**Combatting tax avoidance, the OECD way? The impact of the BEPS Project on developing and emerging countries' approach to international tax avoidance**
Heitmüller, F.

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# 3 Analyzing approaches to tackle international tax avoidance

## 3.1 Introduction

This chapter's purpose is to develop a heuristic device to compare different tax policies across countries and time, to discuss differences between the law and its application in practice, as well as between what is recommended or mandated at the international level and what is done at the national level. There is no obvious measure of "international tax policies" adopted by states (unlike for other phenomena such as for example tax revenue or foreign direct investment or maybe even tax avoidance). Moreover, expecting that there are inevitable differences in wordings of legal provisions, or ways in which these are interpreted, it is necessary to find a way to distinguish important differences from unimportant ones. In essence, making an argument about the extent to which a policy standard had an impact requires some kind of "scale" on which to compare the standard with the policy adopted. However, there is no readily available "scale" on which to compare international tax policies, for example it is not possible to assign a monetary value to them. In this chapter, I propose two kinds of categorizations that I think are useful for that purpose.

I proceed as follows: First, I discuss more generally what the term "international tax avoidance" means. Then I distinguish three different roles that countries can adopt with regards to tax avoidance structures. I argue that in many structures, there is one or more countries that lose revenue, as well as one or more countries whose laws or practices facilitate the structure. In addition, countries in which an MNE is headquartered have a specific role through their choice of enacting policies that could help prevent MNEs from avoiding taxation in third countries or not.

Finally, I turn to the different policy choices that countries can adopt on the defensive dimension, i.e., I discuss what main themes of responses countries that lose revenue due to international tax avoidance can adopt. This categorization can be used to assess policies that deal with specific problems such as treaty shopping, excessive interest deductions, or transfer mispricing of specific services or goods, but also the overall policy direction of a country that results from the interaction of different policies.

## 3.2 What is international tax avoidance?

### 3.2.1 Tax avoidance and tax abuse

Different authors use the term "tax avoidance" to describe different types of behaviour. For the purposes of this dissertation, I generally use "tax avoidance" to refer to behaviour of companies or individuals that attempt to obtain benefits relative to the "normal tax regime" which were not intended for their situation by the legislator or that obtain such benefits using arrangements or transactions that lack economic substance. In contrast to behaviour qualified as "tax evasion", taxpayers that engage in tax avoidance comply with all disclosure obligations towards tax authorities.[1] Combatting tax avoidance is from the point of view of the state not only a question of obtaining information – even though disposing of relevant information is important – but also of having the appropriate legal and analytical tools and the capacity to successfully argue that a certain behaviour constitutes indeed tax avoidance. Many types of behaviour that are sometimes called tax avoidance are unproblematic such as the often-cited avoidance of excise taxes for cigarettes by quitting smoking or taking advantage of tax incentives intended for a specific economic activity by engaging in precisely that activity.[2] Such behaviour could be called "tax mitigation".

However, delineating tax avoidance from behaviour that is unproblematic is often challenging. Attempts to define tax avoidance often make reference to the intention of both the taxpayer and the legislator, i.e., tax avoidance occurs when the taxpayer makes a transaction with the intention of reducing its tax burden in a way that was not intended by the legislator. The problem is, of course, that intentions of taxpayers are difficult to verify objectively. Therefore, rules that attempt to directly prohibit tax avoidance try to objectify avoidant behaviour, often through references to the "substance" of a transaction.

What the intention of the legislator was may be debatable, as well. Some difficult cases are for example those where taxpayers use a particular structure to avoid being caught by an anti-avoidance provision that they would be subjected to even though they were not avoiding any underlying tax. In my study of Nigeria, interviewees pointed out that a principal reason for companies to "round-trip" payments through companies incorporated in low tax jurisdictions was to avoid paying an "excess dividend tax". The provision applied where companies distribute dividends in excess of taxable profits made during a given year, supposing that this may indicate that the true profit could have been higher than what is shown in the company's accounts. However, the provision also applies in cases where companies

1 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*, v.

2 Picciotto, *International Business Taxation*, 92.

established domestic holding companies, which would normally distribute more dividends than profits, but which are unlikely to be useful for purposes of avoiding Nigerian corporate tax on profits.[3] Assuming that there were no other important reasons, the incorporation of a holding company abroad by Nigerian groups or foreign MNEs setting up several different businesses in Nigeria thus mainly served the purpose of avoiding the excess dividend tax. However, the corporate income tax on corporate profit earned in Nigeria would still have been paid in such situations. Qualifying this behaviour as tax avoidance or not may therefore be problematic.

This is merely one example to show the difficulty in defining the term. Comparative legal research has shown that in the past, legislatures and courts in different countries have defined or interpreted “avoidance” in many different ways, leading to the conclusion that there is no internationally harmonized definition of the term.[4]

My aim in this research is not to change this situation and better define the term “tax avoidance” or “tax abuse” than previous authors, international organizations, or other legal documents or to find a compromise between divergent interpretations. As I will explain in section 3.4, improving the definition and more precisely delineating which behaviour should be labelled as tax avoidance and which not, is one of the policy approaches that governments and international organizations have adopted to fight the phenomenon. It is also the dominant approach pursued in the BEPS Project. However, as I will explain in more detail, as well, it is not the only possible approach. My analysis rather consists in analyzing when and why governments privilege one approach over the other. Finally, for some people or in some contexts, the term “tax avoidance” may have an inherently negative connotation, while for others it is a value-free term describing a certain behaviour. Notwithstanding my personal views about specific types of behaviour, I intend to use the term in a neutral fashion.

