy and legality of the adopted measures.

It might seem that the fact that the Union has to adopt its tax rules by unanimity (Article 115 of the TFEU) grants an *ex ante* legitimacy and consequently an analysis of the EU competence would lack practical utility. Nevertheless, national parliaments do

17. For example *see* Case C-476/98, *Commission v. Germany*, ECLI:EU:C:2002:631, para. 111. In this regard, the *affect ratio* is interpreted strictly, considering that agreements with third countries do not affect the Community common rules when the scope of the latter is limited to intra-Community situations. Nevertheless, for the first time, the recent Anti-Tax Avoidance Directive (ATAD) extends the scope of a tax directive to certain extra-Community situations. However, it is unlikely that this situation grants the Union exclusive competence in tax treaties considering that the ECJ has required that the content of EU rules covers ‘to a large extent’ the scope of such treaties, such as it is established in para. 108 of the referred ECJ decision and in ECJ Opinion 1/03, 7 Feb. 2006, ECLI:EU:C:2006:81, para. 126.

18. K. Vogel, D. Gutmann & A.P. Dourado, *Tax Treaties Between Member States and Third States: ‘Reciprocity’ in Bilateral Tax Treaties and Non-Discrimination in EC Law*, 15 EC Tax Rev. 2, p. 90 (2006). The authors state that the fact that tax directives have been adopted to eliminate withholding taxes at source, does not mean that the Union has established a common policy with respect to the allocation of taxing rights with third countries.

19. H. Koot & M. de Rijke, *The Netherlands Court of Audit: An Audit on Tax Avoidance*, 69 Bull. Intl. Taxn.11 (2015).

20. Communication from the Commission to the European Parliament and the Council on an External Strategy for Effective Taxation, COM (2016) 24 final (28 Jan. 2016).

21. Communication from the Commission to the European Parliament and the Council: Anti-Tax Avoidance Package: Next steps towards delivering effective taxation and greater tax transparency in the EU, COM (2016) 23 final (28 Jan. 2016).

not grant the consent, it is the governments that do so.<sup>22</sup> Consequently, it is important to secure compliance with the rule of law principle<sup>23</sup> in the adoption of Community tax measures and to assess whether the adoption of such measures is framed within the competences granted by the TFEU in light of the subsidiarity, opportunity and proportionality principles. Thus, external action of the Union must be monitored and duly pondered in order that Member States' sovereignty not be violated.

Currently, EU external action in tax matters is focused on aggressive tax planning and tax base erosion.<sup>24</sup> This increasing interest in tax avoidance has led the OECD to develop the colossal BEPS (Base Erosion and Profit Shifting) Project. The Union, whose Member States generally form the leadership in the OECD, has echoed this project and has started to work on implementing the OECD measures.

The fact that tax policy of the Union should be aimed at securing the internal market suggests, at first glance, that the fight against tax avoidance should be limited to having an intra-Community scope. However, Member States' relations with third countries may give rise to distortions in the internal market. Consequently, the Union has included in the ATA Package not only a set of anti-avoidance rules (that have been crystallized in the Anti-Avoidance Directive, or ATAD),<sup>25</sup> but also its external strategy.<sup>26</sup>

The ATAD has fixed a common framework in order to ensure that Member States implement anti-avoidance measures to combat tax base erosion. The criterion that underlies the BEPS Project and the ATA Package is the territorial alignment of taxation with the location where the economic activity takes place.<sup>27</sup> This principle does not mean an obligation on the Member States to effectively tax the economic activities carried out within their territories, but the evolution towards a fairer tax system where income derived within a given state may not be diverted to other jurisdictions by means of artificial structures. We should not forget that, currently, international tax competition is accepted by the Union, allowing its Member States to tailor their tax systems to their preferences and necessities, and the Member States are by no means obliged to maintain a minimum level of taxation.

At the intra-Community level, the policy aimed at mitigating tax base erosion is guided by the broader goal of securing equality in business competition, without

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22. For A.P. Dourado, *International Standards, Base Erosion and Developing Countries*, in *Tax Design Issues Worldwide* p. 187 (G.M.M. Michielse & V. Thuronyi eds, Kluwer Law International 2015), the legitimacy of the international tax standards depends to a large extent on the debate in the national parliaments.

23. The legality principle in tax matters has its roots in the principle of 'no taxation without representation'.

24. About the definition of aggressive tax planning, see A.P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, 43 *Intertax* 1, pp. 43 et seq. (2015).

25. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L193, 19 July 2016, pp. 1–14.

26. COM (2016) 24 final (28 Jan. 2016).

27. Paragraph 1 of the ATAD's Preamble lays down that 'the current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated'.

distortions or barriers that erode the ‘level playing field’. The increasing harmonization of the anti-avoidance measures, mainly enshrined in the ATAD, has a double objective. The first one is to combat the misuse of the fundamental freedoms. Fundamental freedoms (and the tax directives that develop them) must be effective, ensuring a true common market. The fundamental freedoms may not be used as a tool for multinationals to artificially shift income from one Member State to another. The Union considers that tax avoidance distorts the free competition between companies in the internal market.<sup>28</sup> On the other hand, the intention of the ATAD, in order to create legal certainty within the EU for citizens, companies and the Member States, is to fix a common and coordinated framework for the implementation of anti-abuse measures. This way, anti-abuse measures will not violate EU fundamental freedoms<sup>29</sup> and will not create additional distortions in the internal market (e.g., in the form of double taxation).<sup>30</sup>

Nevertheless, that assumption, on which the legitimacy of the Union to legislate in tax matters is settled, is not completely acceptable when analysing the tax measures adopted by the Union in relation to third countries. Tax sovereignty of the Member States is even more intense with respect to their relations with third countries in so far as it does not affect Community rules and goals. Consequently, Member States have more freedom to establish tax measures affecting income streams with third countries. Member States have more autonomy in establishing the distribution of taxing rights with third countries (in part because the harmonization of withholding taxes by tax directives only affects intra-Community income streams, and in part because of the non-application of the non-discrimination principle, with the exception of the free movement of capital), but they also have more autonomy to establish anti-avoidance rules with respect to third countries.

The first step to address this tension between the external tax sovereignty of the Member States (and their freedom to establish an adequate balance between tax collection requirements and the need to be competitive) and the realization of the EU internal market is to recall the new paradigm of the international tax system: the alignment of taxation with the place where value of the business activities is generated. This first step is fundamental to understanding how this new principle has been established and spread to the international community from the OECD and the

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28. COM (2016) 23 final (28 Jan. 2016), p. 2.

