An emerging issue: “international tax arbitrage” and supranational constraints

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Introduction

Economic globalization needs cooperative negotiation to reach global governance

The experience of the last decades within GATT/WTO negotiations, to build international trade on a *rule-based* framework, brings to our attention the fact that multilateral Country agreements, even though complex and time consuming, have fundamental pillars on reciprocity, mutual benefits and clear definitions of limitations.

Globalization as a trend is already on the way, clearly the speed of this contagious process is different from countries' perceptions of opportunities and risks coming from this "wave".

At present, after the 90's aggressive market and performance approach, after the beginning of 2000 where serious economic slowdown of traditionally powerful countries has been balanced by the growing importance of emerging countries, global governance is the most appropriate goal not only for the international organizations: WTO, FMI, BM or regional UE, NAFTA, but particularly for each single Nation which while still remaining the main actor in the Global Playing Field, needs to develop its role from being competitive and selfish towards other Nations to being more cooperative in order to guarantee interaction among national markets, and this includes by preventing or solving conflicts[1].

Global governance does not necessarily imply a kind of centralized world government, but it has lead to the evolution of a multidimensional regulatory system of networks and transnational legal as well as political processes that require us to broaden our

[1] S. Sideri, Cooperazione Economica internazionale e regolamentazione del commercio internazionale, Università Bocconi 2003

understanding of international relations and to find the interrelationship between global governance and International law by enforcing new concepts that are already in practice and rendering the mechanism more flexible yet still compliant with the international legal order.

The purpose of my doctoral thesis is to investigate if there might be a global perspective on the issue of international tax that, without any ambitious guarantee of success, might nonetheless represent the starting point for "an indispensable edge in gaining survival and prosperity in today's globalized economy"[2] by learning from the best and the worst that can be found in each Country as well as at an international level. These elements represent the real challenge of global thinking, without forgetting that the most important basis for developing a global market is to understand value perspectives around the world.

Starting from a different field, namely the Marketing discipline, let me lead you through the same conclusions that might be considered as common shared beliefs in a totally different matter: international taxation.

"S*trategic planning involves committing corporate resources to the most promising areas of the world. The process requires accurate projection of world population trends over the next few decades. A managerial perspective on global strategy requires more than forecasting and quantitative analysis, however. It also requires what might be called cultural empathy.*

Cultural empathy is defined as the ability to understand the inner logic and coherence of other ways of life....One of the most important concepts in developing global

[2]Roger D. Blackwell, From the Edge of the World global lessons for personal and professional prosperity, Ohio State University Press, at 199.

marketing strategies is cross cultural analysis, which is the comparison of similarities and differences in the culture…

Global strategies need to be adapted to meaning systems of the market rather than attempting to change the market to the customary marketing programs of the firm. The process of analysing markets on a cross-cultural basis is particularly helpful in deciding which elements of a marketing program can be standardized in multiple nations and which elements must be localized"[3].

These statements give the opportunity to summarize the main highlights of my doctoral thesis as follows:

1. Globalization means world competition among business players who are looking for differential advantages, opportunities using cross-border transactions including by way of delocalizing resources (capital, people etc.). International tax arbitrage is part of this process since tax differences are exploited by taxpayers to achieve non-taxation or to minimize the tax burden that would not be available if transactions occurred entirely domestically;
2. Interaction among different regulatory aspects might generate potential conflicts, and as a matter of fact fair competition should rely upon global, international governance which also has to be empowered locally in order to identify and stop those transactions that generally lack economic substance and that sooner or later will represent a serious distortion of market rules.
3. Any tax policy, domestic or international, on cross-border tax arbitrage fundamentally has to face the following questions: Does exploitation of different

[3]Roger D. Blackwell, supra 1

tax rules, benefiting from inconsistent treatment across jurisdictions represent[4] per se an abusive practice? How and whether a Country should react in a way that might be evaluated appropriate in a context of high competition in a global and integrated economic world where any disproportioned restriction would be seen as discriminatory and ring-fencing?

4. Unilaterally, response from a single Country to defend its own interests from international tax arbitrage might imply counteractions from other nations which might be significantly impacted by this opportunist and only national interest basis[5] rule. Anti-harmful tax competition efforts by the EU and the OECD are the most promising developments in the struggle against international tax arbitrage because such efforts show how Countries can act united to curtail tax avoidance practice [6].

Therefore strategic interactions among jurisdictions are one of the most relevant analyses of cross-border transactions based on transparency and cooperation[7].

[4]Diane M. Ring, One nation among many: policy implications of cross-border tax arbitrage, in Boston College law Review 2002

[5] M.A. Kane, Strategy and cooperation in National responses to International Tax Arbitrage in Emory Law Journal Vol 53, 2004

[6] R. Avi Yonah, Commentary, in 53 Tax L. Rev., 2000

[7] M.A. Kane, supra

1. “International tax arbitrage” within the current economic scenario

1.1 Tax arbitrage and international tax law: interaction and definitions

The process of internationalization of US companies, due to the size, importance of this growth and impact on domestic taxation firstly, and international taxation secondly, has led to broad discussion on tax arbitrage among Scholars and to the enactment of several rules by US Government starting from the 80’s and consistently over the 90’s. Therefore the most relevant doctrine on this issue necessarily refers to Professors at US Universities, and the analysis of progress made in this field, as well as any comment on institutional limitations introduced in curbing the phenomenon, have as their starting point US rules that are already implemented at local level. Nevertheless the focus should then necessarily be shifted towards the developments at the EU as an organization, EU Countries and the OECD on the international tax field and how they have ruled or still bring under discussion the prevention of abusive and non-purposive activity in cross-border transactions.

In defining international tax arbitrage we try to lead the attention to general and recurrent characteristics outlined by many authors to provide understanding of the phenomenon that, despite its legal and theoretical nature, has broader concrete and substantial implications.

Cross-border tax benefit arbitrage occurs when a taxpayer enters into a transaction or structure to benefit from differences between tax systems in different countries with the

intentional goal of exploiting such differences to eliminate tax and to minimize the overall tax burden [8].

Jurisdictions often differ in their tax treatments of particular transactions or items. The tax treatments are sometimes so different as to be inconsistent.

Cross-border arbitrage might be the price of the absence of an international consensus on tax matters and therefore arbitrage might be just a technique, a means to obtain a lower overall tax burden but not an end in itself. Inconsistency is not sufficient to achieve tax avoidance and in many cases can actually generate forms of double taxation[9].

The exploitation of differences and inconsistencies among legal systems with reference to the same tax issues regarding certain cross-border transactions, to obtain advantages which would not necessarily be obtained at domestic level, involves the fundamental elements of the international tax system; especially how the role of foreign law should be viewed in interpreting domestic tax rules, as well as in the interpretation of tax treaties (better the OECD Commentary to Tax Treaty) and the boundaries of local sovereignty and jurisdiction on tax.

As a matter of fact international tax planning experts look for loopholes and substantial advantages based on tax arbitrage research while Countries' administrations and legislators have reacted to such attempts by enacting domestic rules and standards.

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[8] H.D. Rosembloom, International Tax Arbitrage and the "International Tax System", in 53 Tax L. Rev. 2000.

[9] Luca Dell'Anese, Tax Arbitrage and the changing structure of international tax law , Egea 2006, commenting M.A. Kane paper.

In order to evaluate what the correct answer to tax arbitrage would be from the perspective of the countries in a globalized context where the taxpayers are carefully committing corporate resources, it is important to look at two main factors:

1. diversity and peculiarity of domestic tax laws and rules;
2. degree of "substance" in the cross-border activity performed.

The above mentioned analysis should take into consideration that due to the globalization and consequently the internationalization of companies, any international problem could not be solved on a stand-alone basis and with the same approach adopted at domestic level to fight tax avoidance.

The present global business environment is based on diversity represented by each single market where the competition is; strategies for surviving or growing faster than our competitors requires a keen understanding of local legal requirements and market dynamics[10].

Countries' tax and legal systems might be different for historical reasons related to common and civil law evolution, judiciary interpretations, the definitional issue of the same problem due to different languages and legal meaning traditions, regulatory aspects, accounting principles and currencies.

The most relevant differences on tax rules, apart from the legal and accounting background, concern economic and political issues such as: *different policy choices – the political consensus about tradeoffs may vary among societies with different values, traditions and expectations; different judgements about the impact of given rules,*

[10] Mark Goldston, CEO of L:A.Gear Inc.

politics – political systems permit or facilitate different access to rule makers and allow different form of power and influence, randomness, path dependence and resources- a Country could determine that an otherwise attractive rule is unrealistic due to administrative , resource and technical skill constraints.

Any plan to coordinate rules would require the countries balance their domestic policy choice against the benefits from coordination with other countries[11]*."*

Therefore the inconsistency of domestic legal systems that might allow tax arbitrage and tax shelters as well will be reviewed by balancing the above mentioned constraints with the values of efficiency, equity, political accountability and revenue impact.

Domestic sovereignty that has always faced a barrier in the international context of cooperation between different countries, especially on tax matters, under certain conditions will be enhanced to properly reach those goals as part of its own policy, making the interpretation of international rules rather acceptable.

1.1.1 Fair competition, allocation of resources and social responsibility

In theory tax arbitrage can be evaluated both from an efficiency and equity point of view within the tax system.

Efficiency valuation should refer to the proper and measurable[12] allocation of risks and resources that might prove unbalanced if allocated abroad solely for the purpose of benefiting from reduced taxation on certain very complex transactions or structures.

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[11] Diane M. Ring, supra

[12] Transfer pricing guidelines on risks and functional analysis might help in rendering quantifiable this Concept, OECD

Based on standard economic analysis tax arbitrage effects, apart from tax savings, would be viewed as indicatory of inefficient investment decisions. Any over-supplied capital demand for cross-border investment, unless reasonably explained under risks and returns on investment perspective over a certain period of time, would be a hint of a tax driven transaction which, on the other domestic side of the feature, causes an under allocation of resources[13].

An efficient system means the ideal realization of that which, as to a certain extent the Ruding Report said, is based on economic assumptions: within real competition, in developing differentials in effective tax rates on corporate income, one expects that they will encourage significant movement of capital, people, technology, and resources and, as a consequence, some countries might exploit these measures to direct these resources towards them.

These movements will involve real capital and resources as well as reallocation of taxable profits. Therefore competition is likely to induce and improve some countries to lower their effective tax rates as well as other factors in investments other than taxation such as location of natural resources, access to large markets, the existence of a skilled

[13] Luca Dell'Anese, supra: The cornerstone of the economic analysis of the international tax system is the notion of "tax neutrality". A neutral tax system is considered desiderable because it eliminates the efficiency costs derived from the distortion of taxpayers' preferences, making investment decisions not affected by tax considerations…Tax scholarship has traditionally discussed three notions of neutrality: Capital Export Neutrality (CEN), Capital Import Neutrality (CIN) and National Neutrality (NN). A specific mechanism for the alleviation of double taxation is associated to each of these standards: foreign tax credit for CEN, exemption of foreign source income for CIN and a deduction of foreign taxes for NN. CEN which the most popular in USA, exist when a resident of any Country pays the same marginal rate of income taxation regardless of the Country in which he invests. CIN on the other hand, requires that all investments in a given Country pay the same marginal rate of income taxation regardless the residence of the investor. Differently from CEN and CIN, NN seeks to maximise national prosperity, not the global one, encouraging taxpayer to invest abroad only if both the investor and the government benefit from such investment. According to NN standard, a Country should set tax rates on foreign investment income so local investors are indifferent between investing at home or abroad."
On the same issue please see Ring, Diane and Avi Yonah R, supra

labor force and political stability. The attempt regarding global competition was and still is to attract real capital investment because of employment, know-how increasing effects.