Instead of tax avoidance, the term “tax abuse” is sometimes used by authors or legislators. In the opinion of some, the term should be interpreted differently than “avoidance”. For example, the British GAAR Committee, a group of academics, public servants and private sector representatives that was set up to provide recommendations with respect to the introduction of a general anti-avoidance rule in the United Kingdom, recommended that the rule should be called “general anti-abuse rule”, which according to Freedman, who participated in the committee, was supposed to convey a narrower meaning than “tax avoidance”.[5] However, Freedman also opined

3 NG12, also Okoro, “Nigeria: Finance Act 2019 And The Excess Dividend Tax Rule.”
4 Rosenblatt and Tron, “General Report,” 5.
5 Freedman, “The UK General Anti-Avoidance Rule: Transplants and Lessons,” 332.

that this difference in wording had no practical implications.[6] In addition, analyses of OECD and EU documents have shown that the terms are used rather interchangeably.[7] Therefore, I will not further distinguish both terms.

### 3.2.2 International tax avoidance and aggressive tax planning

While tax avoidance strategies can be implemented in purely domestic situations, the focus in this dissertation lies on international tax avoidance, which encompasses all structures in which a cross-border transaction or entities resident or present in more than one jurisdiction play a role. International tax avoidance schemes come in a great variety. However, the goal of most strategies is to minimize the MNE group's tax burden in high tax countries so that it is liable to taxes on only a small share of the total profits in high tax jurisdictions and on a higher share of profits in low tax locations.[8]

In the years preceding the BEPS Project, OECD documents frequently used the term "aggressive tax planning" to refer to such strategies.[9] Subsequently, the European Commission defined aggressive tax planning in 2012 as "taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability."[10] The term has subsequently been taken up by other official reports and authors, some of whom have debated whether it should be distinguished from tax avoidance or tax abuse.[11] Possibly, the term aggressive tax planning should be understood as broader than tax avoidance since it also encompasses strategies that could not possibly be tackled with a general anti-avoidance rule, but that are nevertheless undesirable from the perspec-

6 Freedman, 332.

7 Piantavigna, "Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD Are Establishing a Unifying Conceptual Framework in International Tax Law, Despite Linguistic Discrepancies."

8 International tax avoidance need not necessarily involve low-tax jurisdiction (for example hybrid mismatches) but in the UNCTAD's classification of most common schemes (i.e. transfer mispricing and financing schemes), low-tax jurisdictions are always relevant. UNCTAD, *World Investment Report 2015: Reforming International Investment Governance*, 193–97.

9 OECD, "Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure. Report on Disclosure Initiatives"; OECD, *Corporate Loss Utilisation through Aggressive Tax Planning*.

10 European Commission, Commission Recommendation of 6 December 2012 on aggressive tax planning, para. 2.

11 European Commission et al., "Aggressive Tax Planning Indicators"; Mosquera Valderrama, "The OECD-BEPS Measures to Deal with Aggressive Tax Planning in South America and Sub-Saharan Africa: The Challenges Ahead"; Arnold and Wilson, "Aggressive International Tax Planning by Multinational Corporations: The Canadian Context and Possible Responses"; Piantavigna, "Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD Are Establishing a Unifying Conceptual Framework in International Tax Law, Despite Linguistic Discrepancies."

tive of an "international tax system", hence justifying a policy response by countries or international organizations.[12] Piantavigna argues that "While both ATP [short for: aggressive tax planning] and tax abuse connote the idea of obtaining undue tax benefits, ATP implies a reaction that cannot be found in interpretative tools on the intent of the specific relevant rules avoided."[13] One could think of hybrid mismatch arrangements, through which taxpayers do not specifically avoid the tax law of one or the other of both countries involved, but achieve a globally undesirable result (for example using the same expense as deduction in both countries).[14] Piantavigna also provides numerous examples where the use of the terms "avoidance", "abuse" and "aggressive tax planning" is confused within OECD and EU reports. However, the BEPS reports, with the exception of Action 12 on mandatory disclosure rules, do not often refer to the term "aggressive tax planning" anymore.[15] They rather use terms that describe specific tax strategies (manipulation of transfer prices, treaty shopping, earnings stripping), or that describe their consequences (erosion of the tax base). Since neither hybrid mismatch strategies nor mandatory disclosure rules are in the focus of this study, I retain the term "international tax avoidance" for the remainder of the discussion but noting that not all practices described may always fall under a strict definition of "tax avoidance".

Distinctions among international tax avoidance strategies can be made, depending on the type of tax avoided and the type of taxpayer. Typical avoidance structures include thin capitalization (exploiting the fact that interest payments are usually deductible from tax while dividends are not), non-arm's length transfer pricing, treaty shopping, or artificial avoidance of permanent establishment status.[16] Sometimes, several of these techniques are combined, also with the purpose of circumventing existing anti-avoidance rules (see e.g., Google's famous "Double Irish with a Dutch sandwich"[17] or Starbuck's structure)[18]. In sections 5 and 7, I focus on transfer pricing and treaty shopping, which are perhaps the most simple and most classical problems.

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12 Calderón Carrero and Quintas Seara, "The Concept of 'Aggressive Tax Planning' Launched by the OECD and the EU Commission in the BEPS Era: Redefining the Border between Legitimate and Illegitimate Tax Planning," 210.

13 Piantavigna, "Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD Are Establishing a Unifying Conceptual Framework in International Tax Law, Despite Linguistic Discrepancies," 76.

14 Piantavigna, 79–80; OECD, "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues," 13.

15 Piantavigna, "Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD Are Establishing a Unifying Conceptual Framework in International Tax Law, Despite Linguistic Discrepancies," 56.

16 UNCTAD, *World Investment Report 2015: Reforming International Investment Governance*.

17 Kleinbard, "Stateless Income," 707–12.

18 Kleinbard, "Through a Latte, Darkly: Starbucks's Stateless Income Planning."

Many transactions could involve both a transfer pricing and a treaty shopping problem. Consider the case of a subsidiary located in country B that borrows funds from its headquarter company located in country A and pays interest on the amount. In the general case, interest payments are deductible as costs. If the tax rate in country B is higher than in country A, the MNE has an incentive to increase the costs in country B, in that case the amount of interest paid. The pricing of any transaction among subsidiaries, including interest but also transactions of goods, services, or licenses, is a transfer pricing problem. Sometimes, country B also levies a so-called withholding tax rate on outbound payments. The maximum rate it is allowed to levy is, however, constrained when country B has agreed a tax treaty with the country of destination of the payment. If country B has agreed a more favourable tax treaty with a country C than with country A, the MNE has an incentive to route the payment through this country C by setting up a so-called conduit company there. Finally, since most headquarter countries have relatively high taxes, as well, the MNE may try to avoid taxes there as well, and, instead of the headquarter company, use a company located in a low tax jurisdiction D as financing company.