29. In a situation where there was no coordination (in the absence of the ATAD), where each Member State can establish its own anti-avoidance measures on an autonomous basis, there would be a risk that such measures violate the Community principle of non-discrimination.

30. A.P. Dourado, *The EU Anti Tax Avoidance Package: Moving Ahead of BEPS?*, 44 *Intertax* 6/7, p. 442 (2016). According to this author, the *de minimis* character of the ATAD entitles Member States to broaden the scope of the anti-avoidance rules, which might put at risk the non-discrimination principle, to the detriment of legal certainty. Nevertheless, if the ATAD had adopted a *de maximis* approach, it would not have been effective with respect to the goal of combating aggressive tax planning. Besides, a *de maximis* ATAD would have meant maintaining an uncoordinated situation between the Member States, giving rise to double taxation risks. In the context of the ATAD measures aimed at third-country situations, this double taxation risk persists because of the non-binding nature of the BEPS Project with respect to third countries, which are free to design and apply anti-avoidance measures. This double taxation risk with respect to third-country situations is even stronger with respect to the anti-hybrid rules.

European Union. Assuming this new paradigm, the external tax policy of the Union can be analysed from two dimensions: international tax avoidance within the Union and harmful tax competition carried out by third countries.

### **[B] International Tax Avoidance Within the EU and Its Implications with Respect to Third Countries**

Diplomatic tax relations between the Union and third countries depends largely on the attitude of the Union towards aggressive tax planning. The main problem is not that income sourced within the Union is not taxed in any Member State, since the will to collect taxes is an attribute belonging to Member States' sovereignty. The main problem lies in the fact that the erosion of the Member States' tax bases gives rise to distortions in the EU internal market in the form of competitive advantages for certain multinational companies.

The ATAD has included several anti-abuse rules applicable to transactions with third countries, particularly the interest limitation rule (Article 4), exit taxation rule (Article 5), controlled foreign company (CFC) rule (Articles 7 and 8) and the anti-hybrids rule (Article 9).<sup>31</sup>

The obligatory or *de minimis* nature of these rules (Article 3 of the ATAD) is justified by the need to avoid distortions in the EU internal market, since tax avoidance, wherever it comes from, gives rise to market distortions in the form of competitive advantages for the companies that take advantage of legal gaps. Nevertheless, the anti-avoidance rules may give rise to other distortions in the form of double taxation.<sup>32</sup> Whereas the Union, acting as though it was a unique state, has established anti-avoidance rules for its transactions with third countries, the latter are not bound by the ATAD (not even by the BEPS Project). The reason is that if a third country does not coordinate with the Union on the application of those measures, a double taxation risk arises. This potential effect is evident in the context of hybrid mismatches, where it is essential that every involved country applies the uniform criteria established by the OECD and the European Union in order to maintain a proper balance in the allocation of taxing rights and not to generate double taxation outcomes.<sup>33</sup> As long as there is no full coordination in the application of anti-avoidance measures throughout the international community, there is some risk of international double taxation. This risk might harm investments between the Union and third countries and favour intra-Community investments. The most-developed regions (such as the European Union), which are the source of capital in most cross-border investments, have imposed their conception of 'inter-nation equity'<sup>34</sup> whereby a 'fair' allocation of taxing rights is

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31. Article 9 of the ATAD was amended by Council Directive (EU) 2017/952 of 29 May 2017, OJ L144, 7 July 2017, pp. 1–11, in order to extend its scope to hybrid mismatches resulting from third-country situations.

32. See Dourado, *supra* n. 30.

33. Exit taxation rule (Art. 5 of the ATAD) also sets out some double taxation risks where the recipient country is a third state.

34. P. Musgrave & Richard Musgrave, *Inter-nation equity in Modern Fiscal Issues: Essays in Honor of Carl Shoup* (University of Toronto Press 1972); K. Brooks, *Inter-Nation Equity: The Development*

characterized by a territorial alignment between taxation and the value generation (even though this concept is somewhat ambiguous).<sup>35</sup> This means that less-developed regions, dependent on capital from wealthier regions, are compelled to accept those principles and to adapt in order not to give rise to more distortions (double taxation) that could undermine their attractiveness to receive foreign investment.

It is relevant to point out that the final draft of the ATAD has not included certain anti-abuse rules that would have applied on an automatic basis, such as the switch-over clause.<sup>36</sup> Nevertheless, the ATAD does include other types of clauses with automatic application, such as the interest limitation rule, the anti-hybrids rule, and the CFC rule when applying to subsidiary companies located in third countries.<sup>37</sup> These are clauses that apply automatically to structures or transactions where certain objective conditions are met (such as the condition that the state where the income is sourced has a tax rate below a certain threshold), turning those transactions automatically into abusive, a sort of *iusuris et de iure* presumption. Beyond their compatibility with the EU fundamental freedoms (particularly with the free movement of capital, which also applies to third-country situations), the existence of measures applying without real abuse means the annulment of the tax benefits granted by third countries, taxing extra-Community income at the same level as the Member States tax it. In the current context where the European Union is a capital exporter, limiting the ability of less-developed countries to attract capital might be seen as a sort of indirect protectionism carried out by the Union.<sup>38</sup>

On the other hand, these types of rules applying automatically (not requiring real abuse) and the exit taxation rule, in so far as they have an imperative or *de minimis* character, should be understood as an instrument to allocate taxing powers between

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*of an Important but Underappreciated International Tax Policy Objective in Tax Reform in the 21st Century* (R. Krever & J.G. Head eds, Kluwer Law International 2009).

35. COM (2016) 23 final (28 Jan. 2016), p. 5. In the same line, the OECD establishes that there should be an alignment of taxation and economic substance; OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), p. 13. About the difficulties of determining the value generation in the digital economy, see M. Olbert & C. Spengel, *International Taxation in the Digital Economy: Challenge Accepted?*, 9 *World Tax J.* (2017).
36. Article 6 of the Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM (2016) 26 final (28 Jan. 2016).
37. The anti-hybrids rule (Art. 9 of the ATAD) and the CFC rule (Arts 7 and 8 of the ATAD) when applying to subsidiaries established in third countries, may have similar problems to those of the switch-over clause. Although with an optional or *de maximis* character, the ATAD establishes in Art. 7(2)(a) that where the CFC is resident or situated in a third country that is not party to the European Economic Area Agreement (EEAA), Member States may apply the CFC rule even though such subsidiary company has economic substance.
38. Nevertheless, if the rest of the international community does not follow the path of the European Union, opting not to implement the BEPS standards, the Member States might be at a competitive disadvantage with respect to other competing countries not applying the BEPS rules. In this sense, A. Navarro, L. Parada & P. Schwarz, *The Proposal for an EU Anti-avoidance Directive: Some Preliminary Thoughts*, 25 *EC Tax Rev.* 3, pp. 122 and 129 (2016); Dourado, *supra* n. 30, at p. 441.