However, *at the margin* some enterprises will exploit the benefits that may come from these differentials in effective tax rates by obtaining them only by way of allocation of taxable profits rather than from enduring and real allocation of capital and resources.

These "marginal" effects obviously frustrate efficient measures of the competition among countries by making *artificial* distortion and misallocating resources on a world wide basis.

Apart from the system used to control the distortion that might be created in using tax arbitrage, it is clearly a matter of how develop cooperation among Countries in order to reach fair competition. This general issue has been taken into consideration by Europeans by introducing Arts. 43 and 48 of the EU Treaty regarding the safeguard of the main freedoms established among Member States and how important nowadays is the role played by a supranational institution such as the European Court of Justice (ECJ). To really enact those principles and rebut any attempt of protectionist behaviour in the name of National sovereignty.

Another problem that is becoming an emerging issue among Developed Countries is the ethic one strictly connected to the social responsibility towards what is called the "sense of legal obligation"[14] to comply with tax rules.

When tax arbitrage increasingly becomes the common behavior of Multinational companies as well as of wealthy people, this attitude is definitively pervasive and it

[14] A. D'Amato, The Concept of Custom law",

could have not only a real but also a physiological effect on revenue collection by reducing it. One of the fears associated with tax competition, especially within high tax jurisdiction countries, has been that total national tax revenue would be negatively affected thus leading to macroeconomic difficulties for some governments and forcing others to reduce essential or politically sensitive public spending.

The final outcome would be necessary in order to get the same budgeted revenues unless governmental public expenditure was reduced, to endorse the tax burden on taxpayers who earn domestic (therefore under control) source income.

This vicious circle leads to a troubling erosion of confidence in the fairness of the tax system, intentionally or involuntary generating additional problems with reference to compliance and revenue collection and in the meantime significantly increases the costs for monitoring and finding any distortion of the tax system.

In fact, a tax system cannot function properly if taxpayers are compliant under the threat of penalty instead of feeling that it is their duty to comply. The taxpayer starts to look at tax compliance as his/her own risky investment and obviously by cheating it will be financially better surely from a timing point of view but this behaviour would attack from the base a Community's fairness expectation (including the Business one) that we are all fully committed to do our duties and therefore the ethical problem starts to be a critical point to move forwards.

1.1.2. From the “Coexistence” to the “Cooperation” doctrine

Within the context of international trade regulation, the laws of many nations have been harmonized and complex multilateral agreements have been concluded, whereas in the tax area only halting steps have been taken towards multi-jurisdictional harmonization [15]

Indeed the existence and the cross-border operation of multinational companies has brought attention to the need to upgrade international relationships from mere coexistence to cooperation[16] where any commercial enterprise, having a number of directly controlled operations among various countries usually established and operating according to the varied local legal requirements, tends towards a global perspective and functions as a single economic unit. The economic link among those entities in more than one Country regardless of the legal form would like to reach without encountering significant barriers or infringing any legal constraint, the possibility of sharing knowledge, resources and responsibility in order to implement coherent policies and common strategies[17].

Once the relevant impact of multinational companies in organizing their operations beyond the local, national legal and economic framework, was recognized, it was immediately evident at international level that the lack of supranational governance or code of conduct would indirectly enhanced the abuse among countries based on the different weight of economic power and consequently increased the potential conflicts with national policies and objectives.

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[15] Philip R. West, Foreign law in US International Taxation: The Search for Standards, Tax L.Rev. 147, 1996

16 Friedmann W, The Changing Structure of International Law, New York, 1964

[17] Sacerdoti G, L’impresa multinazionale come gruppo internazionale di socisetà, Giur. Comm, 1988 and “Les Codes de conduite sur les enterprise multinationales entre droit international et droit interne: mise en oeuvre, Il diritto internazionale al tempo della sua codificazione, Giuffrè, 1987

The guidelines for multinational enterprises which are part of the OECD Declaration on International Investment and Multinational enterprises, since 1976, literally said: *Considering…. That the multinational enterprises play an important role in this (international) investment process; that cooperation by Member countries can improve the foreign investment climate, encourage the positive contribution which multinational enterprises can make to economic and social progress and minimize and resolve difficulties which may arise from their various operations…within the OECD may lead to further international arrangements and agreements in this field, it seems appropriate at this stage to intensify their cooperation and consultation on issues relating to international investments and multinational enterprises through interrelated instruments….*

Therefore the complexity of relationships among Nations pushed necessarily towards the recognition of an international organization for finding an equitable definition process of guidelines to fulfill international obligations and prevent conflicts, based on a simple and general principle of cooperation in good faith.

As far as the taxation issue is concerned the above mentioned OECD Declaration stated:

Enterprises should

1. *upon request of the taxation authorities of the countries in which they operate, provide, in accordance with the safeguards and relevant procedures of national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations in other countries;*
2. ***refrain from making use of particular facilities available to them**, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed.*

The importance of cooperation among Countries (OECD and non-OECD) has been recently reaffirmed by the outcome of the work done and the report issued on this matter[18] but what gives the maximum evidence that to be part of an integrated system that might ensure mutual benefits, is the fact that Countries that still do not want to cooperate in exchanging information, and improving transparency is dramatically reduced at present.

The only way to promote the value of fairness and reciprocity on the market place is enter into negotiation and therefore bilateral, multilateral and Regional agreements are the sole alternative to competing without rules. The indirect sanction[19] for not being compliant is to be out of the participants ring without any right to share the same benefits coming from cooperation and a legal framework.

1.1.3 Internationalization across companies

Internationalization is a contemporary process of business globalization which can involve both multinational companies and medium and small-sized ones.

The necessity of developing a global perspective of the markets is created and in the meantime enhanced by the following forces [20]:

1. *Growing similarity of countries in terms of available infrastructure, distribution channels and marketing approaches;*
2. *Fluid global capital markets, national capital markets are growing into global capital markets because of a large flow of funds between countries;*

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[18] OECD, Tax cooperation towards a level paying field, 2007 assessment by the global forum on taxation.
[19] Friedmann W, The Changing Structure of International Law, New York, 1964
[20] Porter, Michael E, Ed Competition in Global industries, Harvard Business School Press, 1986

3. *Technological restructuring, the reshaping of competition globally as a result of technological revolutions;*
4. *The integrating role of technology, reduced cost and increased impact of products have made them accessible to more global consumers;*
5. *New global competitors, a shift in competitors from traditional Country competitors to emerging global competitors.*

The interconnections of all these factors push competitiveness towards cost reduction and price falls; therefore any cost saving will be viewed as a highly valuable goal, for example:

1. location closer to customers or suppliers implies reduction of logistic costs,
2. centralization of group companies' procurement usually implies higher discounts;
3. availability of both low cost labour and energy implies significant flexibility in the production costs

There is also growing evidence that tax considerations are important factors in locating resources internationally although according to some analysis taxation is not ranked within the first three main reasons for the business internationalization process of companies.

As a mere sample of the above mentioned trend, it would be interesting look at the figures resulting from a survey of one of the most important Associations of Italian Enterprises.

As mentioned, economic globalization as well as the internationalization of companies' organization is no longer a process belonging to big multinational companies but small and medium size enterprises are also facing the same market rule challenges and they

are looking for diversification of functions, risks and to realize synergies and cost savings; therefore nowadays international tax arbitrage and the opportunity that comes from the cross-border tax approach is one of the resources available to companies regardless their size.

The business of international cooperation must proceed. *Business activity crosses national borders, and the law has no choice but to deal with that activity. Even if there is no international cooperation or coordination, domestic laws will interact with international activity affecting business decisions and human welfare. Under this laissez-faire system, each jurisdiction proceeds as it wishes, without concern for the policies of other jurisdictions*[21]. Without some coordination on choice of law rules, however, a system of this sort will almost always lead to overlapping jurisdictions, conflicting legal regimes, and over-regulation by definitively affecting the reliability of real business and market place.

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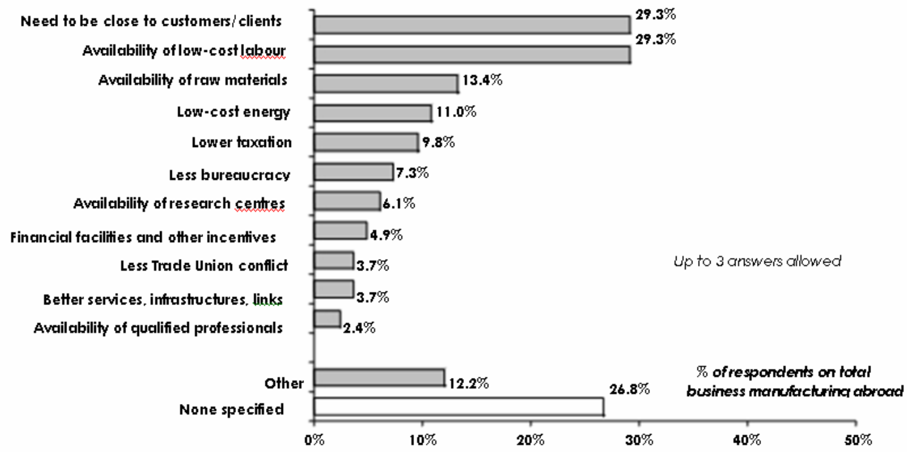
[21] Andrew T. Guzman, EXPLORING THE NEED FOR INTERNATIONAL HARMONIZATION: Introduction--International Regulatory Harmonization, 2002 Chicago Journal of International Law

Figure 2006[22]



[22] Assolombarda 2006 survey on Italian Northern companies' internationalization process. The survey referred to a sample of 4000 companies with turnovers of more than €22 million.

1.2 International tax avoidance: concept and origins

The crucial point in looking for the most appropriate policy response to sham or tax shelter transactions is to define the threshold for being considered under a tax avoidance perspective and how close the relationship between tax shelters and cross-border tax arbitrage actually is.

Based on a recent communication of the European Commission[23] it is clearly stated that *the objective of minimizing one's tax burden is in itself a valid commercial consideration as long as the arrangements entered into with a view to achieving it do not amount to artificial transfers of profits and taxpayers have not entered into abusive practices.*

Tax avoidance is a broad and well known topic which has been treated with an increasing interest by international organizations and domestic Governments in order to evaluate the magnitude of the phenomenon and the connection between tax avoidance and international evasion.

The growing importance is mainly due to the economic globalization trend where the taxpayer would minimize the tax payments for cross-border reinvestment of this source as new finance and the governmental expectation to face missing revenues, fighting against any potential way of upsetting countries' budgetary policies.

Cross-border transactions imply movement of capital, assets and persons across tax borders[24] facilitating the concealment of taxable events and making it more difficult for the tax authorities to undertake an assessment.

[23] COM 2007/785 dated 10 December 2007

[24] Cahiers de droit fiscal international, IFA Venise 1993 "Tax avoidance/ Tax evasion" General report.

In general, the concepts of tax avoidance and evasion cover a wide range of tax behaviour but mainly focus on minimizing or annulling tax burdens.

Over the last decades both have been recognized as one of the major causes of continuous erosion of the taxable base and revenue loss and the latest International reports confirm that they are still increasing.

Tax evasion in principle is recognized as direct violation [25] of a tax provision by breaking the law for the purpose of escaping tax payments.

Judging evasion might imply the evaluation of different factors (so-called subjective elements); in fact, the taxpayer can achieve the same goal both by way of omission or active behaviour. Therefore the real intention should be carefully analyzed, in other words evasion might be caused either by an intentional action taken in a bad faith or by good reliance on misguided advice or interpretation of the law.