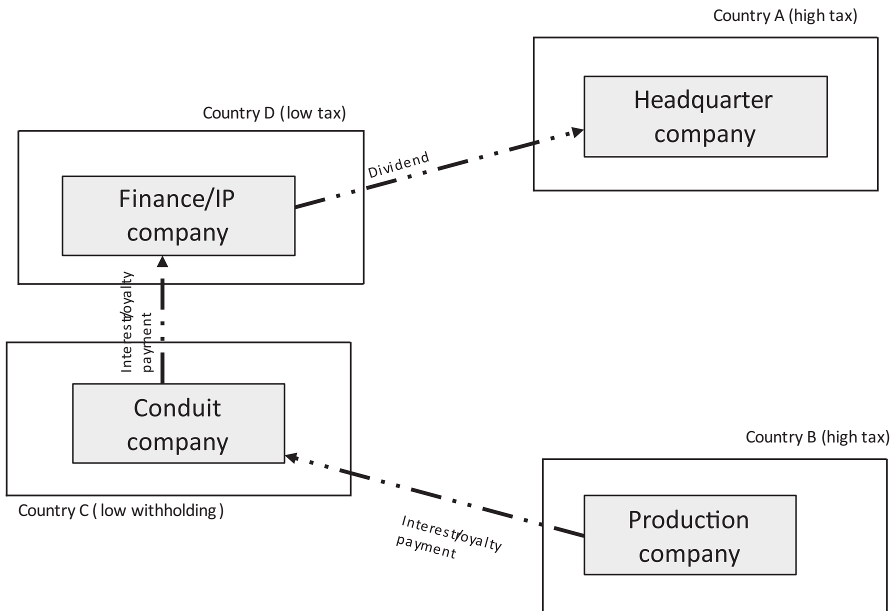
## 3.3 Different country roles in international tax avoidance and the minimum standards

How do countries respond to the issue of international tax avoidance? To start analyzing responses, it is useful to distinguish the different roles that a country can assume with respect to an MNE's international tax avoidance strategy. The structure described above involves four tax regimes A, B, C, and D that fulfil different purposes within the structure.

Country A is the country from which the funds for an investment originate or where the technology of the MNE group is developed, also commonly called "headquarter country" or "home country". In country B, substantial economic activity takes place in form of production or sales activity, commonly called "source country" or "host country". The MNE's presence in country C and D mainly serves the purpose of reducing the MNE's tax burden in country B and/or country A. This includes jurisdictions without a corporate income tax, jurisdictions with specific preferential regimes with a low or zero or corporate tax rate, or jurisdictions in which agreements with the tax authority can be made that allow reduction of taxes or jurisdictions that exempt specific types of income (such as foreign-earned income or income earned by non-residents).[19]

19 Marian, "The State Administration of International Tax Avoidance."

*Figure 1: Country roles in international tax avoidance*




*Source: the author, based on a figure in the OECD's 2013 BEPS report.*[20]

From this framework, one can deduct three different kinds of policy areas that can be usefully distinguished and be subjected to a separate analysis:

1. How countries respond to tax avoidance by which they are themselves affected. This could concern both country B and country A (the source and the residence country) so one could further differentiate between
   a. How countries respond to tax avoidance of outward investors (choices of country A)
   b. How countries respond to tax avoidance of inward investors (choices of country B)
   c. How countries respond to tax avoidance of round-tripping investors (cases in which country A and country B are the same country)
2. How countries enable (or choose not to enable) taxpayers to avoid other countries' taxes (e.g., through preferential tax regimes, low tax rates or low withholding tax rates). This analysis involves the choices of countries C and D.
3. How countries support other countries in their response against tax avoidance (e.g., to what extent country A would support country B, if an MNE headquartered in country A avoids taxation in country B).

20 OECD, *Addressing Base Erosion and Profit Shifting*, 74.

In practice, not all roles are always present with respect to all structures. For example, when the value of transactions is relatively high, an MNE has already an incentive to shift profits through transfer mispricing from one high tax country to another high tax country, provided there is a small difference in tax rates. But what is more important for the purposes of this research is the distinction of international tax policies into policies that have 1) a "defensive", 2) a "facilitating" and 3) a "supportive" character. Action in all three areas is potentially relevant for the overall goal of eliminating international tax avoidance and are interrelated with each other. For example, if all countries that currently have policies that allow companies to make use of them to avoid taxes elsewhere (i.e., play the role of country C or D) abolished these policies, the need for countries A and B to enact defensive policies diminishes. On the other hand, if all countries adopt effective defensive measures, companies may find it more difficult to effectively make use of other countries' regimes that facilitate avoidance.

As I will further explain below, the BEPS project relates to all three aspects. However, the trade-offs for countries are distinct and countries can make different implementation choices with regard to the three areas. Certain countries tend to be more often in one "role" than in others. Developing countries usually have significantly higher inward than outward direct investment and therefore find themselves more often in the role of Country B. The role of country D is most often assumed by countries that have become known has "corporate tax havens".[21] Country C are jurisdictions that often have statutory tax rates in the average range but levy low or no withholding taxes on outbound payments and have signed many tax treaties (more on these in section 7).

Finally, the role of country A is usually fulfilled by those countries which concentrate the headquarters of most MNEs, which are essentially the large OECD countries and China.