countries,<sup>39</sup> so that it is questionable that the Union may claim, according to the subsidiarity principle, powers to interfere in the allocation of taxing rights between Member States and third countries, at least with respect to the switch-over clause, where there does not seem to be any avoidance or aggressive tax planning element that may justify the intervention of the Union. Besides, the existence of these clauses may raise treaty override problems with respect to tax treaties signed by Member States with third countries.<sup>40</sup>

Lastly, the binding nature of the ATAD measures with regard to third-country situations resolves the uncertain and precarious juridical situation over the Member States that had opted, as a strategy to attract foreign investment, for a relaxed attitude towards tax avoidance.<sup>41</sup> Since the Commission has considered as forbidden State aid those tax benefits granted to extra-Community investment,<sup>42</sup> it would appear to be a coherent approach to put a stop to any possibility of Member States facilitating, by means of the absence of anti-abuse rules, the shift of tax bases or mobile activities out of the European Union.<sup>43</sup> In this sense, when a Member State does not close legal gaps,

39. See Dourado, *supra* n. 30, at p. 441; G. Bizioli, *Taking EU Fundamental Freedoms Seriously: Does the Anti-Tax Avoidance Directive Take Precedence over the Single Market?*, 26 EC Tax Rev. 3, p. 172 (2017).

40. Navarro, Parada & Schwarz, *supra* n. 38, at p. 123.

41. R.H.C. Luja, *Do State Aid Rules Still Allow European Union Member States to Claim Fiscal Sovereignty?*, 25 EC Tax Rev. 5/6, p. 323 (2016). According to this author, it is not for the European Union to fill, through the application of the State aid regime, the gap created by the absence of anti-avoidance measures to combat non-taxation because otherwise it would put at risk the tax sovereignty of the Member States and the principle of legality. In line with this, De Broe considers that the State aid regime should not be used as a method to harmonize direct taxation or to combat the double non-taxation resulting from the hybrid structures; see L. De Broe, *The State Aid Review against Aggressive Tax Planning: 'Always Look a Gift Horse in the Mouth'*, 24 EC Tax Rev., 6, p. 293 (2015). Conversely, Rossi-Maccanico considers that the State aid regime is competent to combat international tax avoidance and that it is even more effective than anti-avoidance measures; see P. Rossi-Maccanico, *Fiscal State Aids, Tax Base Erosion and Profit Shifting*, 24 EC Tax Rev. 2, p. 63 (2015).

42. Although the final judicial resolution before the Community instances is currently pending, the Spanish rule permitting the deductibility of the financial goodwill for acquisitions of foreign companies (including non-EU companies), was declared a prohibited State aid by Commission Decisions 2011/5/EC, 28 Oct. 2009 (OJ 2011 L7, 11 Jan. 2011, p. 48) and 2011/282/EU, 12 Jan. 2011 (OJ 2011 L135, 21 May 2011, p. 1).

43. Pistone, *supra* n. 1, at p. 86, has coined the expression 'smart tax competition' to refer to those situations where a State legislates in a very permissive manner with respect to tax avoidance in order to favour cross-border investments and avoid the application of the State aid regime. See also E. Traversa & A. Flamini, *The Impact of BEPS on the Fight Against Harmful Tax Practices: Risks ... and Opportunities for the EU*, British Tax Rev. 3, p. 398 (2015). For these authors, the regimes that traditionally have been considered as harmful tax competition within the European Union have been eradicated through the parallel action of the Code of Conduct Group and, in relation to State aid, the Commission. Nevertheless, Member States have adapted to this circumstance and designed preferential tax regimes that are less recognizable, such as the issuing of tax rulings for particular multinational companies, forcing the interpretation of the domestic law beyond the reasonable or through the establishment of advantageous tax regimes that although *nominally* of a general application, *de facto* are only capable of being accessed by certain multinational companies (e.g., large technology-based multinational groups) may apply them.

multinational companies operating in that territory are the most favoured. Ireland was subjected to some pressure by the Union to introduce effective rules against transfer pricing. The lack of effective transfer pricing rules, along with an opaque tax policy with respect to tax rulings, has put Ireland under continuous scrutiny with respect to its commitment to eliminate any harmful tax competition and State aid practices. Thus, the ATAD means an ex ante control of tax avoidance, which results in more legal certainty.

### [C] Tax Competition by Third Countries

The efforts by the European Union to fight against harmful tax competition have traditionally been focused on the intra-Community scope, instigating Member States to eliminate any unfair tax measure aimed at attracting investment (usually very mobile investments and therefore sensitive to tax stimulus) at the expense of other Member States that, because of their dimension and collection needs, cannot compete on an equal footing. This commitment to eliminate disloyal tax practices within the Union, though not binding, has been reinforced by the EU State aid rules, which have permitted the Union to fight against many harmful tax practices.

However, until recently, Member States have not enjoyed a robust Community programme encouraging third countries to comply with good governance in tax matters.<sup>44</sup> Even though the European Commission has issued some recommendations to Member States in this regard,<sup>45</sup> the autonomous or unilateral path followed by Member States has turned out ineffective. A common and coordinated EU approach is needed.

Backed by the BEPS Project, the European Union has therefore decided to assume a predominant role and a firmer attitude against those third countries that do not comply with tax good governance standards. In this regard, the recent Communication from the Commission to the European Parliament and the Council on an External Strategy for Effective Taxation (2016) has designed the framework for the EU external action against harmful tax competition in third countries.<sup>46</sup>

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44. See Traversa & Flamini, *supra* n. 43, at pp. 404–406. According to these authors, the EU attitude with respect to tax good governance in third countries has varied lately. At first, the Commission suggested the cooperative channel as a means to spread its tax good governance standards to third countries. In this regard, see the Communications from the Commission to the Council, the European Parliament and the European Economic and Social Committee, COM (2009) 201 final, on Promoting Good Governance in Tax Matters (28 Apr. 2009) and COM (2010) 163 final, on Tax and Development (21 Apr. 2010). This cooperation strategy was soon abandoned by the Commission to promote the punitive channel, through the elaboration of blacklists by Member States, towards third countries not complying with the tax good governance standards. In this respect, see the Commission Recommendation of 6 Dec. 2012 regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters (2012/771/EU), OJ L338, 12 Dec. 2012, pp. 37–40.