Tax avoidance [26] can be regarded as indirect violation of tax law for the purpose of removing, reducing or postponing tax liabilities by way of exploitation of legislative loopholes; in other words the taxpayer intentionally looks for a specific transaction which allows compliance with the literal meaning of the law and its legal and economic sense [27] but in a deeper analysis it becomes evident that the transaction has an artificial nature, no business reason can be found and therefore it can be considered exclusively or mainly tax driven.

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[25] See note n.1

[26] Please consider that the term tax avoidance is not commonly recognized with a legal meaning with its own discipline different from evasion.

[27] See note n.1.

In fact, tax avoidance proof should be based on the evidence of the lack of economic substance and the transactions have little or no effect on the taxpayer's overall economic position[28], since it can be easily proved that the tax payer who intends to benefit from cross-border tax arbitrage would simultaneously meet[29] the rules of the different tax jurisdictions involved without infringing any anti-abuse law. The transaction scheme can usually be straight forward without an extra step compared to a typical transaction (the so-called "unusual" scheme should be avoided), no divergence between form and substance and no circularity of two offsetting steps only to the extent each of them would be considered meaningful on a stand-alone basis; otherwise the substantial combination of the two steps perfectly mirrored would not bring the taxpayer any additional economic benefit apart from the tax one.

This structure that apparently meets the tax rules of different jurisdictions in reality, from a mere substance point of view, has no "purposive activity" since the transaction should be analysed considering all facts and circumstances[30], rather than to focus on a single indicator such as pre-tax profit used to ascertain the business reason behind the structure.

It should be recalled that nowadays tax shelters are complex and composed of detailed and customized step transactions that exploit different tax rules. These are likely to be unintended ways to obtain final economic advantage, where the tax advantage is the most relevant one, without significantly affecting the taxpayer's real economic position

[28] Shaviro Daniel N., supra
[29] Rosembloom, supra
[30] Compacq vs. IES

in terms of risks sustained and related benefit obtained considering the resources invested other than the relevant resulting tax consequences.

Therefore, even though cross-border tax arbitrage is potentially undesirable for the impact on revenues and social changes that it might cause at the level of single jurisdictions, on the other hand, in a globalized world it might be considered the way to look at *cross-border tax synergy* [31]. What is clearly disapproved of, since the tax avoidance threshold has been passed, is the fact that cross-border tax arbitrage is not just a means to exploit inconsistencies in the application of legal, accounting and tax concepts but, rather, is an end in itself[32].

After having analysed several papers on measurement and indicators of abusive structure proposal, the circularity concept probably gives exactly the picture of the outcome of an artificially structured transaction in other words regardless of step transactions incurred by the tax payer, the tax shelter will lead through a cycle where the final economic result, apart from the tax benefit, is close to the opening balance as well as the risks associated with it.

This is, in fact, the really crucial point in analysing purposive activity during the so-called "balancing test" with reference, especially, to highly structured financial instruments which usually base their appealing remuneration on cross-border tax arbitrage.

The assessment of economic substance turns critically on the taxpayer's risk position.[33]

Therefore evaluation of economic substance should be based on the following basis:

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[31] Shaviro, supra
[32] Idem
[33] Shaiviro D Supra

- overall knowledge of the transactions (any side letter, reversed step, collateral loan etc) and counteractions linked to the principal investment;
- acceptance of certain risks within the standard of business risk;
- period of time in which risks might occur;
- price of receiving tax benefit compared with other economic effects.

After the experience gained with the two first US law cases (during 50's) on domestic tax arbitrage [34] where it was clearly stated that tax shelters definitively become tax avoidance if the transactions do not meet the minimum purposive activity test and/or pre-tax profit, most reputable Authors [35]said that the indicator of profit before tax as well as risky positions taken by the taxpayer are merely clues of abusive structure since, as a matter of fact, that measurement of normalized, standard profit before tax usually for non-recurrent transactions might be hardly computable and by way of single step the taxpayer might earn a profit before tax but it could eventually realize another side transaction to partially or totally offset the profit or defer its taxation.

The conclusions reached regarding tax avoidance lead at the consideration that tax arbitrage could not be considered as a general category for any abusive transaction but it should be analysed case by case in the light of substantiality and business reasons behind it, to ensure there is no lack or inconsistency in economic substance.

This concept is straightforwardly applicable to domestic and international tax shelters as well; therefore it could not be automatically extended to any company search of non-harmonized tax systems around the world that might give tax relief not otherwise

[34] Knetsch v. United State and Goldstein v. Commissioner

[35] Shaviro D. supra and Rosembloom

applicable in the domestic context if the implementation of the plan, for benefiting from this tax advantage, provides and passes the economic substance test.

To summarize the main contents, and making reference to recent European Commission interpretation, according to *the doctrine of abuse of rights developed by the ECJ in its (mainly non-tax) case law, abuse occurs only where the purpose of law is defeated despite formal observance of the conditions laid down in the law, and there is an intention to obtain an advantage by artificially creating the conditions for obtaining it.*

On direct taxation, in addition, the ECJ has held that the need to prevent tax avoidance or abuse can constitute an overriding reason in the public interest capable of justifying a restriction on fundamental freedoms. The notion of tax avoidance is however limited to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member States concerned.

Tax avoidance or abuse needs to be distinguished from tax fraud which involves deliberate unlawful behaviour which is generally punishable by law (e.g. submission of deliberately false statements or fake documents).

1.3 The general constraints of tax avoidance.

1.3.1 Anti-abuse rules, their rationale and limitations

Even though international tax avoidance is recognized as undesirable and inequitable in most countries, due to encountered difficulties in assessing taxable events cross border and in setting objective criteria valid in defining a rightful tax saving or tax minimization, the same countries have enacted domestic legislative, judicial and administrative systems not specifically addressed to deal with International tax avoidance but focused on preventing the unlawful reduction of the internal tax burden across the national borders by means of introducing domestic measures that also have an impact on cross-border transactions.

Countries such as Italy have introduced over the last thirty years general provisions which would allow both tax authorities and domestic Courts to disregard and assess those mainly tax driven transactions.

Besides entering into a detailed description of the principles adopted in implementing the tax avoidance rules: "substance over the form" or "step- transaction", namely listed considering that those differences belong to the different approaches to the same problem within common and civil law countries, the anti-avoidance rules have been developed from the theory of "abuse of law" applied to the economic and primarily tax field; based on general principle, the "abuse of law" concept means that no one can exercise his rights in conflict with the function to which the right has been attributed.

In translating such a concept specifically within fiscal terms, this would represent the main aim of anti-avoidance rules where the taxpayer has right to minimize his tax

burden in choosing the legal forms and transactions which are the most suitable ones for his business; nevertheless, transactions put in place for the sole purpose of avoiding taxes will cause restrictions to the taxpayer's rights and his freedom to protect those related to third parties such as the Tax legislator who has to prevent the conflict between individual positions and public interest. The legal form of the transaction can therefore be denied, based on the fact that the taxpayer has abused his right by breaching the consistency of the law.

Anti-avoidance rules prevent any loophole within the tax legislation causing a disruption of the substantial essence of the law and therefore also a merely literal interpretation can be disregarded to the extent this interpretation is not consistent with the general principles of the tax system.

The indirect violation of the law can be performed in several different ways and countries are increasingly concerned with treating the phenomenon by using general measures of anti-avoidance in order to avoid that a number of separate transactions with the final and sole aim of reducing tax liability have been legally reviewed step by step while they are part of an avoidance scheme as whole.

Any implementation of the general anti-avoidance rule might pose a basic constitutional question[36] of whether and how domestic Courts can supplement the legislator's intentions when there is (intentionally or not) a gap, a loophole in the law provision or, even more commonly, a difference of opinion about how the law provision has to be applied. Of course the answer is a really crucial point since it represents the most significant way of dealing with the political and economic attitudes of the Courts.

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[36] Frans Vanisteandael "Tax avoidance and the rule of law" chapter 4 page 131 and sub.,, Edited by Graeme S. Cooper, IBFD

From an active perspective, Courts should supplement any mistake or misleading wording made by the legislator whilst from a more conservative perspective, where there is no specific and express law provision to tax, there is no legal basis for taxation for Court judgement either.

Hedging the positions, it could be argued that the deeper and more adherent anti-avoidance rule meaning is to subject legal constructions[37] made by taxpayer to conditions of business purpose in adopting tax laws schemes. In order to leave a free choice between legal instruments provided by the legislator for reaching the same goal, it has to be legally presumed that when there is a non-tax purpose to a transaction, the legal form also automatically fits with the facts of the transaction.

What is necessary is a clear vision and consistent analysis by the Courts and Tax administrations on whether and how the legal construction behind the transactions fits with all relevant facts from a logical and economic point of view of the tax payer.

Therefore, the knowledge of the transaction's final aim would allow a better and more efficient reaction towards the wide range of instrumental possibility available at present on the global scenario.

Limitations or strengths in issuing rules which prevent abuse of law are more and more related to the existence of proper report obligations for the taxpayer, especially in international, cross-border transactions and the consequent assessment procedure of the content disclosed.

It should be necessary to consider, in particular with regard to the application of National anti-avoidance rules to international tax avoidance schemes, that each Country

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[37] See note n.5.

should, in order to protect its tax bases, seek to improve the coordination of anti-abuse measures with other Countries by way of administrative co-operation in exchanging information and sharing best practices and to find an effective and timely cross-border settlement procedure.

1.3.2 The reporting constraints: tax shelter disclosure rules and FIN 48 under US GAAP: aims and limits

The first aid to the systematical fight against evasion (avoidance) is to identify transactions, people involved, income measurement and any information available and useful for defining the transaction framework and final outcome.

The enactment of this statement can be based on general periodical reporting obligation or on requests for specific information. Each single Country has its own reporting procedure for tax purposes that can vary from case by case but is primarily related to periodical (i.e. annual) income tax return.

In light of the tax authorities' power to request any additional information which might increase knowledge of taxpayers' behavior, the US Treasury Department introduced at the beginning of 2000, and recently updated, amendments to oblige to report and register, including a list of maintenance regarding the so-called tax shelter transactions (mainly tax advantageous transactions implemented by corporations and wealthy individuals).

The main aims of this disclosure rule can be summarized as follows:

- to find an intrusive tool for identifying and challenging potentially abusive transactions[38];
- to coax or coerce compliance with Internal Revenue Service (IRS)'s view of law by selective application of settlement programmes and litigation resources;
- to increase the IRS's broad summons power to expose individuals and organizations that create and promote such transactions and to identify the tax payer who engages in them.

The current reporting rules cover any "reportable transaction"[39], which the IRS qualifies as tax shelter, promoted by practitioners based on aggressive interpretation of tax laws, that are technically correct but focus on minimizing, deferring or avoiding US Federal income. Despite the literal interpretation, the definition of "reportable transaction" is broader and would include any written advice rendered by a practitioner concerning any Federal tax issue relating to tax shelter items used to market the transaction.

According to the Treasury regulations (section 1.6011-4 and 1.6011-4 (b) the reportable transaction is any transaction which meets one of the following criteria:

- the transaction is a " listed transaction"[40];
- the transaction was offered to the taxpayer under conditions imposing confidentiality restrictions on the taxpayer;
- the taxpayer received contractual protection (i.e. by way of a contingency fee) for entering into the transaction;

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[38] A. Douane, R. S. Walton, G. M. Clarcke, What the US war on tax shelter transactions means in "International tax review" September 2003.

[39] Andrei Immerman, US New IRS proposals attempt to close down tax shelter in International tax review April 2004

[40] Any transaction that is the same or substantially similar to one of the types of transactions that IRS has determined to be a tax avoidance transaction and identified by notice, regulation or other form of published guidance as a listed transaction.