A particular policy problem can then be analysed from the three different perspectives: The perspective of the country that loses revenue, the country that facilitates the structure, and the headquarter country. One single country can potentially fulfil different roles in the structures of different multinational enterprises. For example, while many MNEs have used the tax regime of the Netherlands to avoid payment of withholding taxes through treaty shopping,[22] the Netherlands is also a location for investment in substantial activities and many MNE headquarters and might be exposed to MNEs' attempts to reduce their tax burden in the Netherlands on the profits derived from such activities. As a consequence, countries can have an ambiguous position with regard to the phenomenon of international tax avoidance as a whole and take action against tax avoidance of companies

21 Garcia-Bernardo et al., "Uncovering Offshore Financial Centers."
22 Lejour, Möhlmann, and van 't Riet, "The Immeasurable Tax Gains by Dutch Shell Companies."

with substance in the country, but still permit companies that have substance in other countries to use its tax system to avoid taxes in other countries. To continue the example, the Netherlands has for a long time tolerated that foreign MNEs set-up conduit companies to make use of the Dutch tax treaty network to benefit from lower withholding taxes when repatriating income from third countries (country C).[23] Nevertheless, many judicial disputes, for example on transfer pricing topics, show that the Netherlands has usually strived at protecting its own tax base by preventing companies with substantial activities in the Netherlands from shifting profits abroad.[24]

Since all countries studied in this dissertation are countries with relatively high tax rates that have not attempted to establish themselves as tax haven jurisdictions, the remainder of the dissertation mainly discusses the policy decisions on the defensive dimension.

## 3.4 Different approaches to defend a country against tax avoidance

Having separated international tax policies into different policy areas does not yet allow to "measure" and hence compare different policies that countries can adopt within each dimension. For that, we need other dimensions along which policies can vary. The following sections propose ways to classify policies on the "defensive dimension" according to their effect on several key variables. I do not do the same exercise for the "facilitating" and the "supporting" dimension, since these are of less direct relevance for capital importing countries that are not tax havens. Hence, the case studies on which I base my findings do not display enough variation to categorize responses.

How can a country respond to international tax avoidance by which it is itself concerned? I argue that essentially five types of responses adopted by states to defend themselves against international tax avoidance techniques can be distinguished:

1) Finely delineating solutions,
2) "Blunt" responses which eliminate or reduce benefits for both avoiders and non-avoiders,
3) Reducing or eliminating the tax avoided (giving-up),
4) Not responding, and
5) international harmonization of tax base and/or tax rate

23 Weyzig, "Tax Treaty Shopping: Structural Determinants of Foreign Direct Investment Routed through the Netherlands."

24 See for example the numerous cases in the database https://tpcases.com/ in which the Dutch tax authorities disputed transfer prices set by multinational enterprises active in the Netherlands.

The following table compares the different types of responses under five dimensions that are reflected in the BEPS Action reports, as well as critiques thereof: the level of tax avoidance, the tax burden for both non-avoiders and avoiders, the administrative costs related to different solutions, and the degree of international cooperation necessary.

*Table 3: Comparison of ideal-typical ways countries deal with international tax avoidance from the defensive perspective*

| | *Level of tax avoidance* | *Change in tax burden for avoiders* | *Change in tax burden for non-avoiders* | *Administrative resources required* | *Degree of international cooperation required* |
|---|---|---|---|---|---|
| *Finely delineating solutions* | Low | Increase | No change | High | Medium |
| *Giving up* | Low | No change (low) | Decrease | Low | Low |
| *Blunt* | Low | Increase | Increase | Low | Low |
| *Tolerating avoidance / no response* | High | No change (low) | No change or increase | Low | Low |
| *Harmonization based solutions* | Low | Increase | No change | Low | High |

*Source: the author*

The five responses identified above are not the only combinations of the different variables that are theoretically possible. Yet, based on the literature analysed, as well as interviews conducted with practitioners, the five ideal types seem to be those that are practically relevant. They have some similarity with a framework developed by Genschel and Rixen, the "trilemma of international taxation".[25] The authors posit that the three goals of eliminating double taxation, curbing tax competition and preserving national sovereignty cannot be attained simultaneously.

The following sections will describe each type of response in more detail. The case studies then illustrate how they can be used and applied in practice. In general, the ideal types can be used to categorize individual policies and administrative behaviour, for example how a country chooses to design and apply a specific policy such as interest deduction rules or country by country reporting requirements, but also the interaction of different policies (e.g., domestic withholding tax regimes and tax treaties) or the trajectory of corporate tax systems in their entirety.

25 Genschel and Rixen, "Settling and Unsettling the Transnational Legal Order of International Taxation."

### 3.4.1 Finely delineating approaches

Adopting a finely delineating approach to international tax avoidance consists in refining policies with the goal of trying to better delineate what kind of taxpayer behaviour is considered as permitted and which not.[26] Through a more detailed formulation of the law and/or more targeted and detailed audits by the administration leveraging more information, countries attempt to better separate the "wheat from the chaff",[27] i.e., prohibiting unwanted "aggressive" tax planning, while still providing the amplest possible freedom to conduct businesses across borders for non-avoidant MNEs. This type of solution implies detailed legislation that takes many different possible situations into account, or it requires tax administrations to undertake case-by case analyses which consider the details of the taxpayer's situation. They allow taxpayers to demonstrate genuine reasons for obtaining benefits and contain many procedural safeguards against administrative discretion. For example, in a situation where a country is concerned that a treaty is used by companies which are actually residents of third countries and only have little presence in the treaty partner country, a response following this theme would consist in adding language to the treaty describing with more details which kind of taxpayer should really be entitled to the treaty benefits and which not (e.g., not those which established subsidiary in the partner country for the principal motive of obtaining the benefits of the treaty).

Throughout the history of global tax governance, finely delineating solutions have been the preferred solutions of the OECD and its member countries to the issue of international tax avoidance. Moreover, the evolution of tax standards over time can be described as generally making these standards more "finely delineating" (see chapter 4 below).

After its creation in 1961, the OECD took over the work previously started by the League of Nation on designing and updating a model for bilateral double tax treaties among countries.[28] These treaties' purpose was essentially to eliminate double taxation for transactions between two country pairs, as the threat of double taxation was considered a major barrier to international investment. Accordingly, double tax treaties usually do not enable countries to tax but rather require countries to give up on taxing certain types of transactions. Their widespread and often uniform adoption by states is considered a success of this soft law standard. Concerns about international tax avoidance were already present in the beginning of the

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26 Picciotto uses the term "case-by-case" to describe a similar concept in his assessment of various legislative approaches to international tax avoidance. Picciotto, *International Business Taxation*.