45. Commission Recommendation, 6 Dec. 2012 (2012/771/EU).

46. COM (2016) 24 final (28 Jan. 2016).

### [1] *Tax Good Governance Criteria Update*

The Commission has reinforced tax good governance criteria by incorporating the new international standards that have arisen in recent years in the OECD context.<sup>47</sup> First of all, the transparency criterion should reflect, as a minimum, the new global standard for the AEOI relating to financial accounts.<sup>48</sup>

On the other hand, the fair tax competition criterion requires third countries to embrace the new anti-avoidance rules developed through the BEPS Project. Even though the fair tax competition criterion has been updated, the Commission has not substantially altered the extent and scope of what the Code of Conduct has considered as harmful tax competition. In this sense, for the Commission there does not seem to be a distinction between preferential tax regimes and State aid, since both phenomena encompass selective tax advantages according to which a selective group of taxpayers benefits from a lower tax burden than the regular tax burden in the reference country.<sup>49</sup> The goal is to avoid situations where European exporters cannot compete on an equal footing with third-country companies. We can therefore see how the Union follows the path of punishing those tax systems referred to as ‘production tax havens’.<sup>50</sup> Besides, even though the selectivity criterion is not met in a formal sense, the permissiveness of certain countries towards tax avoidance results in benefits for multinational companies, which have structures that let them reduce their tax bills very much below the nominal tax rates.<sup>51</sup> The Commission therefore considers as unfair tax practices, not only those tax benefits deliberately granted to a selective group of taxpayers or companies, but also those country practices that in an indirect manner, let multinational companies therein located benefit from an effective tax rate lower than the nominal tax rate by means of narrowing tax base techniques.<sup>52</sup>

47. COM (2016) 24 final (28 Jan. 2016), at sec. 2 and Annex 1.

48. The OECD Council approved on 15 July 2014 the new rule of automatic exchange of information on financial accounts, known as the Common Reporting Standard (CRS). The Global Forum on Transparency and Exchange of Information for Tax Purposes is tasked with monitoring the compliance with this new standard in the international community.

49. The European Commission considers as State aid the fact that ‘third countries grant support to certain local companies through preferential tax regimes, administrative practices or individual tax rulings’ because ‘it can limit market access for EU exporters, by putting them at a disadvantage compared to the subsidised local companies’, COM (2016) 24 final (28 Jan. 2016), sec. 3.2. See also Dourado, *supra* n. 30, at p. 444.

50. R.S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 7, pp. 1586 et seq. (2000).

51. According to Pistone, *supra* n. 1, at p. 90, state inactivity against tax avoidance gives rise to de facto selective advantages. Nevertheless, from an economic and global perspective, there is no consensus about the purported harms of a non-neutral tax system that permits tax advantages to certain multinational companies. In this regard, corporate income tax is a naturally inefficient and non-neutral tax that is intended to tax income. In line with this, O. Marian, *Meaningful Corporate Tax Residence*, 140 Tax Notes, p. 473 (2013). For B. Bracewell-Milnes, *Is Tax Avoidance Harmful?*, 31 Intertax 3, p. 96 (2003), tax avoidance permits countries to retain their competitiveness, being able to attract investment without having to reduce the general tax rates. Mobile investments should be treated with more tax deference.

52. According to the Commission, the international community should adapt to the new tax standards established by the BEPS Project in combating tax avoidance, COM (2016) 24 final (28 Jan. 2016), sec. 2.2.

At the intra-Community level, the phenomenon of ‘smart tax competition’<sup>53</sup> moves across the legal limbo located between the EU fundamental freedoms and the State aid regime.<sup>54</sup> We cannot forget that in an ex post control context, there is no principle in international law that prohibits non-taxation, which would challenge the sovereign decision of a parliament.<sup>55</sup> The Union has therefore had to adopt an ex ante approach, obliging Member States, by means of the ATAD, to comply with the OECD standards relating to tax avoidance. In the same way, at an extra-Community level, the Union has considered the multilateral approach to be a more effective means of spreading those new standards.

### [2] *European List of Non-cooperative Countries and Sanctions*

The European Union has assumed a negotiating role with third countries in order that they embrace, by entering into international agreements with the Union, the minimum rules of tax good governance. This is a negotiating power that the Union has often already been exercising with certain countries, as much in free trade agreements as in specific tax agreements on EOI.<sup>56</sup> In cases where the cooperative approach does not work, the Union has assumed the competence to create a common blacklist of non-cooperative jurisdictions,<sup>57</sup> due to the ineffective, fragmentary and non-uniform application of these kinds of lists by Member States.<sup>58</sup> The assumption by the Union of the competence to ‘tag’ (‘name-and-shame approach’) those countries that refuse to embrace the tax good governance creates the same traditional problems relating to these lists.<sup>59</sup> On the one hand, despite the fact that certain Member States have been carrying out unfair tax practices, the Member States have excluded themselves from the scope of the EU list. It is also unlikely that the EU Council will include in the list third countries with which it maintains close commercial and diplomatic relations. After the recent publication of the ‘Paradise Papers’ by the media,<sup>60</sup> the Council has

53. *Supra* n. 43.

54. Pistone, *supra* n. 1, at p. 86. *See also supra* n. 41.

55. *See* Lujá, *supra* n. 41, at p. 323; W. Schön, *Tax Legislation and the Notion of Fiscal Aid: A Review of Five Years of European Jurisprudence in State Aid Law and Business Taxation* p. 5 (I. Richelle, W. Schön & E. Traversa eds, Springer 2016).

56. *Supra* n. 11.

57. COM (2016) 24 final (28 Jan. 2016), sec. 5.

58. The Commission Recommendation of 6 December 2012 (2012/771/EU) encouraged Member States to draft lists of non-cooperative jurisdictions; lists that were later consolidated through a pan-EU list. This initiative has failed due to the political and diplomatic interests of Member States, which have refused to include in such a list their associated territories that do not comply with tax good governance. Other countries, such as the Germany and the United Kingdom, have directly refused to draft such a list. *See* C. HJI Panayi, *Is Aggressive Tax Planning Socially Irresponsible?*, 43 *Intertax* 10, p. 556 (2015).

59. The European Council approved and provided in detail the tax good governance criteria proposed by the Commission (*supra* n. 47) according to which it will analyse and select those countries that eventually will be part of the list. *See* Council Conclusions on the criteria for and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes (8 Nov. 2016), OJ C461, 10 Dec. 2016, pp. 2–5.