- the transaction did not result in compliance with certain provided thresholds regarding tax losses, tax credits and financial and tax adjustments.

Together with this reporting obligation, Treasury regulation sets forth that the material adviser on potentially abusive tax shelter schemes should maintain a list of participants to such tax shelter.

After the IRS has gathered information by means of reporting, registration and lists of maintenance it has the choice of whether to resolve the tax treatment of the discovered transactions administratively or litigate the resulting disputes in Court. Particularly with reference to this last opportunity by centralizing information, IRS has increased its capability to only target and select for litigation tax significant transactions.

In 2004 the UK, following the US example, introduced a similar system for disclosing tax shelters. The concept behind the new rule is the same as in the USA: material advisers (both external and in-house tax teams) have to register “notifiable arrangements” with the Inland Revenue Service or Customs & Excise; in other words the reporting transaction, as per US experience, is any tax planning scheme by which the taxpayer can obtain a remarkable tax benefit. Particular focus has been placed on employment and financial products.

For two subsequent years, the implementation of the same tax shelters disclosure was discussed in France, in 2005 and 2006, but on both occasions it was rejected and for the time being it is still a debatable matter continuing to rely upon the “abuse of law” concept and also on the tax matter, as recently stated in a case law.

The broad content and the meaning of these new rules, even though they are already in force, are still under discussion to clarify the application framework to narrow the ambit

of control to those situations that really have to be examined under the anti-avoidance guidelines.[41]

The first and significant outcome of such restrictions within the above mentioned countries is clearly to give new tools and supports to Public administrations in fighting the erosion of the taxable basis by diverting income through sophisticated transactions. These reporting obligations combined with settlement programmes and litigation initiatives would be likely to result in changing the taxpayer's behaviour in implementing or even considering transactions, plans that might be considered tax aggressive.

The difficulty in defining abusive, tax avoidance transactions as narrowly possible, to separate them from transactions which are not of this nature, implies the necessity to carefully estimate the impact of listed transactions on each case of transactional planning and to know the border line of legitimate structuring.

Sometimes a listed and disclosed transaction (better if financially cross-border) might be implemented only once within the Countries which have tax shelter regimes, but there are no additional supranational constraints that if the same cross-border transaction is recognized as tax aggressive it might be disallowed in other countries where it has been reproduced to benefit from the same tax profits based on similarity in accounting classification, foreign tax credit relief, etc.

In conclusion, the tax shelter disclosure is a broad database that is extremely useful for aligning the Tax Authorities' knowledge with the most sophisticated cross-border

[41] During Novemebr 2007, also the Portuguese Government has finally released a bill that lays down preventive mesures against aggressive tax planning. The mesures provide a mandatory disclosure of any tax planning that might imply significant tax benefits in order to analyse and to prosecute those plans that represent abuse of law.

transactions and tax planning in a short period of time. Nevertheless, apart from having the merit of discouraging most aggressive and sham transactions, after several years of implementation, tax shelter disclosure has been considered less effective then forecast, since a side effect of tax shelter disclosure might be a significant timing difference compared with the goals (financial effect, foreign tax credit, deferred taxation) that are immediately reached by the taxpayer, and until there is a formal challenge or bias by the tax Authorities there is no immediate impact on the Corporate tax burden of the companies shown in the statutory books to be published.

An interesting interaction between Governmental tax policies to "tackle" the aggressive or debatable tax position of the companies and the fairness view of companies' financial statements, has been found by introducing on July 2006, under US GAAP, the Interpretation N.48 (so-called FIN 48) to be applied starting from periods after December 2006 (say 1 January 2007) to disclose tax adjustments and provisions with reference to tax uncertainty.

The underlying methodology of FIN 48, that might be substantially different from similar provisions within IAS 12, is its fundamental characteristic: to be an assets model whereas the above mentioned IAS 12 is a liabilities method[42].

To summarize, the main content and goal of FIN 48 are to determine whether any benefit in relation to the tax position, either current or deferred, may be gained in the accounts based on whether it is more likely than not (MLTN). [43]

[42] Both Pippa, Planning for tax uncertainty, International tax review, 2007

[43] It means that the largest part of the tax benefit amount is greater than 50% is likely to be realized based on cumulative probability assessment of the possible outcomes. For instance it may be based on the

FIN 48, despite the detailed guidance on its application, remains highly complex due to the fact that it involves an outstandingly balanced and technical judgement of related law, case law and Doctrine environment on each single tax benefit issue to be evaluated. The main "discriminant" between IAS 12 and FIN 48 is represented by passing or not passing the MLTN test. Under FIN 48 principles no benefit would be recognized, whereas with IAS 12, some benefit may be recognizable (no threshold percentage is clearly defined) where a negotiated settlement with the taxing authorities is likely.

For example: Assuming that from a cross-border transaction company A has a $ 1000 deduction (tax benefit equal to $ 350) on its tax return and, by applying FIN48 the conclusion regarding tax benefit recognition is that it is not MLTN, upon examination by the Tax Authorities and ultimate Court settlement, (if a Court trial were the case), the company is obliged to recognize a liability or other adjustment for an unrecognized tax benefit for the full amount of the tax benefit ($ 350) in its financial statement (perhaps also penalties and interest if due).

Under IAS 12, the company would recognize the most reliable estimation of the obligation and it might be the case that the company discloses in its financial statement part of that benefit (say $150).

Companies are looking to reduce their overall tax burden and minimize or delay cash outflows for taxes. Positions taken in tax returns may be well-grounded and taken in good faith, but with the complexities and varying interpretations of the tax law, these

amount the taxpayer would ultimately accept in a negotiation settlement with the tax Authorities or after the final Court case decision.

may not ultimately prevail. FIN 48 establishes the accounting for uncertain tax positions, including recognition and measurement of their financial statement effects[44]. Therefore FIN 48 has the merit of creating a link between company tax behaviour and the related measurement as information that is finally and immediately available in the hands of stakeholders: Tax Authorities, Analysts, Employees, Government, Investors, etc.

This raises potentially significant challenges in evaluating tax positions not only at local, domestic level but also at the level of foreign jurisdictions where the company has its own subsidiaries.

The process, as mentioned above, is quite complex and begins with the initial valuation of the sustainability of the Company's open tax position and the management should assess whether factors underlying the sustainability assertion have changed and the amount of recognized tax benefit is still appropriate in the light of the so-called developments.

Developments should have a dynamic map of any case law, changes in the tax laws, new rulings or regulations issued by the Tax Authorities could affect whether a position should be recognized or the amount should be reported. Any different assessment can be done only if new or subsequent developments occur at the expiration date of the fiscal period that the uncertain tax position refers to.

FIN 48 requires a much more detailed analysis from the mere yearly tax provision. Every year the company should reconcile the unresolved uncertain amount deriving from unrecognized tax benefits on a world-wide aggregate basis at the beginning of the

[44] American Institute of Certified Public Accountants: Practice Guide on Accounting for Uncertain Tax Position under FIN 48, 2006.

year, with that amount at the end of the year giving qualitative-quantitative information such as the following:

1. the total amount of unrecognized tax benefit that if recognized would affect the effective tax rate;
2. nature of the uncertainty.

FIN 48 addresses the recognition, measurement and disclosure of uncertain tax positions within the financial statement and consequently the management evaluation will be subject to an audit and to the judgement of the financial statement readers with direct evidence of company tax policy and how aggressive it is. Saving taxes increases by definition the bottom line result and this seems to be a very popular common shared position by everyone interested in the good standing of the company; nevertheless if it were possible to know in advance the potential recapture risk of that tax benefit plus possibly penalties and interests, the popularity of certain tax aggressive policy would be less effective. FIN 48 is finally the principle that denies the recognition of tax benefits if the related tax position is not assessable at the level of MLTN, therefore no deferred surprise should be hidden within tax benefit measurement. Under current procedures IRS auditors do not request working papers related to FIN48 except when related to "listed transactions" for tax shelter disclosure; nevertheless recently a specialized tax magazine[45] published the news that a multinational US company, had been asked by the IRS for such working papers on FIN 48 that referred to different transactions from tax shelters.

[45] International tax review of 2007

The present result after one year of implementation is that the client is more seriously reluctant to undertake aggressive tax planning strategies that also, while meeting the requirements for avoidance penalties and sanctions, may nonetheless have to be disclosed in the financial statement.

Another important factor to be taken into consideration for tax planning strategies based on inter-company cross-border transactions is the fact that FIN 48 applied to US multinational companies, with foreign subsidiaries, intends to evaluate the uncertain tax positions that might affect the tax benefits of US companies on a world-wide aggregate basis and consequently disclosed even though related to an Italian subsidiary; therefore the MLTN test would be indirectly applicable to foreign jurisdictions, obviously the test would be based on their local tax environment but in any case subject to FIN 48 rules.

The extension of FIN 48 in a world wide context for US Multinationals might really refrain (at least inter-company) the exportation of tax shelters in different jurisdictions where those rules do not exist but uncertainty and an aggressive tax position might have a significant impact anyway.

It is an increasingly shared belief that through an accounting principle relating to tax, the FIN 48 which represents an assets (tax benefit) valuation method for the purpose of financial statement disclosure, a conscious management responsibility towards firstly Corporate governance (unfairness of financial statement might become a serious trouble matter for Corporate Bodies such as Board of Directors and specially Chief Executive Officer) and secondly towards any social party interested in the respect of the legal and moral obligation of fair tax burden, has been created.

1.4 Tax arbitrage between lawful reduction of taxes and tax avoidance

The globalization of economic systems, free movement of people, capital and investments are having and will continue to have a significant impact on tax jurisdiction.

Multinational enterprise in particular, like all tax payers, has the legitimate incentive to minimize its global tax burden by allocating income according to the most attractive tax system around the trade world in terms of lower tax rates as well as adequate tax incentives.

Tax planning is also achieved by way of tax arbitrage among countries with better tax opportunities, nevertheless the main distinction between benefiting from fair and unfair competition is the intentional manipulation of tax systems for artificially reaching the aim of reducing and deferring tax burden, such as planning unfair transfer pricing policy to shift income to low tax jurisdictions and charging cost where taxes are higher. Manipulation of transfer pricing has become a growing concern for tax administrations as well as the migration of profitable assets to low tax jurisdictions. The same transaction (i.e. migration from fully fledged to stripped distributor) might be considered compliant with tax jurisdictions involved if based on proper contractual evidence, which fits with the business reality, also considering fair compensation based on functions and risks allocated. The transaction represents a real and risk-free tax opportunity whilst same opportunity if not managed in a proper way might cause potential tax assessment and detrimental effects from business perspective too.

Tax planning per se does not represent an unlawful way to deal with a taxation system, the absence of any business reason and the abuse of law even though realized through a loophole in the law consistency might represent a serious concern.

Therefore, today's urgency is to reach a fair and objective evaluation of purposive activity of the transaction or structure scrutinized in order to implement legislative rules and *ad hoc* standards among different jurisdictions without creating barriers to investments.

A set of standard rules is the first step towards global governance applied to sham transactions, so-called tax shelters, then the most important upgrade is to build around the general but fundamental concepts, a coherent process of interpretation of the local judicial Tax Court as well the possibility of benefiting from an International settlement of any dispute on cross-border tax matters.

Coming from different Countries' experiences and different attitudes in dealing with tax anti-avoidance both by Tax Authorities and Tax Courts, tax harmonization might represent a suitable solution to work on once a context of International cooperation becomes a stabile reality; in the meantime it will result in a more fruitful relationship to reaching a common notion of tax abuse instrumental for the application of an anti-avoidance judicial doctrine and this would be the primary aim of a supranational organization such as the OECD or other Regional entities that should identify coordinated standards in judging the "substance and purposiveness" of the cross-border activity performed, identifying harmful tax competition and enhancing transparency and information.