27 Azaino, "Nationality/Treaty Shopping: Can Host Countries Sift the Wheat from the Chaff?"

28 Picciotto, *International Business Taxation*.

work, as well, but remained subordinated to the liberalizing goal.[29] When spurred by the growth of MNEs in the 1970s and the establishment of more tax haven jurisdictions, these concerns became more pressing and incremental steps to curb international tax avoidance were taken by the OECD and its member countries, through the establishment of the transfer pricing guidelines and guidance on controlled foreign company rules.[30]

The response to the issue of transfer mispricing exemplifies well the idea of tackling tax avoidance through more detailed rules that distinguish between avoidance and non-avoidance situations in a more fine-grained manner. Most bilateral tax treaties already contained a paragraph which spelled out the "arm's-length standard", requiring companies of a same MNE group to price intra-company services and goods exchanged as if they were sold among unrelated companies. Faced with the problem that this requirement was not clear for many situations (e.g., where no comparable goods or services were exchanged among unrelated parties), the OECD started working on better descriptions what "dealing at arm's-length" would mean for different types of transactions (e.g., sale of goods, rendering intra-group services, financing and benefitting from research and development, etc.). The first step was a still relatively general report on transfer pricing in 1979,[31] followed by the transfer pricing guidelines initially released in 1995 and continuously enhanced with more details.[32]

The OECD has not been the only driver of the finely delineating approach: Another example is the European Court of Justice, which has ruled with regard to anti abuse rules of member states that only those that that finely delineate between abusive and non-abusive solutions should be permissible.[33]

### 3.4.2 Blunt responses: Eliminating/reducing the benefit for both avoiders and for genuine businesses

The approach of finely delineating situations that should be qualified as avoidance from those that are genuine, which I described in the preceding section, is not the only possible approach to address tax avoidance. A second type of solutions consists in denying or reducing the benefit in question

29 Rixen, "From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance."

30 Picciotto, "Technocracy in the Era of Twitter: Between Intergovernmentalism and Supranational Technocratic Politics in Global Tax Governance"; Rixen, "From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance."

31 OECD, *Transfer Pricing and Multinational Enterprises.*

32 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.*

33 Lenaerts, "The Concept of 'Abuse of Law'in the Case Law of the European Court of Justice on Direct Taxation."

not only for avoiders but also for those for whom it was intended. Such solutions are effective at tackling tax avoidance and require little administrative effort. However, they increase the tax burden for genuine businesses, as well, and hence discourage cross-border investment compared to domestic investment. I therefore call them "blunt" solutions.

Examples of blunt solutions are rules that deny or limit certain deductions where it is difficult to verify if the deductions are justified. Other examples of blunt responses could be fixed margins in transfer pricing, high withholding taxes on gross outbound payments, low thresholds for a taxable presence of non-residents in a country, or simply aggressively enforcing existing rules by the tax authority (i.e., enforcement practices where the benefit of the doubt is not given to the taxpayer) with few perspectives for the taxpayer to dispute decisions.[34]

Possible outcomes of blunt solutions could be that taxpayers are subject to double taxation or taxed on gross income instead of net income. If that is the case, the tax may adopt more the character of a sales tax and no longer be akin to a tax on net income with the disadvantage that taxation may no longer correspond to the ability to pay principle.

To understand why blunt responses may lead to a reduction in tax avoidance, one can imagine the different parts of countries' corporate tax systems as protective layers staggered upon one another. The first layer is the corporate income tax (CIT)[35]: Each enterprise resident in the country (or foreign enterprise with a branch) pays CIT on its net income, i.e., revenue minus related expenses. The CIT is vulnerable to "primary" international tax avoidance devices, such as transfer mispricing of fees for services or license payments paid to foreign residents, as well as excessive interest deductions (due to thin capitalization strategies for example). However, the negative impact on a country's tax revenue – and at the same time the incentive for firms to engage in such strategies – is mitigated if the country also taxes the foreign recipients of these outbound payments by means of withholding taxes or it deductions are denied.[36]

If a country sets its withholding taxes for typical base-eroding payments at the same rate (or nearly the same rate) as its statutory tax rate, the tax avoidance risk stemming from such payments can be significantly mitigated, since a deduction from the tax base for one taxpayer is compensated by a proportionate increase in the tax burden for the foreign recipient of the payment. Experts sometimes recommend developing countries to set

34 Interviewees from the corporate and advisory sectors in India feared that the implementation of rules from the BEPS Project would increase the tax burden for non-avoiding firms, due to the tax authority's propensity to use any rule as a means to simply "collect revenue", e.g., IN18

35 CIT can also be considered as a second layer, which protects personal income taxation of shareholders of family businesses.

36 Balabushko et al., *The Direct and Indirect Costs of Tax Treaty Policy: Evidence from Ukraine*, 4.

withholding rates in this fashion: For example, in 2003, Echavarría and Zodrow recommended in a World Bank report that Colombia increase its interest withholding rate from 7% to 20% to bring it closer to the statutory rate in force at the time (35%) and alleviate concerns due to tax planning with foreign entities.[37]

Depending on how high the withholding rate is, however, such a policy is a rather blunt tool against tax avoidance, since withholding taxes are levied on gross payments and do not allow the foreign taxpayer to deduct costs. A part of the tax might therefore economically be passed on to the buyer or prevent the transaction altogether, regardless of whether there was an intention to shift profits out of the source country or not.

The purpose of "secondary" tax avoidance is to avoid these withholding taxes or denials of deduction, for example by claiming the benefits of a tax treaty. The stated aim of tax treaties is to ensure that the same income is not taxed twice (either only by one country, or with a shared taxing right).[38] However, sometimes treaties may produce the result that no country taxes the transactions, usually when the right to tax a payment is allocated exclusively to the residence country but this country refrains from actually levying a tax. To achieve this result in situations where there is no tax treaty, a company sometimes engages in "treaty shopping" structures, routing income through conduit countries.[39] A "blunt" response towards "secondary" tax avoidance would be a termination or a renegotiation of a treaty, for example to include higher withholding taxes or otherwise extend source taxation (i.e., making the treaty less beneficial compared to domestic law).