60. *See* <https://www.icij.org/investigations/paradise-papers/> (accessed 15 Jun. 2018).

rushed through the blacklist elaboration<sup>61</sup> and recently published the first version of the list, which should be updated once a year.<sup>62</sup> This first version of the list demonstrates the reluctance of the Union to mark as tax havens those countries with which it has closer relations.

With respect to developing countries, beyond the cooperation and provision of development aid to improve their tax infrastructures in the framework of the Addis Ababa Tax Initiative,<sup>63</sup> the Union has adopted a flexible approach. The Union has made flexible the negotiation process with those countries that, due to deficiencies in their public infrastructures, lack the capacity to adapt to the new standards of tax good governance. In this sense, some authors have suggested the possibility, as a temporary alternative to the introduction of the new tax good governance clauses, of signing agreements with developing countries that oblige them to impose a minimum WHT on passive income for a temporary period,<sup>64</sup> just like the Union has done in the past with certain Member States and other associated countries (such as Switzerland). Nevertheless, this preferential treatment granted by the Union to developing countries requires a greater rigour and certainty with respect to the definition of 'developing country'.<sup>65</sup>

The inclusion in such a list entitles Member States to apply defensive countermeasures,<sup>66</sup> which would usually dissuade European companies from investing in the

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61. In a first phase, the Commission published in September 2016 a ranking of third countries drafted over a set of economic indicators (such as the economic ties with the Union, financial activity or stability) that without prejudging compliance with the tax good governance criteria, established the need to carry out a second phase aimed at monitoring those countries and negotiating with them, [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/2016-09-15\\_scoreboard-indicators.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/2016-09-15_scoreboard-indicators.pdf) (accessed 15 Jun. 2018). In February 2017, the Council sent a letter to those countries that had been included in this preliminary selection in order to communicate to them that they would be subjected to scrutiny and to involve them in the promotion of tax good governance. In December 2017, as a result of the third and last phase, the Council decided which countries become part of the final list.
  62. See Council Conclusions of 5 December 2017 on the EU list of non-cooperative jurisdictions for tax purposes, OJ C438, 19 Dec. 2017, pp. 5–24. In this document the Council identified seventeen non-cooperative jurisdictions (either because they do not comply with the EOI standards or because they maintain preferential tax regimes or because they have not implemented the BEPS measures). This list has changed over the last few months because some listed countries have committed to adapting to the tax good governance standards, so that at present (July 2018) the list comprises the following seven countries: American Samoa, Guam, Namibia, Palau, Samoa, Trinidad and Tobago, and the US Virgin Islands. There having been excluded from this list those countries that even though they do not comply with tax good governance standards, have committed to modifying their tax policies.
  63. See European Commission, *A Contribution to the Third Financing for Development Conference in Addis Ababa*, [https://ec.europa.eu/europeaid/sites/devco/files/com\\_collectmore-spendbetter\\_20150713\\_en.pdf](https://ec.europa.eu/europeaid/sites/devco/files/com_collectmore-spendbetter_20150713_en.pdf) (accessed 15th June 2018).
  64. See Dourado, *supra* n. 22, at p. 194. According to this author, the introduction of the EOI standards in countries with an ineffective democracy and without an effective system to protect taxpayers, might be counterproductive (at pp. 185 and 187–193).
  65. Dourado, *supra* n. 30, at p. 444.
  66. Among the defensive measures, not only ATAD measures are included, but also whatever domestic measures that Member States consider appropriate, such as the switch-over clause, the non-deductibility of payments to non-cooperative jurisdictions, high withholding taxes, etc. According to COM (2016) 24 final, sec. 5.3, 'options could include withholding taxes and non-deductibility of costs for transactions done through listed jurisdictions. This would make it

listed countries.<sup>67</sup> Traditionally, the application of these defensive measures was at the discretion of the Member States, but since the approval of the ATAD, Member States have lost the sovereign power to decide, in consideration of their international competitiveness, whether they want to permit the erosion of their own tax bases.

The execution of defensive measures against non-cooperative third countries, in so far as those measures are not subjected to any supranational control of legality (whereas at the Community level the EU fundamental freedoms are a counterweight and a limit),<sup>68</sup> leaves those countries defenceless. This discrimination by the Union towards countries who are not willing to eliminate advantageous tax regimes might be seen rather than as a defensive means of ensuring the effectiveness of their taxing rights, but instead as an alteration of the taxing rights allocation criterion whereby taxation should take place where value is generated.<sup>69</sup> This attitude of the Union is of a sanctioning character and, might be interpreted as indirect protectionism, a stance clearly in contradiction with its fundamental values.<sup>70</sup>

In light of this situation, third countries have only two options. They can embrace the principles of tax good governance, giving up part of their sovereignty for the benefit of the most-developed countries that have led the formation of the new BEPS paradigm. Or, they can reinforce their protectionist attitude, applying defensive countermeasures against the Union. This second option is less probable, however, given the current dependence of these countries on the capital of wealthier countries.

## [D] Conclusion

In recent years, two patterns have emerged in the new framework of international relations in tax matters. Firstly, multilateralism has surfaced as the new paradigm in the formation process of the international tax rules, replacing bilateral negotiation. Secondly, the substantive criterion whereby taxation must be territorially aligned with the place where companies generate value has turned into the new paradigm for the allocation of taxing rights; thus, giving rise to an international tax law more oriented to substantive criteria than purely formal ones (such as the juridical qualification of income and person categories).

With respect to the 'place where value is generated', even if it is a *prima facie* fair principle, its implementation may not satisfy all of the international community. Each country has its own distinct needs and preferences and thus certain countries depend on offering an attractive tax system to attract investment and develop. Therefore, encouraging the entire international community to adopt this standard under penalty

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much less attractive for companies to invest or do business in these jurisdictions, as the administrative burden and risk of double taxation would be higher.'

67. Dourado, *supra* n. 30, at p. 443.

68. The non-discrimination principle means a brake for the intensive use of defensive or compensatory measures by Member States against unfair tax practices carried out by other Member States. See L. De Broe, *International Tax Planning and Prevention of Abuse* pp. 925 and 926 (IBFD 2008).

69. Dourado, *supra* n. 30, at p. 444.

70. *Supra* n. 38 and accompanying text.

of application of defensive countermeasures might be seen as a display of a certain protectionist bias by Europe.