Relying upon a common shared approach might lead to reshaping fundamental legal categories at Country level, such as abuse of law or anti-avoidance measures, to deny the undue tax benefits under the condition that the legal scheme of tax-abusive transactions would be maintained as such.

In this respect it is important to notice the reason behind the European Commission Communication on the implementation of the anti-abuse provision.

In the light of achieving coordinated initiatives in the direct tax field, considering that the attention of States is obviously focused on the need to apply anti-abuse rules, the supranational entity, the European Commission[46], would address the issues related to the application of such anti-abuse rules and how this implementation is compatible with the development of the European tax law and its fundamental freedoms.

This need for a coordinated approach is due to growing attention over the past few years by the European Court of Justice (ECJ) in this area in which it has clarified the limitations on the lawful use of anti-avoidance rules. The judgements will have a significant impact on the existing rules which have not been formulated with these constraints in mind. There is thus a need for a general review of national anti-avoidance rules to explore the practical application of the relevant principles beyond the circumstances of the particular contexts in which they arose. Cooperating in building a general principle will ensure that there are no undue obstacles to the exercise of the rights conferred upon individuals and economic operators by European Community law provisions, and in meantime each Member State will be able to operate within an

[46] COM 2007/785 dated 10 December 2007

effective tax system and prevent its tax bases from being unduly eroded because of abuse.

The need to prevent tax avoidance or abuse can constitute an overriding reason in the public interest capable of justifying a restriction on fundamental freedoms, but *in order to be lawful national anti-avoidance rules must be proportionate and serve the specific purpose of preventing wholly artificial arrangements. It is in particular clear that those rules must not be framed too broadly but be targeted at situations where there is no genuine establishment or more generally where there is a lack of commercial underpinning*[47].

1.4.1 Main issues and examples:

1.4.1.1 Conflict of qualifications: Leasing Double dip

As part of international tax arbitrage, successful schemes based on a hybrid structure as well as on different assets/revenues recognition and qualification are extensively diffused cross border.

An example of double dip (costs) structure based on inconsistency of transaction classification under the jurisdiction of two different countries, is the cross-border leasing, particularly with reference to the differences pertaining the concept of user property within the leasing scheme. The basic transaction provides that an operative company sells cross border its equipment to another group company and then leases

[47] COM 2007/785

back the same equipment by way of financial leasing. The intentional purpose of this arbitrage is to allow a double dip deduction of the equipment depreciation assuming that, according to the substance over the form principle, the operative company entered into a secured loan and therefore is entitled to continue the equipment depreciation also in the Country of the lessor's residence, where the tax treatment sticks to the legal ownership title and therefore the lessor is also entitled to depreciation deduction on the same equipment.

The above mentioned structure therefore allows tax arbitrage across national tax systems since it relies upon either different income qualifications and/or on different entities' tax status as well as on different accounting principles[48].

1.4.1.2 Double exemptions: capital gain taxation

The main Authors who describe the most sophisticated cross-border tax structures do not usually mention the double exemption that comes from the application of the Tax treaty provision on capital gain generated by a seller, resident in a Country where participation exemption is applicable, from the sale of shares related to a company resident in a Country where capital gain on shares is not or is only partially tax exempt.

From a practical point of view, this is the typical scheme of a foreign holding company resident in a Country such as Luxembourg, The Netherlands, etc. where according to domestic law capital gain on shares transfer is totally exempt, that for example owns Italian shares and the holding decides to sell those shares to a third party.

[48] For further comments on different accounting principle implications please see paragraph 2.3.2.1.

In principle, according to Italian domestic law the capital gain realized from the sale of the shares should be taxable in Italy, nevertheless thanks to the application of Art.13 of the Treaty signed both with Luxembourg and the Netherlands on capital gain, the conventional treatment provides that such capital gain should be taxable only in the State of residence of the seller, therefore in our example in Luxembourg or in The Netherlands. By shifting the taxation into the Country of residence of the seller, according to the Treaty provision the ultimate result would be the total exemption of capital gain realized, based on the domestic rules of participation exemption implemented in the Country of residence of the seller.

Usually, this structure does not lead to any surprising cross-border tax arbitrage considering the diffusion of the above mentioned holding structure for a multinational group.

Therefore the aim of such analysis is to point out that in principle, based on the present interpretation of the Treaty provisions, nothing is unusual or to be blamed on anyone for benefiting from this double exemption; which is not itself sufficient to constitute an abusive structure.

The mere fact that a subsidiary is established in another Country which applies a lower income tax rate or certain tax benefits, to the extent they are not considered within the harmful tax measures (Luxembourg or Dutch participation exemption is not) cannot be treated as giving rise to tax avoidance; nonetheless as it can be argued by looking at several examples of recent case law and law changes within different Countries, the substantial purposive activity test should be passed by the foreign subsidiary through

objective proof in order to be considered as established for well-grounded business reasons, regardless of benefits that may derive from the tax efficient location.

1.4.1.3 Hybrid structures: financing structures

A well known example of hybrid instruments are those qualified with a financing purpose such as: Convertible bonds, preference shares, perpetual debt, subordinated debt, floating rates debentures, profit participating loans and index linked debt. For tax purposes these are particularly attractive since they are deemed to be debt from one perspective and from the other cross-border jurisdiction are deemed to be equity, shares. The tax advantage is represented by a double dip when a multinational company is able to deduct interest expenses in the source Country, usually the Country where the hybrid is considered debt, while the income is not taxed or is subject to a low rate of tax in the recipient's Country of residence, since it is considered as remuneration for equity investment and therefore similar to dividend tax treatment, including potential participation exemption, if any, or benefiting from deferred taxation at the time of equity instrument redemption.

The basic forms of finance or investment are equity and debt. The return on a debt investment is interest, whereas the return on an equity investment is a dividend. The tax treatment of interest and dividends is not neutral; rather, they are treated differently for tax purposes. Dividends are not deductible from the paying corporation's taxable profits, whereas interest normally reduces the corporation's taxable profits. In cross-border situations, the source-state interest is also deductible at a higher tax rate than the taxation, if applicable, in the recipient State of the dividend.

The different tax treatment of interest and dividends requires that debt and equity, and interest and dividends be distinguished for tax purposes, based on cross-border inconsistency of legal and accounting representations of the same instrument, especially with hybrid financial instruments which possess features of both equity and debt or which may be converted from one type to the other.

As explained through the examples in paragraph 2.3.2.1, regarding the accounting treatment according to IAS 32 and 39 of financial instruments, there is a wide range of debt-equity hybrids which includes corporate shares attached with conditions that make the shares, from an economic point of view, closer to debt as well as loan contracts attached with conditions that make the loan, in its economic substance, closer to an equity investment.

As regards the aim of any hybrid structure it should be noted that it is not the legal form that is relevant, but it is the actual economic substance that may be determinative for tax purposes.

The distinction between equity and liability is strictly connected to the return and risks of the investment, and therefore the financial instrument would be realized based on the tax benefits to be reached by the counterparties that will consider the inconsistent cross-border classification fruitful.

Generally speaking, from an economic point of view, the only actual difference between debt and equity may be the variability of the return and particularly the possibility to know and predefine the return in order to cover any risk or to bear the risk within a certain range or without any limitation.

The second distinctive indicator is the risk involved. Only a shareholder might intend to bear the entrepreneurial risks, whereas a creditor does not intend to assume such a risk on a whole investment, consequently the remuneration of the former should be different from the latter and computed according to the return predictability based on risk factors to be taken into consideration.

Creditors, in principle, bear a smaller risk than equity holders that the return on the investment will not be paid or that the investment will not be paid back. Because the return on equity depends on company profits, and on a decision to distribute them, and because the return on the investment is subordinate to creditors' claims, equity generally bears a higher risk than debt.

With reference to tax arbitrage that derives from hybrid financial instruments, there would be few counteractions to be put in place in discouraging sham transactions, and one is transaction accountability on principle based on a substance over the form principle such as IAS where regardless of the legal form, interest, gains, and losses should be reported in the income statement in accordance with an instrument classified as a liability, in addition the dividend payments on preferred shares classified as liabilities should be treated as expenses. On the other hand, distributions, even though not strictly and legally defined as dividend, to holders of a financial instrument classified as equity, should be treated accordingly.

On the other hand, as a unilateral domestic response, each Country might deny deductibility or disregard any expense that did not suffer from any taxation cross

border[49], in addition no participation exemption benefit can be allowed to revenues coming from a jurisdiction where it has deducted as a cost.

Obviously the effectiveness against cross-border tax avoidance of this latter treatment should be evaluated in the light of cooperation and coordinated actions in an International context

1.5 The regulatory problems raised by international tax arbitrage

The dynamic scenario whereby the taxpayer, and primarily the multinational enterprise, has to compete, imposes the expansion of economic relationships within the International arena.

For this reason, the increasing interest of players in knowing and exploiting the implications of differences among countries' tax systems in order to minimize the overall tax burden by cross-border transactions, is not surprising. In the meantime, this growing attention has caused a lot of Governmental concern regarding the behaviour to be adopted by tax legislation and administrative processes in order to face this emerging issue, at the least to better characterize the phenomenon and find a consistent approach where the domestic setting can be considered quite useless. Taxation in the International context is different and any tax policy implemented in this regards will impact the competitiveness of the States, cross-border activities and its right to tax the income from international commerce and investments[50].

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[49] This anti-avoidance measure would be likely to be effective also for CFC located in a tax haven

[50] Mitchell A. Kane in Strategy and cooperation responses to international tax arbitrage, Emory law Journal, Winter 2004.

Over the last decades, as mentioned above, the taxpayer's interest has turned from opportunities in the domestic taxation system to wider and more advantageous "international tax arbitrage" possibilities.

In standard terms international tax arbitrage is not related to a taxpayer dilemma as regards which tax jurisdiction should be compliant and consequently breaching one of the two but, on the contrary, what represents a differential aspect of international tax arbitrage from another scheme used for minimizing avoidance of taxation such as the under-evasion concept and for that reason appealing to the taxpayer, is the full compliance with all applicable laws in each single Country involved.

The taxpayer's intention is not to rely on a gap or loophole in the national tax system, but concentrates on looking for inconsistencies and differences across national tax laws in order to benefit from them.

It should be added to the above definition the fact that in most cases of international tax arbitrage there might be a lack of independent non-tax motivation for transactions performed on a cross-border basis.

The absence of an independent business purpose does not necessarily mean that the transactions performed are fictitious and artificial for having tax benefits. For instance, the leasing transaction really occurred within the two countries. Substance over the form and business reasons would be the "discriminant" under which to analyse potential tax abuse, avoidance issues and undue tax savings related to cross-border transactions to distinguish between legitimate, lawful tax planning arbitrage and a less correct type, to the extent that international tax arbitrage does not in itself represent a straightforward way to avoid tax.

Nevertheless, the taxpayer's intention is not relevant for the definition purpose of international tax arbitrage, but it might be relevant for evaluating the governmental response to this increasing phenomenon.

The starting point for better understanding the phenomenon is certainly finding a narrow definition of its complexity and probably the most appropriate one could be considered "the deliberate exploitation of differences in national tax systems" [51].

The identification of international tax arbitrage might represent a strategic opportunity for the governments to pursue tax policy which could increase their competitiveness and cooperation possibilities towards other border countries, particularly towards those that are industrialized and that have a sophisticated tax system.

At the same time, countries characterized by a high tax jurisdiction are threatened by deviation of taxable revenues through cross-border transactions and therefore see international tax arbitrage as a real problem to be solved in order to avoid a forthcoming impact on budgetary policy.