It is important to mention that "blunt" responses do not have to be "responses" in the sense of being a reaction to an event that occurred before. As we will see in section 5, the chronological order is often different. Countries operated closed economies, in which many international tax avoidance schemes were unlikely because of multiple tax and non-tax restrictions on cross-border flows. These restrictions could be considered as "blunt" in the sense that they did not discriminate between avoidant and non-avoidant taxpayers (indeed, avoidance may not have been their focus at all), but they are not really "responses". Rather, they are features that (within limits) prevented the issue from arising in the first place.

One might also wonder what the difference is between blunt responses and policies that simply reallocate taxing rights among countries and per extension, whether they always increase the burden for non-avoidant taxpayers. Tsilly Dagan observed that, since most countries provide credits or exemptions for foreign earned income through their domestic laws, tax treaties that reduce country's rights to levy withholding taxes on outbound

37 Echavarría and Zodrow, "Foreign Direct Investment and Tax Structure in Colombia," 26.
38 See the preamble to the OECD Model Tax Convention
39 Arel-Bundock, "The Unintended Consequences of Bilateralism: Treaty Shopping and International Tax Policy."

payments essentially shift the burden of alleviating double taxation from capital exporting to capital importing countries.[40]

To what extent this argument holds up depends on a number of factors, some of which have evolved over the last decades. First, if a capital exporting country exempts foreign income altogether, levies a lower standard corporate tax rate than the withholding tax of the capital importing country, (part of) the withholding tax may not be credited and therefore signify a higher tax burden compared to a situation where no withholding tax is levied. If the capital exporting country exempts foreign income for the type of payment in question, levying source-based taxes does not lead to double taxation, but it leads to a higher effective tax burden for the MNE compared to the situation where no source-based tax is levied. Over the last decades, more countries have introduced exemption systems with respect to dividends and capital gains.[41]

For other payments, such as royalties, interest, and service payments, most capital exporting countries apply the credit method. In these cases, relatively low source-based taxes should not lead to a higher total tax burden for the company. However, they could lead to a higher burden if the profits on which residence-based taxation is levied are lower than the gross receipts of the foreign payment, for example when costs have been incurred to generate the income (for example for rendering a service, or for developing intellectual property). In such cases, even source withholding taxes that are lower than the resident country's statutory rate could lead to a higher tax burden.

Finally, not all countries provide credits or exempt foreign income. Some only permit a deduction of foreign taxes paid for cases when no double tax treaty was signed with the other country.[42]

Whether withholding taxes should always be characterized as blunt response is therefore not clear and likely dependent on the specific circumstances. One of the primary critiques of the BEPS Project was, however, that the reports do not sufficiently explore source-based solutions, although they may be easier to administer without necessarily leading to higher tax burdens for non-avoidant taxpayers.[43]

40 Dagan, "The Tax Treaties Myth."

41 Shin, "Why Do Countries Change the Taxation of Foreign-Source Income of Multinational Firms?"

42 This is the case of Switzerland, for example.

43 Oguttu, "A Critique of International Tax Measures and the OECD BEPS Project in Addressing Fair Treaty Allocation of Taxing Rights between Residence and Source Countries: The Case of Tax Base Eroding Interest, Royalties and Service Fees from an African Perspective"; The BEPS Monitoring Group, "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project."

### 3.4.3 Giving up: Eliminating or reducing the tax avoided

A third possible response is to remove (or reduce) the incentive for taxpayers to engage in tax avoidance through eliminating or reducing the tax avoided or providing a legislated tax exemption to those companies which were avoiding the tax. Giving up is frequently advocated by tax advisors or other policy experts.[44] An Indian tax advisor, for example, explained with regard to India's reduction of the statutory corporate tax rate in 2019 that "that also in some sense reduces the need for planning."[45] The United States, faced with the issue that many outward investing multinationals circumvented the country's worldwide tax system by deferring the repatriation of dividend endlessly (while still using funds as collateral for raising debt),[46] gave up on taxing on a worldwide basis and switched to a (partial) territorial system in 2018.[47] As a consequence, companies repatriated large amounts of dividends back to the United States, which then however were no longer taxable.[48] A 2003 paper on international tax policies in Colombia suggested lowering corporate tax rates as a way to reduce the incidence of tax avoidance by multinational enterprises.[49]

"Giving-up" is an effective (probably the most effective) solution against tax avoidance. Put simply: If there's no tax, there's nothing to avoid. However, as already pointed out in section 3.4.2, tax systems can be imagined as layers on top of each other and certain taxes often have a function of disincentivizing the avoidance of other taxes. For example, withholding taxes on interest and royalties prevent the avoidance of the tax on business income by making income shifting strategies that increase costs (and hence reduce profits) in the country in question less attractive.[50] Capital gains taxes disincentivize strategies that aim at avoiding taxes on dividends by deferring the distribution of profits.[51] Corporate income taxation also functions as protective layer for personal income taxation, by reducing the incentive for an individual to transform salaries into business income.[52]

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44 Neidle, "Pointless Taxes That Should Be Abolished #3: Withholding Tax."

45 IN17

46 Kleinbard, "Stateless Income."

47 Avi-Yonah, "The International Provisions of the TCJA: Six Results after Six Months."

48 Avi-Yonah.

49 "These results strongly suggest that many multinationals engage in international tax avoidance activity, and that multinationals in Colombia are no exception to this general rule. Thus, a major advantage of relatively low corporate income tax rates in Colombia is protection of the revenue base from such manipulations." Echavarría and Zodrow, "Foreign Direct Investment and Tax Structure in Colombia," 25.