On the other hand, countries have lost negotiating power in the new multilateralist context.<sup>71</sup> With bilateralism, each country retains its sovereignty so that it decides in each tax treaty the concrete extent to which it is willing to give up this power. However, under multilateralism (of which the highest expression has taken place in the BEPS Project and in the multilateral agreements of EOI), states have their negotiating power diluted in favour of international organizations and forums.<sup>72</sup> The benefit of international cooperation is a greater efficiency and coordination, eliminating externalities. Thus, bilateralism is the breeding ground for tax avoidance (and particularly treaty shopping), since the non-harmonization of taxes and legal asymmetries and mismatches are only possible in a bilateral context. Consequently, these new international cooperation processes make it easier to advance towards common international tax principles able to eliminate such distortions. In the context of the European Union, where Member States have similar economic structures and similar idiosyncrasies, multilateral cooperation and growing tax harmonization have contributed to stop tax avoidance, to improve the level playing field and to advance towards an internal market without barriers.<sup>73</sup> Nevertheless, this consensus reached at the European level is not necessarily applicable at a more global level, where each region has different and particular needs and preferences. In this global context, those countries with lower participation in international forums (such as the OECD) might feel that new tax rules do not fulfil their needs.<sup>74</sup> Tax harmonization at a global level erodes the sovereignty of many countries that are not involved in these international organizations. Thus, the extension of the State aid regime to third countries, through international agreements, may be seen as interference in the tax policies of such countries.<sup>75</sup> Moreover, due to the unpopularity of granting express tax privileges to certain sectors or certain companies (or even due to the application of the prohibited subsidies regime to members of the World Trade Organization),<sup>76</sup> many countries might prefer to grant less-transparent tax benefits in the form of rules that are more permissive with regard to tax avoidance.<sup>77</sup> In this sense, tax privileges for foreign investment may take forms that are less transparent but more effective in maintaining the competitiveness of the country. Although

71. P. Pistone, *Coordinating the Action of Regional and Global Players during the Shift from Bilateralism to Multilateralism in International Tax Law*, 6 *World Tax J.* 1, p. 3 (2014).

72. To the extent that the new BEPS paradigm and the tax good governance standards are expanding over more countries, keeping isolated is more harmful for the 'rebel' countries. Multilateralism bases its power on the unity and cooperation in the international community.

73. P. Pistone, R. Julien & F. Cannas, *Can the Derivative Benefits Provision and the Competent Authority Discretionary Relief Provision Render the OECD-Proposed Limitation on Benefits Clause Compatible with EU Fundamental Freedoms?* in *Base Erosion and Profit Shifting (BEPS): The Proposals to Revise de OECD Model Convention* p. 213 (M. Lang et al. eds, Linde 2016).

74. It is important to keep in mind that these new supranational legislative processes have been driven by the most-developed countries, particularly by the G20 group and the European Union, which have imposed a vision favourable to their interests.

75. Dourado, *supra* n. 30, at p. 444.

76. *Supra* n. 43. About the prohibited subsidies regime of the WTO, see P.W. Jessen, *State Aid and Taxation in Relation with Third Countries*, 40 *Intertax* 2, p. 134 (2012).

77. *Supra* n. 43.

these practices may be contrary to the principles of legality and equity, they are domestic concerns, over which neither the European Union nor the OECD should exercise a paternalistic attitude.<sup>78</sup>

The main advantage of multilateralism occurs in the context of EOI and transparency. Whereas opposing countries to the BEPS Project stress the loss of sovereignty, EOI permits countries to reclaim sovereignty over their taxpayers that hide income in opaque jurisdictions.<sup>79</sup> The European Union may be more effective in achieving taxpayer compliance with tax obligations through agreements on EOI with third countries.<sup>80</sup> Besides, the increase in tax transparency is encouraging a public debate about the international tax system and how to move towards a fairer allocation of taxing powers among countries.<sup>81</sup>

Although it might seem that the European Union is one of the main beneficiaries of this multilateralism due to the spread of its tax principles towards the rest of the international community, which is true in the current economic situation, in future, it is possible that due to the growing economic development of other regions, the Union might lose weight in international forums such as the OECD. In that case, the Union would suffer what today is already becoming a reality: that even the Union has lost autonomy in favour of international organizations. The ATAD is not the only unavoidable consequence of the BEPS Project, the current EOI standards implemented by the Union through directives, are also a consequence of the agreements reached at the heart of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

#### **§21.04 LIMITS TO EU EXTERNAL ACTION AGAINST TAX AVOIDANCE: COMMUNITY FREEDOMS**

The European Union has designed its external action in tax matters on the same integration principles underlying the intra-Community scope. Thus, the EU external action seeks, though less stressed than the internal policy, global economic integration and the creation of an international market without barriers based on a level playing field. The Community policy of tax integration is reflected to some extent in this external policy. On the one hand, there is growing positive integration, which looks for third countries to implement the new international tax principles developed by the

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78. From a purely legal perspective, according to Pistone, *supra* n. 1, at p. 90, states do not have any obligation to combat tax avoidance, but rather a right. Nevertheless, for this author, this right may turn into an obligation where, in application of the EU State aid regime, the absence of anti-avoidance rules in cross-border situations results in *de facto* privileges for certain companies.

79. When tax bases are diverted into opaque jurisdictions, anti-avoidance measures are not effective. Commission Recommendation of 6 December 2012 (2012/771/EU), OJ L338, 12 Dec. 2012, p. 37, states that low level of income tax is 'not necessarily undesirable as such, as long as the State participates in international cooperation in order to allow other States to enforce their tax policy'.

80. See Taha, *supra* n. 4, at p. 159, with respect to the conclusion of agreements on EOI between the European Union and third countries.

81. Traversa & Flamini, *supra* n. 43, at p. 399.

OECD and the European Union; in the previous section, we have seen how the Union is trying to move towards positive tax integration beyond the European borders by promoting the OECD principles in third countries. On the other hand, there is negative integration. The Union, either through the EU fundamental freedoms enshrined in the TFEU or through the free trade agreements entered into with third countries,<sup>82</sup> places some limits on Member States' tax sovereignty with respect to their relations with third countries. In this section, we will briefly look at how the EU fundamental freedoms limit the autonomy of Member States to establish certain barriers to commerce with third countries.

When analysing the effect of the EU fundamental freedoms on the relations between Member States and third countries, it is necessary to distinguish between two kinds of effects. On the one hand, Article 63 of the TFEU has a direct impact on the movement of capital with third countries. On the other hand, the other EU freedoms, even though they do not affect extra-Community relations, could have an indirect impact on certain situations where third countries are involved.<sup>83</sup>

As a result of the EU desire to liberalize the global capital market, the Maastricht Treaty extended the scope of the free movement of capital to flows of capital between Member States and third countries.<sup>84</sup> Thus, Article 63 of the TFEU has a more global scope than that of the other freedoms. Article 64(1) of the TFEU establishes a grandfather clause whereby all restrictions on capital movements with third countries in force at 31 December 1993 (prior to the entry into force of the aforementioned extension of the freedom of capital movements to third countries) shall be permitted.<sup>85</sup>

On the other hand, Article 65(1) of the TFEU, codifying the ECJ doctrine, establishes the lawfulness of restrictions on the free movement of capital that are justified on a legitimate basis and apply according to the proportionality principle.<sup>86</sup>

In the context of the present analysis, it is interesting to analyse the compatibility with the EU freedoms of the recent measures approved in the framework of the ATA Package.<sup>87</sup> The ATAD measures have been subjected to many studies in this regard.