Nevertheless, considering that globalization from economical perspective is a reality and that the multinational enterprise perception is, despite the legal status and taxation system in each Country where it carries out its business, a single entity, international tax arbitrage would be an increasingly natural attitude to plan the best allocation of financial resources, including by way of minimizing tax burden in each jurisdiction. Vice versa, the existence of many tax jurisdictions with different tax classifications might lead to continuous inconsistency among tax laws, and the fact that no world tax

[51] Prof- H. David Rosenbloom , International tax arbitrage and the International tax system 53 Tax L. Rev. 137, 137-41.

organization has the power to enforce the proper and consistent interpretation of tax laws [52] still causes domestic Governments concern about international tax arbitrage.

Potential planning solutions for the future should be achieved through the cooperation and convergence of tax systems from a legislative, procedural and judicial perspective. In fact, it might be possible to reach quite similar results from a different starting point by incorporating within the domestic tax laws elements and concepts from different tax jurisdictions that are the most reliable and advanced on international matters. This because for those countries enhancing international relationships means interacting with each other and having a direct influence also on tax implementation developments[53]in order to be harmonized within the same economic playing field[54].

[52] Reunen S. Avi-Yonah in Commentary 53 Tax L. Rev 167 (2000)

[53] See note n. 16.

[54] This is the comparable experience within the European Union.

2. Enforcement of Supranational constraints on tax arbitrage

2.1 OECD definition and role

2.1.1 The traditional goal of double taxation prevention and the progressive elimination of discrimination and restrictions in international taxation

The role of multinational enterprises in world trade has increased dramatically over the last decades and integration of national economies by developing technology and communications is a factual reality. Economic growth has implied complex taxation issues and no tax rule can be viewed from a stand-alone point of view but must necessarily be addressed in a broad international context. In this respect, if a multinational entity has been subject to tax in more than one State or if two entities have been taxed on the same income in different State, a double tax situation arises. This aspect represents a remarkable barrier. The primary purpose of the International organization, the OECD, is to minimize double taxation as well as to prevent potential tax obstacles from promoting and actually increasing the economic cooperation within countries by way of bilateral/multilateral treaties.

The OECD is the most powerful organization for tax coordination since it is used to actively interacting with institutions, business community and Governments.

Recently on taxation issues, several Committees have worked on reports and manuals that will represent the forthcoming developments on subject matters at International level, primarily because the outcomes of proposed draft and revised versions are based on "stakeholders" opinions on the relevant impacts as well as the necessary improvements in order to become an effective measure.

Over the last years the purpose of preventing double taxation, by applying allocation rules to income taxation rights and the methods for carrying out the division of revenues windfall, are quite often associated with the objective of preventing double non-taxation as one of the legal obligations behind and inherent to the meaning of the Treaty clauses[55]. This underlying concept is still a debatable issue and according to the discussions held during the 2004 IFA Conference several reporters were sceptical in sharing this point of view, based on the fact that behind the possibility to benefit from double non-taxation by way of DTC, there are still opportunities for treaty Countries and sometimes the non-taxation is a mere downside to the interaction or better inconsistencies between Treaty provisions and the domestic tax laws integrated by the local Courts' interpretations.

One of the main aims of the OECD's Tax Working group is to reject the introduction of harmful tax measures and welcome any laws or practices that are deemed to be fair in complying with the cooperative standard approach; nevertheless the fairness and equality principle is largely affected by discrimination circumstances within the legal systems in general and in taxation systems in particular as extensively mentioned above.

Non-discrimination is one of the most complicated concepts to define and, considering the consistent growth of globalization, market integration, it becomes the most relevant one in building a common framework, as mentioned, where persons (in the wide meaning of entities and individuals) interact on the International platform.

In the near future the relevance of said principle will imply the most substantial tax reform with significant practical effects on domestic taxation[56] since the latter would be

[55] Lang Michael, General report on Double Non Taxation , Vienna IFA conference 2004

[56] Prof. Vanistendael, Tax revolution in Europe: The impact of Non Discrimination, in European taxation ,

necessarily developed in the light of International tax rules for improving relationships on the Common Market.

"*The non discrimination principle shall be defined by comparison of different relationships to which different juridical effects are attributed. In this regard the key for the non discrimination principle is to assess whether those relationships are different enough to accept different juridical effects attributable to them or not*."[57]

It is interesting to notice how the EU with regard to the OECD, through its Court of Justice (ECJ), ruled on a different approach and interpretation of the non-discrimination principle.

The OECD would that any Country, on a reciprocity basis by means of Double Tax Treaty (DTT), entitles non-national residents and non-residents to the same substantial and procedural tax treatment as residents.

In this context and within the traditional interpretation meaning of DTC there would not be an immediate perception of the potential distortion effect on free market caused by Double non-taxation with reference to the taxpayer's choice in applying one Treaty instead of another, which provides more favourable tax treatment and less constraints.

The OECD Model Clause [58] aims to prevent tax protectionism that would interfere in competition with residents (national) and non-residents (non national) by way of an additional burden. The interpretation of said clause by Member States seems to be very

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[57] Joan Hortalà i Vallvè, Discrimantion in International Direct taxation in the light of European Court of Justice Cases, Rassegna di Fiscalità internazionale n. 2-04.

[58] Art. 24 of DTT Model

restricted; therefore apparently the OECD Model Article leaves out the aim of widening potential application of discrimination measures.

The legal and fundamental problems with this Non-Discrimination OECD Clause, together with the reciprocity application requirement and different interpretation, would not ensure a proper discrimination protection considering the many discriminatory situations that exist nowadays, such as double non-taxation.

In this respect the ECJ ruled in a consistent way that the non-discrimination meaning is to strictly forbid in Community law the implementation of the provisions on different tax treatments, from both a procedural and a substantial point of view, which allow ring fencing, under domestic tax sovereignty of each single Member State, or harmful tax practice.

The ECJ's view is linked to wide and rapidly changing business opportunities within EU territory and it would prevent any interruption of financial and human capital flows caused by domestic laws.

The different view and application environment between the OECD and the ECJ is mainly due to the different solutions for facing the same problem: potential conflicts and litigations should discrimination occur.

The OECD provides a specific Clause under the above-mentioned limitation of reciprocity as well as a Mutual Agreement Procedure (MAP) [59] which has not given, for the purpose under examination, significant results on a consistent basis; no proper checking mechanism or better proper rights to ensure the respect of DTC has been provided for solving on a timely and effectively basis the problems that have arisen.

[59] Art. 25 DTT OECD

MAP is not eligible in the private sector directly but only through Tax Authority bureaucracy.

The ECJ represents the interpretation way commonly recognized by Member States which are obliged to ensure compliance with Community Law.

The concepts ruled by the ECJ have the purpose of guaranteeing the undertaking of cross-border economic activities as well as ensuring that any legal measures adopted within the EU are in conformity with EU treaty principles.

ECJ rules have binding and direct effects on Member State jurisdictions since any private economic player has the right to invoke the application of ECJ provisions in front of any Court, regardless of whether domestic authorities have ruled them into national regulations or not .

As explained above, the OECD Model, on the same issues, has different juridical effects very far from those arising from ECJ jurisprudence; the latter offers a wide range of income tax matters ready to be used directly by private sector. This is also the reason why the EU approach will allow a tighter relationship between the implementation of EU laws and the Business Community's needs, since together they would remove any tax obstacles to cross-border activities on the Global perception of the market.

Another remarkable result from ECJ jurisprudence is a widening of discrimination meaning and the progressive abandonment of such a word for a better self-explanatory definition of "difference of treatment"[60].

"*Rules regarding equality of treatment between nationals and non nationals forbid not only overt discrimination but also all covert forms of discrimination, which, by the*

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[60] ICI (1998) Saint Gobain (1999) Amid (2000) Metallgesellschaft (2001) Lankhorst- hohorst (2002) Bosal (2003)

application of other criteria of differentiation, lead to the same result….The different treatment of non-comparable situations does not lead automatically to the conclusion that there is discrimination…..Substantive discrimination would be treating either similar situations differently or different situations identically…"[61]

The Sovereignty of Member States is recognised and defended by the ECJ when different treatment can be qualified as a barrier or restriction justified by reason of overriding general interest whereas discriminations are always debatable unless introduced by reasons expressly provided for by the EU Treaty.

The "cohesion of tax systems" as well as "preventing the risk of tax avoidance" have been consistently refused as justification of different treatments between residents and non-residents, unless the national legislation has the specific purpose of preventing artificial arrangements to circumvent national tax legislation.

Therefore discrimination is a matter which impacts the principle of equality, fairness related to International relationships, and cannot be overcome by virtue of domestic tax legislation whilst restriction can be justified to the extent it would avoid *undue competitive improvement* by lowering taxation in a fraudulent way with regard to national tax provisions.

Within a market all participants should be obliged to act under the same conditions and tax is a market condition; therefore any unfair advantages that result in a formally (i.e. additional accomplishments burden) or substantially differential treatment (i.e.

[61] C-152/73, C-13/63

additional taxes) between residents and non-residents should be viewed as direct or indirect discrimination and consequently removed.

Paradoxically, the restrictions introduced by Tax authorities to prevent fraud or abuse of Treaties, to the extent that they are strictly limited to these purposes, should be considered as a measure to ensure the competitiveness among Business Players on the Common Market[62]; overcoming this rule might lead undue advantage to be considered as part of a discrimination process.

In accordance with recent interpretational developments by the ECJ and the Fiscal Authors community [63] double dip or double exemption could also be part of discrimination since both of them might have, as said in the previous sentence, as a result an unfair (considering on overall and cross-border basis) relief.

Based on the recent EU results in facing the abuse of general freedoms within EU Community law, it is probably evident that Tax Treaties (DTC), even though based on the OECD model and often interpreted, also within local Country jurisdictions, based on the OECD DTC Model Commentary, have a huge obstacle in timely reacting to any kind of cross-border tax avoidance structure based both on its legal nature of bilateral agreement, and therefore subject to negotiations, and on procedure to be implemented within the Country's legal framework which is really time-consuming.

[62] OECD recommendations on anti-avoidance and CFC rule

[63] Cahiers de droit fiscal international, Volume 89-A Wien Congress.

2.1.2 The Mutual Agreement Procedure as a dispute settlement mechanism

As trade and investments have an increasingly international character, tax disputes may very well occur based on different national approaches to same principle. Most treaties contain an article under which the enterprise can require the competent authorities in the countries involved to negotiate for the purpose of eliminating the double taxation. This article in any case does not represent a guarantee that an agreement between the two authorities will be reached as the article only imposes an obligation to negotiate, to start the so-called Mutual Assistance Procedure but not to reach a definitive and binding agreement. In most countries negotiations between tax authorities of different countries cannot commence until the case has been settled by the tax courts.

The Mutual agreement procedure is not as widely used as it supposed to be. There are a number of reasons for this and the following are probably the most significant limits to this treaty provision and to its enactment:

- the procedure is extremely time consuming (no time limit exists);
- the time impairs the economic value of a final agreement;
- no procedure is laid down;
- some countries are not very keen to surrender any tax base which is compliant with the domestic tax act;
- the absence of a guarantee for a final agreement;
- it is not possible to appeal against a decision;
- the enterprise has very little control or insight in the negotiation and
- the procedure does not apply to penalties.

This political procedure in order to be effective, in other words to ensure coordinated assessment of the facts and uniform application, should be enacted with more judicial means of dispute resolution such as international arbitration or litigation[64].