50 Balabushko et al., *The Direct and Indirect Costs of Tax Treaty Policy: Evidence from Ukraine*, 4.

51 Cui, "Taxation of Non-Residents' Capital Gains," 134.

52 Ganghof and Genschel, "Taxation and Democracy in the EU."

Therefore, if the corporate income tax is given up, this may increase avoidance of the personal income tax.[53] Giving-up one tax can therefore mean giving-up other taxes as well.

Rixen and Genschel summarized the dilemmas of the "giving up" response as follows: "Taxpayer arbitrage can, in turn, trigger an interactive spiral of tax cuts by governments trying to attract inflows or prevent outflows of mobile capital. This limits the ability to generate revenue from capital taxation, creates inequities in relation to immobile tax bases, and accelerates international economic integration".[54]

Nonetheless, reducing a very high rate, or aligning tax rates for different types of income may be a sensible strategy if a high rate or the divergence of rates creates too many enforcement problems. In addition, when the tax avoided can itself be characterized as anti-avoidance provision and only fulfils its purpose in an inefficient way, it may be sensible to give up on levying this tax. The Nigerian excess dividend tax mentioned in section 3.2.1 arguably is such a case, and the Nigerian government's decision to amend the provision in 2020 was probably sensible.[55]

More generally, one can assume that avoidance opportunities are lower if there are little differences in the tax treatment of different types of taxpayers or transactions.[56] This idea is present in political debates. For example, the Nigerian "National Tax Policy", a high-level policy document, recommended that "The tax system should gradually seek a convergence of the highest marginal rate of personal income tax, capital gains tax rates and the general companies income tax rates to reduce opportunities for tax avoidance."[57]

### 3.4.4 No response (tolerating avoidance)

For the purpose of completeness, it is important to mention the zero category, i.e. no response at all. It captures when a country that can be considered as affected by international tax avoidance does not change its policy. Previous studies have provided rational explanations for why a country may want to tolerate some degree of tax avoidance. Here, two rationales can be distinguished: First, tolerance may achieve a concrete policy aim. Economists have pointed out that a government might be willing to provide a favourable tax treatment to foreign investors but may not be able to do so

53 Although this may be a bit less accurate in the context of developing countries, where a large share of CIT is collected from foreign owned businesses and state-owned enterprises.

54 Genschel and Rixen, "Settling and Unsettling the Transnational Legal Order of International Taxation," 157.

55 Okoro, "Nigeria: Finance Act 2019 And The Excess Dividend Tax Rule."

56 Picciotto, *International Business Taxation*, 84–85.

57 Federal Ministry of Finance (Nigeria), "National Tax Policy," 4.

in a transparent way for legal or political reasons. Tolerating tax avoidance by foreign investors might then be a way to achieve the desired level of tax for foreign investors without formally providing for preferential treatment.[58] It may also be a way to implement a short-term policy response that can easily be revoked without fundamental policy debates. In the 1970s, structures entered into with the objective of avoiding US withholding taxes on interest payments were tolerated by means of official rulings by the US tax administrations for a period of a few years.[59]

Second, tolerance may be a rational choice under limited policy and administrative capacity, when a certain international tax avoidance problem is not considered salient enough in terms of revenue loss. A government's action can be categorized as "no response" if no rule is implemented or if a rule is implemented but not applied in practice and it is sufficiently clear to taxpayers that they do not need to comply with the rule. A former Colombian government official said that that after the introduction of a new legal or administrative tool by the tax administration, one could sense more cautious behaviour from the private sector but that sooner or later it would become aware of the administration's lack of capacity to apply the tools.[60] If a country introduces a rule that "on paper" would correspond to the "finely delineating" logic, the challenge for the researcher is to find out whether the way it is applied by the administration in practice actually corresponds to the "finely delineating" way, the blunt way or the "no-response" way.

For example, whether a tax administration interprets a treaty anti-abuse rule in a narrow or broad way can significantly affect the tax burden of investing foreign companies since it affects whether multinational groups can still channel investment through conduit companies how costly the use of such companies might be.[61] Therefore, not enforcing the rule or enforcing it to a lesser extent than other countries do may affect the tax competitiveness of a country. It should be noted, however, that this could occur because of a deliberate plan of the government or rather unintendedly – for example because a judge interprets the rule in a certain way and creates a binding precedent that administration and taxpayers need to respect.[62]

58 Hong and Smart, "In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment."

59 Irish, "Tax Havens," 468.

60 CO01

61 A more stringent interpretation may require the multinational enterprise to "put more substance" into its conduit company, e.g., in the sense of hiring more employees, renting office space or directors flying to the country in question to take decisions there.

62 Correctly making these distinctions is one of the main reasons why the analysis of legal provisions needs to be complemented by interviews with practitioners.

### 3.4.5 International harmonization

Harmonizing tax laws among countries represents a fifth way of dealing with the issue of *international* tax avoidance. Proposals based on some degree of harmonization among countries have been proposed in the literature,[63] and have been put forward by advocacy organizations such as the ICRICT,[64] academics,[65] and supranational bodies such as the European Union.[66] The underlying idea of these proposals is that, if international tax avoidance is facilitated through divergences among tax systems, divergences should be reduced. Two main variants can be distinguished: In one variant, divergences in tax rates persist but an MNE's subsidiaries are no longer treated as separate entities. Instead the global profit of the entire MNE is taxed by apportioning the tax base among different countries according to a cooperatively agreed formula (which could be based on objective factors such as the number of employees or sales in a given country).[67] International tax avoidance strategies exploit the fact that a multinational enterprise is generally not taxed as one unit, but that each entity is a separate taxpayer in the country, in which it is incorporated. However, since the different entities are part of a group and control each other's decisions, and what matters to shareholders is the overall profitability of the MNE and not of the individual entities that constitute the group, MNEs have an incentive to allocate profits and structure transactions among the entities in a way that reduces the group's overall tax burden. If instead the consolidated income of the whole MNE group was taxed, allocations would not matter so much anymore.