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82. See F. Sicard & O. Debat, *The EU and Third Countries: Any New Tax Opportunities Under Association Agreements?*, 45 *Intertax* 5, p. 402 (2017). See also P. Pistone, *The Impact of European Law on the Relations with Third Countries in the Field of Direct Taxation*, 34 *Intertax* 5, p. 234 (2006). With regard to the relation between the TFEU and the free trade agreements concluded by the Union with other regions or countries, in Case C-464/14, *SECIL*, ECLI:EU:C:2016:896, the ECJ takes the implicit position of giving primacy to the TFEU. Conversely, however, the Opinion of Advocate General Wathelet in *SECIL*, ECLI:EU:C:2016:52, para. 57, advocates for the application of the rules of public international law provided for in the Vienna Convention on the Law of Treaties (1969), placing the TFEU and the free trade agreements on the same level but giving priority to the free trade agreements in application of the general principles of *lex specialis* and *lex posterior*. The present authors believe that the position adopted by the ECJ makes more sense because the competence to conclude international agreements by the Union derives from the EU founding Treaties.
83. See E. Traversa, *National Report: Belgium in The EU and Third Countries: Direct Taxation* pp. 158 et seq. (M. Lang & P. Pistone eds, Linde 2007).
84. D.S. Smit, *Capital Movements and Third Countries: The Significance of the Standstill-Clause ex-Article 57(1) of the EC Treaty in the Field of Direct Taxation*, 15 *EC Tax Rev.* 4, p. 203 (2006).
85. See Case C-464/14, *SECIL*, ECLI:EU:C:2016:896, para. 92.
86. See Traversa, *supra* n. 83, at p. 151.
87. *Supra* n. 21.

The fact that many of those measures do not combat abusive situations but merely presume abuse, has given rise to debate about the legality of those measures that, applying to transactions with third countries, affect the free movement of capital. For instance, Article 5 of ATAD on exit taxation, does not require the source Member State to allow deferral of payment when the recipient country does not belong to the European Economic Area. Even though exit taxation has traditionally been analysed from the freedom of establishment perspective,<sup>88</sup> the ECJ has left the window open for the application of the free movement of capital.<sup>89</sup>

It does not seem that problems could arise with respect to the interest limitation rule (Article 4 of the ATAD) and the CFC rule (Articles 7 and 8 of the ATAD). The interest limitation rule may affect the free movement of capital but it applies to domestic transactions as well as cross-border transactions, thereby it should be compatible with the TFEU.<sup>90</sup> Regarding the CFC rule, even though the ATAD permits Member States to apply this rule in a more extensive way<sup>91</sup> (disregarding the existence of an artificial structure that justifies such a measure, as the ECJ requires)<sup>92</sup> when the subsidiary company is established in a third country, it is difficult to hold that free movement of capital is applicable.<sup>93</sup> Lastly, the anti-hybrids rule (Article 9 of the ATAD) might affect the free movement of capital. In such a case, some scholars have suggested the potential discriminatory nature of this rule to the extent that qualification conflicts only arise in the cross-border context.<sup>94</sup> Since the application of this measure is not dependent on the existence of real abuse that could justify such a measure,<sup>95</sup> such a restriction could only be justified in the event that the ECJ accepts that it is intended to preserve the ‘coherence of the tax system’.<sup>96</sup>

88. Case C-9/02, *Lasteyrie*, ECLI:EU:C:2004:138.

89. Case C-164/12, *DMC*, ECLI:EU:C:2014:20. See Navarro, Parada & Schwarz, *supra* n. 38, at p. 120.

90. Bizzioli, *supra* n. 39, at p. 173. 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*, 45 *Intertax* 2, p. 123 (2017).

91. *Supra* n. 37.

92. Case C-196/04, *Cadbury Schweppes*, ECLI:EU:C:2006:544.

93. Nevertheless, as long as the ATAD is a *de minimis* rule, Member States could design certain CFC rules so that they extend their scope and affect the free movement of capital. Such would be the case where the CFC did not require an effective control over the foreign company, sufficing a small shareholding over the foreign entity to trigger the CFC rule. In this sense, see Joined cases E-3/13 and E-20/13, *Olsen*, 2015/C 68/05, paras 114–116; Case C-112/14, *Commission v. United Kingdom*, ECLI:EU:C:2014:2369, paras 16, 17 and 20. It is established in both cases that the CFC rules affecting the free movement of capital are compatible with the TFEU to the extent that they only target wholly artificial arrangements. See A.P. Dourado, *Free Movement of Capital: The European Union Anti-Tax Avoidance Package and Brexit*, 44 *Intertax* 12, p. 874 (2016).

94. A. Rust, *BEPS Action 2: 2014 Deliverable—Neutralising the Effects of Hybrid Mismatch Arrangements and its Compatibility with the Non-discrimination Provisions in the Tax Treaties and the Treaty on the Functioning of the European Union*, *British Tax Rev.* 3, p. 320 (2015). See also Navarro, Parada & Schwarz, *supra* n. 38, at p. 128; Christiana HJI Panayi, *The Compatibility of the OECD/G20 Base Erosion and Profit Shifting Proposals with EU Law*, 70 *Bull. Intl. Taxn.* 1/2, pp. 98–101 (2016).

95. In the context of VAT, the ECJ has established that the exploitation of the qualification conflicts by taxpayers may not constitute an abuse as long as there is no wholly artificial arrangement. Case C-277/09, *RBS Deutschland*, ECLI:EU:C:2010:810, paras 50–54.