If on the one hand the OECD's primary purpose is to eliminate double taxation on cross-border activity, on the other hand this cooperative attitude must be completed by means of obtaining information and countering abusive tax practices. Exchanges of information are common today and it is absolutely realistic to assume that in future tax revenues in different countries will intensify the use of existing bilateral and multilateral instruments for exchanging information.

Under the OECD Model Tax treaty, information which would disclose trade business, industrial, commercial or professional secrets or trade processes should not be supplied if it would be contrary to public policy to do so.

A practical problem in this context of increasing importance of trade and technical secrets is that an enterprise cannot be informed about the aim or even about the existence of the information exchange. This means that it depends on the discretion of tax officials to determine what a trade secret is and what it is not.

[64] Mario Zuger in "Arbitration under Tax treaties improving legal protection" in International Tax Law, IBFD.

2.1.3 The exchange of information: a way for inter-country cooperation

As definitively reported by the OECD Global Forum on Taxation in 2007 and by prominent Scholars,[65] one of most effective means to counteract tax avoidance as well as contributing to a harmonized and cooperative environment, is substantially represented by an effective information exchange between Countries.

The Exchange of information between Tax Administrations is an important tool in fighting non-compliant behaviour with the tax laws, in an increasingly borderless world. Therefore, Art 26 of the OECD-based Tax Treaty provides exchange of tax information upon request, on a spontaneous and automatic basis; nevertheless due to the complexity of present day tax situations and cross-border relationships, on 23 January 2006 the Committee on Fiscal Affairs approved a new Manual on Information Exchange. The Manual provides practical assistance to officials dealing with the exchange of information for tax purposes and may also be useful in designing or revising national manuals. It has been developed with the input of both member and non-member countries in the light of widening the field of cooperation on the same issue relating to the exchange of information, and in the meantime, to safeguard the Treaty-Country sovereignty on its own tax basis and ensure the correct allocation of taxing rights between tax partners.

Exchanges of information can be requested for several reasons; nevertheless they should be grounded on a legal framework such as: tax collection, tax avoidance, criminal tax implications etc.

[65] Avi Yonah Reuven, Globalization, tax competition and the fiscal Crisis of the welfare State Roin Julie, Competition and Evasion: another perspetive on International Tax Competition, 89 Geo L.J. 543

The tax administration that has been asked for the exchange is obliged to release the information requested without limiting it just to the information contained in the tax files of the administration. Tax Authorities have to carry out special investigations and any examination that is required, in the ordinary domestic course of their duty as if its own taxation were at stake.

Therefore also information related to nominees, agents, fiduciaries and ownership that might be refer to one or more taxpayers under examination, should be made available.

Naturally, the information exchanged cannot be used for purposes other than the original ones and are covered by any tax secrecy and confidentiality.

The exchange rules are subject to any legal limitations legally provided where the information has been requested: professional secrecy, bank secret etc.

Any progress towards transparency will lead to the International content of the cooperation culture where the legitimate Country's rights should be exercised within the awareness that the cost of internationalization is also the obligation to comply in good faith with the International legal framework around which a strong sense of responsibility to comply should be built.

2.2 Current status of the OECD's tax agenda

Pursuant to the recent issuing of the 2004-2006 Progress report on "the OECD's Project on harmful tax practices"[66] as well as the results of the OECD Global Forum on Taxation held in Berlin on June 3-4 2004, international attention is definitively focused on the fact that Member Countries' work on eliminating harmful tax practices and on the definition of a Global Level Playing Field especially in Taxation are the way:

- "*To achieve the highest sustainable economic growth and employment and the rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to developing the world economy;*
- *To contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and*
- *To contribute to the expansion of world trade on a multilateral, non- discriminatory basis in accordance with international obligations."*[67]

In fact, in this respect the OECD's commitments are as follows:

- Standard access to bank information by tax authorities;
- Improving transparency of the tax and regulatory regime and enforcing effective exchange of information for tax purposes[68] ;
- Enhancing cooperation also with non-OECD countries for removing tax obstacles to cross-border trade and investment.

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66 The 2004 Progress report published on February 4th, 2004
67 Idem
68 Please see the new OECD provisions for Exchange of Information between Tax Authorities which amends Article 26 and its Commentary.

The implementation of these issues should necessarily rely upon a progressive improvement, by negotiation of bilateral agreements, in achieving a global tax environment by way of the above mentioned Global Level Playing Fields[69].

No sustainable growth, which improves international competitiveness, can be asserted without promoting tax reform, agreeing on international tax rules and implementing an effective mechanism for resolving tax disputes.

2.2.1 The OECD's report on Harmful Tax Practice: The 2004-2006 Progress report

The first report in 1998 focused on identifying and eliminating harmful features of preferential tax regimes in OECD Member Countries.

The aim of the analysis was to create awareness of tax havens and to seek their commitment to principles of transparency and effective exchange of information and therefore this effort brought together OECD and non-OECD Countries to cooperate in the same direction on a common understanding.

The OECD, by promoting the implementation of the principles of transparency and effective exchange of information, seeks to compromise International duties with Country-legitimate sovereignty over national matters and particularly in applying its own tax laws.

The aim of this work is to create an environment in which all Countries (OECD) and non-OECD can compete on tax matters freely and fairly without impacting each other's economic growth and revenues flows.

[69] Jeffrey Owens' article on International Tax review, July 2004 " How the OECD helps the global tax environment"

Transparency, International co-operation through an effective exchange of information are the three main pillars for the foundation of a fair environment.

2.2.2. Definition of Tax Co-operation: towards a level Playing Field (2007 Assessment by the Global Forum on Taxation).

Finding fiscal integration characterized by fair competition first of all means avoiding distortions that might create a migration of business (i.e. capital investments) to economies that do not encourage transparency and effective exchange of information for tax purposes, as well as providing harmful special tax incentives and preferential regimes.

Cooperation effectively implies that all countries, regardless of their tax systems, should converge the existing tax practices into the same and acceptable standards for an effective exchange of information, and should be coupled with a process that ensures equity and fair competition.

The Global Level Playing Field can be defined as follows:

The level playing field serves as a goal.

Achieving a level playing field in respect of exchange of information requires that all jurisdictions, OECD and non OECD members, should act in a ***fair*** *manner consistent with the concept in their bilateral relationships and more broadly.*[70]

All efforts in reaching such a common objective, as already mentioned, pass through integrated individual, bilateral and collective actions which can ensure or facilitate, even

[70] OECD Global meeting Berlin 3-4 June 2004 report on “A Process for achieving a global level playing field”

though gradually, the creation of an environment in which all countries, especially financial centres, meet the same standards of the global community.

An essential part of the global level of field work to ensure fairness would be to review and assess the current laws and practices within OECD Countries as well as financial centres. Standard reviews should be made on a consistent and continuous basis for evaluating any progress and addressing new tax issues arising from a changing business environment but in meantime avoiding lack of information and failure in implementing transparency.

Cooperation and bilateral contacts within OECD and non-OECD Countries (with the title of Participating Partners) can actually develop and implement the minimum standard requirement for moving away from harmful tax practices and encourage the creation of the previously mentioned level playing field.

The actual aim of this report is to explain to any Country how the tax system should be structured for supporting fair competition; this would imply minimising tax distortions of financial and real investment flows to reach an acceptable level of confidence in tax rules compliant with international standards.

There is a need to promote the ongoing dialogue within OECD and non-OECD countries to establish a bilateral mechanism for effective exchange of information.

The tax issues regarding harmful regimes directly affect the global economy in such a way that the business community should have been involved in the process of issuing the application guidelines on transparency and exchange of information, ring fencing, transfer pricing, rulings, holding companies, fund management and shipping, for defining the most effective practice.

This report provides that exchange of information, one of the main criterion of fairness, for tax purposes can only be effective "when reliable information, foreseeable relevant to the tax requirement of a requesting jurisdiction, is available or can be made available in a timely manner and there are legal mechanisms that enable the information to be obtained and exchanged. This requires standards for maintenance of accounting records and access to such records."

Nevertheless, recognising the sovereign right of member States, any compliance work burden should be flexible, ensuring that the application of any measure is proportionate and prioritised and appropriate for the circumstances of each member Country.

The effectiveness of defensive measures against harmful tax regimes depends on a framework for a cooperative and common approach by reaffirming the value of the Global Playing Field to overcome the limit of unilateral and/or bilateral agreement where the problem is on a global basis.

Therefore, the common framework should be completed by an effective assessment mechanism of potential lack of implementation and of resolving tax disputes especially on discrimination, double taxation or double exemption.

Implementation control of new international standard rules allows perception of common understanding of rights and duties belonging to any Country interested in being an active part of the Business Community.

Undoubtedly a part of integration and globalization market process, is the effort of each State to check its tax law for compatibility with EU (for European countries) and OECD treaties and revise them accordingly through a bottom-up review as well as to proceed

with the implementation of the Global Level Playing Field finding fiscal integration to avoid any distortions.

In a cooperative manner all Member Countries and Participating Partners should converge the existing tax practices to the same and acceptable standards and common understanding on the following areas:

- Design of the tax system: as regards limitation to foreign tax credits, anti-avoidance rules, controlled foreign companies, exit taxes;
- definition of taxable person: tax consolidation group regimes, partnership;
- definition of the tax base: constructive dividends, deductions available;
- tax rates: incentive rates, withholding rates applicable;
- special procedures: withholding taxes on transfers, collection techniques, tax representation, additional accounting or documentation requirements for economic activities performed without a permanent establishment by a non resident.

This would be the way to gradually approach definition or mutual concept of recognition on major outbound investment/international flows: dividend, interest, royalties, permanent establishment, revenues/losses and foreign tax credit[71].

After deep discussion of the matters in agenda, on May 2006, the OECD published: Tax Cooperation towards a level playing field, 2006 assessment by the Global Forum on Taxation.

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[71] Please see IRS comments to new DTT USA- Italy (not yet ratified) with regards the possibility to recognize tax credit on taxes levied in the other contracting States (i.e.USA) in case of income reclassification for US tax purpose, particularly as deemed dividend.

The report substantially highlights that the keys to success of transparency and information exchange for tax purposes are the mainly the following:

- Existence of mechanism for exchanging information upon request;
- Exchange information for the purpose of domestic tax law in both criminal an civil matters;
- No restriction of information exchange by application of different criminality principles on domestic tax interest requirements;
- Respect for safeguards and limitations;
- Strict confidentiality rules for information exchanged;
- Availability of reliable information (bank ownership, identity and accounting information, bearer securities disclosures) and power to obtain and provide such information upon request.

The result of this outstanding work was to restrict the list of Countries (non-OECD) that have no Tax Information Exchange Agreement (TIEA) and Double Tax Convention (DTC) only to five.[72].

The 2004 Berlin report on the same cooperation matters outlined that even though by way of exchange of information most of the goals in preventing tax avoidance can be achieved, due to the fact that the exchange should be bilaterally agreed, this process will take time but in any case fairness and equity implementation processes would be ensured within a reasonable time frame.

[72] Andorra, Liberia, Liechtenstein, Monaco, the Marshall Islands

This progressive evolution of cooperation between the OECD and OECD Countries will ensure mutual benefits to further reach the goal of helping financial centres to meet high standards of transparency in order to be fully integrated into the financial system and global community avoiding being on the so-called "Black list Countries of Tax havens".
One of the most interesting success stories of this negotiation approach is the outcome of the agreement between the EU Countries and Switzerland on the EU Saving Directive.
Under the above-mentioned Directive, Switzerland accepted to withhold tax on interest payments made by the paying agent established in Switzerland to beneficial owners who are individuals resident within the EU. The revenue received from the withholding tax will be shared between the withholding tax agent Country (i.e. Switzerland) and the Country of residence of the beneficial owner of the interest; withholding can be avoided only if the beneficial owner allows the revenues disclosure from the paying agent to the competent Tax Authorities in his residence Country.
Switzerland signed this Directive with the EU since it agreed that based on a specific clause (Art 15) it would have been entitled to the same tax benefits represented by the application of zero withholding tax on dividend distributed between Swiss and EU companies under the same terms and conditions of the EU Parent and Subsidiary Directive, as well as the zero withholding tax on interest and royalty flows between Swiss and EU companies as per the Interest and Royalties EU Directive.