In the other variant, countries harmonize tax rates and tax bases, thereby completely eliminating the incentive for companies to shift profits. Already in 1986 Irish wrote: "If there were a globally uniform income tax rate, tax avoidance through transfer pricing would decline since there would be no tax reason to shift profits from one jurisdiction to another. With a globally uniform tax rate, profits would be subjected to the same tax rate wherever they are realized."[68] These solutions have in common that they would most likely not raise the overall burden for non-aggressive businesses (and in the long run probably result in reduced compliance costs), if

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63 Brauner, "An International Tax Regime in Crystallization."

64 Faccio and Fitzgerald, "Sharing the Corporate Tax Base: Equitable Taxing of Multinationals and the Choice of Formulary Apportionment."

65 Avi-Yonah, "A Proposal for Unitary Taxation and Formulary Appointment (UT+FA) to Tax Multinational Enterprises"; Picciotto, *International Business Taxation*.

66 European Commission, "Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB)."

67 Rixen, "From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance," 206.

68 Irish, "Transfer Pricing Abuses and Less Developed Countries," 101.

adopted in a multilaterally co-ordinated way among countries.[69] However, initiatives advocating such advanced forms of cooperation have so far not overcome countries' willingness to safeguard tax sovereignty.[70] Unilateral adoption of formulary apportionment by only few countries however could lead to double taxation (or in some cases double non taxation) of income and might thus more resemble a "blunt" response.[71]

### 3.4.6 GAARs vs. SAARs

International tax literature often opposes General Anti-Avoidance Rules (GAARs) and Specific Anti-Avoidance Rules (SAARs), investigating whether adopting one or the other is preferable with respect to their effect on tax avoidance, legal certainty or administrative resources.

The categorization introduced above does not use this differentiation. In fact, both types of rules could *a priori* belong to the category of finely delineating approaches.[72] The difference is that in the case of SAARs, the task of separating avoidant from non-avoidant transactions is undertaken by the legislator, whereas in the case of GAARs, the task of separating is primarily undertaken by the tax inspector in charge of auditing the transaction and possibly other instances that confirm or invalidate the tax inspector's assessment. Therefore, the debate "SAARs vs. GAARs" is less relevant for the current investigation, as it arguably takes place within one of the paradigms that are opposed here.[73]

It is important to mention, as well, that the fact that a GAAR or SAAR is introduced does not necessarily mean that a country is pursuing a finely delineating approach. If for example, a GAAR is introduced but never applied, one could rather argue that the government is pursuing a "no response" approach. In Colombia, for example, tax advisors interviewed in

69 It should be noted that a formulary apportionment of the tax base without harmonization of tax rates would work without the participation of small countries with low tax regimes, whereas a harmonization of tax rates without formulary apportionment would require the collaboration (and hence elimination) of low-tax regimes, unless home countries of MNEs include the profits reported in tax havens within the income of the headquarter, such as proposed (subject to certain carve outs and reservations) in the current proposal for a minimum tax.

70 The treaty of the West African Monetary Union prescribes some degree of harmonization of tax rates. However, the significance of this is limited since tax rates were already relatively harmonized before this was legally prescribed by supranational law. See Mansour and Rota-Graziosi, "Tax Coordination, Tax Competition, and Revenue Mobilization in the West African Economic and Monetary Union."

71 Irish, "Transfer Pricing Abuses and Less Developed Countries," 121.

72 The fact that I put both rules together in one category does not mean either that I consider the choice irrelevant.

73 That is not to say that the debate is not relevant for policymakers.

2019 said that the GAAR which had first been introduced in 2012 had never been applied.[74]

If in contrast a GAAR is applied to many cases, without much analysis of whether the respective transactions really constituted tax avoidance, the policy could rather be qualified as "blunt approach". Moreover, SAARs can be designed in more or less blunt ways, for example including "rebuttable presumptions" or not, or using thresholds that are likely to capture genuine transactions or not. For example, whether an interest deduction rule follows the finely delineating logic or not depends on how well the rate of interest expenses divided by Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) above which deductions for interests are denied reflects the practices of non-avoidant businesses.

What ultimately matters for assessing the policy approach taken by a country is how rules are applied in practice. Interpretations can vary between countries or over time. In that sense, administrations can interpret provisions in ways that resemble more a blunt approach or more a "tolerance" approach. In Senegal, for example, a tax inspector explained that the tax administration would sometimes apply the so-called "Sixth Method" in transfer pricing (which can be considered as blunter than the transfer pricing regime embodied in OECD guidelines) even though this may not directly be foreseen by domestic legislation.[75]

## 3.5 Preliminary conclusions

After explaining the term of international tax avoidance (and its somewhat contested use), this chapter asked in a general manner what international tax avoidance is, and what categories can policies countries could be adopted to it. It shows that there are many ways to deal with the issue.

First, policy standards developed by international organizations can target rather the jurisdictions that are on the (potentially) revenue-losing side of the problem, they can target those jurisdictions the regimes of which are used to avoid taxes in other countries, or they can rather target headquarter countries.

Second, zooming in on the different ways that countries on the defensive side can deal with the issue, one can further identify a multitude of options: A country can adopt a finely delineating response which consists in analyzing a taxpayer's behaviour as closely as possible to distinguish good from bad behaviour, or it can adopt responses that go more to the

74 CO30, CO28

75 SN09. The "Sixth Method" is a rule whereby transfer prices are calculated with reference to public prices for certain commodities. Gómez Serrano, Bolado Muñoz, and Arias Esteban, "Cocktail of Measures for the Control of Harmful Transfer Pricing Manipulation, Focused within the Context of Low Income and Developing Countries," 35.

"root" of the problem by either eliminating benefits that taxpayers may try to obtain artificially (blunt response) or by eliminating taxes. For the sake of completeness, I also discussed the possibility and rationales of not adopting any response, and discussed ideas that attempt to tackle international tax avoidance through international harmonization. Each response comes with trade-offs with respect to administrability, tax revenues, effects on non-avoidant taxpayers or the degree of international cooperation required. These broad categories will be used to analyze the evolution of policies that countries have adopted with respect to specific policy issues, such as transfer mispricing, and treaty shopping, as well as for distinguishing the preferences voiced by different stakeholders. However, before that, it is useful to describe how the BEPS Project fits into the framework outlined. This is the purpose of the next section.