96. At the present time, it is unlikely that the ECJ may accept as a justification the ‘coherence of the tax system’ because the Court only accepted this justification motive in cases where the direct

Out of the ATAD, but within the framework of the ATA Package, are other measures that might potentially affect EU fundamental freedoms. Anti-treaty shopping clauses, such as the principal purpose test (PPT) or limitation on benefits (LOB) clauses, may be incompatible with the TFEU in so far as they apply automatically without assessing whether there is a ‘genuine economic activity’.<sup>97</sup> Therefore, all clauses in tax treaties that disregard the assessment of the economic substance of a transaction are susceptible of being considered incompatible with EU fundamental freedoms. Such incompatibility may arise either when the clause is applied by a Member State with respect to payments to third countries<sup>98</sup> or when the clause is applied by a third country with respect to payments to a Member State.<sup>99</sup>

Lastly, the potential defensive measures that Member States could adopt against countries that are listed in the EU list of non-cooperative jurisdictions might be incompatible with the TFEU to the extent that they affect the free movement of capital. Such restrictive measures would be justified if the Member State applying them does not have sufficient EOI instruments and such measures are applied with proportionality.<sup>100</sup> Nevertheless, whereas it is possible to justify defensive measures against third countries not cooperating in EOI, it is more difficult to justify defensive measures taken against third countries which, while complying with international EOI standards, maintain practices deemed as ‘unfair’ tax competition. In this regard, the fact that

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link between the offsetting restriction and the tax benefit takes place within the same taxpayer. In this regard, see Case C-204/90, *Bachmann*, ECLI:EU:C:1992:35, para. 21 and Case C-157/07, *Krankenheim*, ECLI:EU:C:2008:588, paras 42 and 43. In Case C-559/13, *Grünewald*, ECLI:EU:C:2015:109, para. 49, the Court denied this direct link where the tax benefit and the offsetting restriction take place in two different taxpayers.

97. In the framework of the ATA Package, the Commission issued a Recommendation on the implementation of measures against tax treaty abuse, C(2016) 271 final (28 Jan. 2016), in which the Commission suggests the introduction of a PPT clause that would not apply as long as there is a ‘genuine economic activity’.
98. In this regard, Case C-6/16, *Ejiom and Enka*, ECLI:EU:C:2017:641, paras 30–33, states the discriminatory character of a domestic PPT clause (only applicable to cross-border situations) because it applied on an automatic basis without assessing whether there was a wholly artificial arrangement. This decision is susceptible of being applicable to the tax treaty signed between a Member State and a third country to the extent that the PPT clause affects the free movement of capital.
99. Despite the fact that the ECJ does not have sovereignty over third countries with respect to the restrictive measures applied by them, this type of clause might be incompatible with the TFEU if it is contained in a treaty concluded with a Member State. In this regard, a limitation on benefits (LOB) clause, although applied by a third country to its outbound payments to a company resident in a Member State, is only applied to companies controlled by a non-resident entity established in another Member State, giving rise to a discrimination with respect to the companies controlled by domestic shareholding. See the set of ECJ decisions referred to as *Open Skies* (e.g., Case C-466/98, *Commission of the European Communities v. United Kingdom*, ECLI:EU:C:2002:624). See also Traversa, *supra* n. 83, at p. 160.
100. E. Nijkeuter, *Exchange of Information and the Free Movement of Capital Between Member States and Third Countries*, 20 EC Tax Rev. 5, p. 241 (2011). See Case C-101/05, *A*, ECLI:EU:C:2007:804, paras 55 and 56. The Court recognizes that ‘the need to guarantee the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of freedom of movement guaranteed by the Treaty’. Thus, the ECJ has admitted that a Member State may establish a defensive measure against a third country as long as no EOI agreement exists between them.

certain third countries have preferential tax regimes that may harm the competitiveness of European companies, does not justify in any way the adoption of measures that could break the free movement of capital with third countries.<sup>101</sup>

This last idea gives rise to one of the main problems of Article 63 of the TFEU. The fact that free movement of capital is only applicable to Member States means an asymmetry and a competitive disadvantage of the European Union with respect to third countries.<sup>102</sup> Thus, a company established in a third country can invoke Article 63 of the TFEU in order to avoid restrictive measures imposed by a Member State, but a European company cannot require a third country to abstain from applying measures that amount to a restriction on the free movement of capital.

## §21.05 CONCLUSION

The external action of the European Union in tax matters does not follow the same guidelines as the EU ‘internal’ tax policy. Currently, the integration in this field is not sufficient to achieve an external tax policy that is truly effective in combating tax fraud and tax avoidance. This situation gives rise to a sort of vacuum in EU external tax policy, whose implementation and application falls on the Member States:

- Even though the ATA Directive has established a set of measures against aggressive tax planning, including some that apply to third-country cases, the application and interpretation of such measures are in the Member States’ hands. This means there is a risk of a heterogeneous and fragmentary implementation and application.<sup>103</sup>
- On the other hand, this fragmentary application of EU tax law may continue perpetuating some tolerance of the Union towards harmful tax competition practices carried out by third countries. In this regard, the requirement of unanimity in the exercise of EU tax competences, internal or external,<sup>104</sup> is liable to maintain a conservative and moderate attitude, permanently subjected to the diplomatic and economic interests of Member States with respect to non-cooperative countries.
- Furthermore, the autonomous and uncoordinated exercise of tax sovereignty by Member States in their relations with third countries is a source of continuous distortions in the internal market, affecting not only Member

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101. *Supra* n. 96. See Case C-294/97, *Eurowings*, ECLI:EU:C:1999:524, paras 43–44.

102. Pistone, *supra* n. 82, at p. 236; A. Cordewener, *Free Movement of Capital Between EU Member States and Third Countries: How Far Has the Door Been Closed?*, 18 EC Tax Rev. 6, p. 261 (2009). According to Smit, *supra* n. 84, at p. 204, the grandfather clause provided for in Art. 64(1) of the TFEU was introduced to preserve the principle of reciprocity for Member States with respect to third countries.

103. The more paradigmatic example of this problem is the general anti-abuse rule (GAAR), which has been included in the ATAD (Art. 6). See Navarro, Parada & Schwarz, *supra* n. 38, at p. 125. See also L. De Broe & 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*, 26 EC Tax Rev. 3, p. 144 (2017), p. 144; Dourado, *supra* n. 30, at p. 442.

104. *Supra* n. 8 and accompanying text.

States' competitiveness,<sup>105</sup> but also the exercise of EU fundamental freedoms.<sup>106</sup>

Nevertheless, if the EU external action is analysed from a more global perspective, avoiding a purely 'Europeist' vision, it is possible to conclude that countries of the international community are losing sovereignty in favour of international organizations, such as the OECD. In the negotiation processes in international forums, the most powerful regions, such as the European Union, have imposed their criteria, eroding the ability of developing and small countries to attract capital through fiscal instruments. Whether those criteria will end up as part of the international tax law remains to be seen.

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105. *Supra* n. 19 and accompanying text.

106. *Supra* n. 99 and accompanying text.