2.2.3 OECD review of countries' profile on Mutual agreement procedure: MEMAP (Manual of Effective Mutual Agreement Procedure) Version 2007

The integration process should be completed by an effective mechanism which should be focused on solving all kinds of cross-border tax treaty disputes in case they fail in enhancing the above-mentioned Common base of understandings. The mechanism should be properly empowered and entitled to reach, on a *bilateral or broader* basis, the suitable tax position on cross-border transactions.

According to the paper entitled [73] "Cross border Tax Treaty Dispute Resolution: County profile" OECD has recently launched a major project, to improve the effectiveness of the MAP, named "Questionnaire for business on procedure for resolving international tax disputes provided by Art. 25 of OECD Model and in Transfer Pricing Guidelines for Multinational Enterprises and Tax administration" (so called MAP and Advanced Pricing Agreements) for a frank disclosure of business community experience and comments.

A Special Working Group formed by the OECD Committee on Fiscal affairs (CFA) would be charged with examining ways of improving the MAP, including the consideration of other dispute resolution techniques which might be used to supplement the operation of the MAP

A report issued on February 2007 to improve the effectiveness of MAP, according to the suggestions gathered along the consultation process started in 2004, proposed the introduction of an Arbitration procedure anytime the parties cannot settle the dispute through the MAP within two years and this arbitration decision will be binding; in the

[73] Published on web site 23 July 2004.

meantime the access to this new settlement procedure does not oblige the domestic remedies related to the disputes to be waived, by introducing additional opportunities either for taxpayers and for Countries to solve disputes. This new proposal will primarily solve three of the main limitations of the practical efficacy of MAP:1) the timing is not predictable (at least 5 years), 2) there is no binding result in terms of reaching an agreement and once the settlement is agreed this is not mandatorily applicable by both States, 3) waiver of any domestic remedies in case of MAP involvement.

For the purpose of this doctoral thesis it is interesting to note that within the procedure it has be provided that access to MAP or any other alternative solutions is denied in the case of tax fraud and tax abuse, to be defined in advance by the Country before implementing the new revised rules.

In other words each Treaty Country has to list cases of tax abuse and fraud that do not allow MAP as way of dispute settlement even though a treaty interpretation might be involved.

The circumstances proposed in which a taxpayer should be denied access to the MAP would be analysed together with a discussion of possible appropriate practices in this regard, taking into account the differing domestic law circumstances in different countries. This analysis would be reflected in the MEMAP, and, if it were thought necessary, in the Commentary to Article 25.

In some cases, notwithstanding paragraph 1 of Article 25, countries refuse to enter into the mutual agreement procedure, where they consider that the relevant taxpayer has engaged in fraud or certain kinds of tax avoidance in relation to the case for which MAP

is sought. A complication is that different States take different views of when the test is met.

In the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure, however. The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement. However, where serious violations of domestic laws resulting in significant penalties are involved, some States may wish to deny access to MAP. The circumstances in which a State would deny access to MAP should be made clear in the Convention.

In the proposed new version, Country issues concerning the relationship between domestic law and the MAP process would be analysed and addressed with a view to allowing the MAP to operate to the fullest extent possible, taking into account the possible constitutional and other legal limitations in the domestic legal systems. The outcomes of this work could be reflected in the MEMAP and/or in changes to the Articles of the Model Tax Convention or to the Commentary.

The Treaty Country should take view of and note in a good faith obligation any possible domestic law limitations on taxpayers initiating the mutual agreement procedure as well as any limitation which prevents an agreement being reached by the competent authorities.

Effective Mutual Agreement Procedure (MEMAP) represents the revised version of MAP according to the final review of the 2004 report.

A Manual on Effective Mutual Agreement Procedure practices ("MEMAP") would be developed for both tax administrations and taxpayers. The positions taken in the Manual

would not be binding on Member countries but would reflect the analysis made in connection to the particular issue. The MEMAP would discuss appropriate practices and possible alternative approaches to issues considered by the Committee.

The reports on MAP work in progress, as well as on procedures finalized, will be made periodically available through the OECD website and will be updated annually, along with periodic updates to the Country; with this MAP reporting structure, taxpayers will have a better understanding of a Country's MAP program and may be in a better position to make a decision on their course of action. Tax administrations should also find this information useful in evaluating the performance of their MAP program.

The Committee will develop a proposal examining the feasibility of implementing the mandatory submission (not mandatory resolution) of unresolved MAP cases to a form of supplementary dispute resolution mechanism in the light of the general international law obligation to apply and interpret the treaty in good faith. This could possibly involve amending paragraphs 26 and 46-48 of the Commentary to Article 25 to make explicit that the international law obligation of endeavouring in good faith to come to an agreement when applying the MAP process requires that, where agreement has not been possible under the normal MAP discussions, the unresolved issue(s) will be submitted to the appropriate form of supplementary dispute resolution procedure. Other implementation techniques might also be feasible, including changes or additions to the articles of the Model Tax Convention, according to the Countries' best practices and suggestions from reputable tax experts.

2.3 Potential Solutions to tax arbitrage at an international level

2.3.1. The promising role of OECD Commentary in preventing abusive tax schemes: one single taxation, subject to tax clause and avoidance of non-double taxation

Any potential solution to tax arbitrage would involve international agreement and in this respect it has to be noted that "the only way States can consciously create international law"[74] is by means of bilateral or multilateral treaty.

Without entering into details regarding international law ranking and the relationship with the Vienna Convention, from a tax standpoint special regard has been granted to the Double Tax Treaty Model and its Commentary defined as soft law with reference to the fact that as outlined by remarkable scholar [75] "at least some form of a soft obligation must, therefore, be derived from recommendations of the Council: the OECD MC must be applied unless the Member State has entered original reservation or unless material reasons, such as peculiarities of the domestic law of the contracting State weigh against the adoption of the model, with regard to an individual treaty provision.

In other words, unless otherwise required, the implementation of a common understanding and a shared tax position to avoid conflicts within tax category classification and definition is usually placed within bilateral tax treaties (e.g. tax residence, dividend, interest, capital gain, source-state concepts etc.) which have definable principles modeled in a similar manner within all countries adherent to the Organization for Economic Cooperation and Development (OECD) or refer to the

[74] Dixon M. Textbook on International law, London 1993.
[75] K. Vogel on Klaus Vogel on double taxation convention, London 1997.

OECD model treaty. Nevertheless, the following limitations in dealing with the Treaty model for reaching an international tax regime have to be taken into account: firstly, the International tax arbitrage scheme can comply with different local tax jurisdictions in the meantime, therefore double taxation should not exist and consequently no treaty can be claimed; secondly because the tax treaty is traditionally meant to remove the double taxation phenomenon, convergence of different tax systems by adopting the OECD model treaty as a potential international tax law solution according to reputable scholars' [76] opinions, requires that every item of income from cross-border transactions be subject to tax once and only once[77].

Treaty concessions cannot move from double taxation to no taxation otherwise the State which waives to its right to tax will loose its rationale if the treaty partner does not tax the income.

Ultimately, international tax arbitrage can be limited by way of a tax treaty only if and when the solution of double exemption is conventionally solved and commitment to the so-called " single tax principle" [78] to ensure that one single level of taxation is collected, exists.

Double non-taxation might derive from an improper use of the tax treaty [79] or in a worse case, by an abuse of it. *The terms of "abuse of tax treaty" may be defined loosely as the use of tax treaties by persons the treaties were not designated to benefit in order to derive benefits the treaties were not designated to give them.* Therefore it might be argued that the purpose of double non-taxation is indirectly pursued by DTC and is to

[76] Avi-Yonah and Kane in their articles see note above.
[77] Avi Yonah, Reuven, Tax Competition, Tax Arbitrage and the International tax regime.
[78] See note n. 16.
[79] the United Nations *ad hoc* Group of experts on International Cooperation in Tax matters. Prevention of tax abuse, Geneve 1987

be considered as a regrettable end, only to the extent that DTC provisions have been intentionally used with the sole aim of benefiting from a substantial tax exemption available under the Treaty protection.

Double non-taxation is a potential means of discrimination or distortion in the light of its potential exploitation within a treaty shopping context.

This is also the reason why several Countries prefer to negotiate with other Countries within the Treaty provision's specific rule to prevent such a double non-taxation effect by way of a clause, widely named according to the different Countries' wording, to make reference to taxation at least in one State[80] The need of such a written clause stems from the increasing awareness that non-taxation is undoubtedly a "side" effect of tax arbitrage strategies.

To this extent, the Commentary of the OECD DTC Model and its recent releases, renewed interpretation positions taken on several cross-border taxation issues that seriously impact multinational companies, as well as the Reports periodically issued by the Committee for Fiscal affairs, might be considered as fruitful reference for a developing tax environment and looking at the best common practices by creating a "de facto" tax coordination; nevertheless as any soft law Commentary is not a binding interpretation but might enhance commitment of Treaty Countries to an interpretation that is consistent and made in good faith of the obligations deriving from it. In other words, among several and wide possibilities, the Commentary should rely upon the more purpose-based interpretation.

2.3.2 Structural options for tax harmonization at International level

2.3.2.1. International Accounting Standards IAS/IFRS and a Common tax basis

The objective of the International Accounting Standards is to prescribe the basis for presentation of general purpose financial statements, in order to ensure comparability both with the enterprise's own financial statements of previous periods and with the financial statements of other enterprises. To achieve this objective, these standards set out considerations for the presentation of financial statements, guidelines for their structure and minimum requirements for the content of financial statements. Specific standards deal with the recognition, measurement and disclosure of specific transactions and events.

The objective of general purpose financial statements is to provide fairly structured financial representation of the enterprise's financial position and the transactions it undertakes, and the performance and cash flows of an enterprise that are useful for a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it.

Management should select and apply an enterprise's accounting policies so that the financial statements comply with all the requirements of each applicable International Accounting Standard and Interpretation of the Standing Interpretations Committee. Where there is no specific requirement, management should develop policies to ensure that the financial statements provide information that is:

(a) relevant to the decision-making needs of users; and

[80] Clause "Liable to tax", "Subject to tax", "Taxed" etc.

(b) reliable;

(c) representing faithfully the results and financial position of the enterprise;

(d) reflecting the economic substance of events and transactions and not merely the legal form[81];

(e) neutral, that is free from bias;

(f) prudent; and

(g) complete in all material respects.

In making the fairness judgement, the concept of substance over form plays a dominant role. In other words, management considers whether the financial statements reflect the financial reality of the entity rather than the legal form of the transactions and events which underlie them and describe the entity's financial risk management objectives and policies, including hedging policies.

In particular, managers as well as auditors have to look for transactions where the substance of the transaction differs significantly from the form. The form is the description the auditee gives the transaction(s). For example, the auditee may describe the transaction(s) as a lease of equipment or a sale of inventory. There may be evidence that appears to support the form of the transaction, but auditors look beyond the evidence and the description given to the transaction(s), and instead focus on the substance of the transaction(s).

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[81] Particularly to Evaluate the Substance of Transactions Involving the Legal Form of a Lease

Auditors look for a transaction or groups of transactions that do not make economic sense or appear to have been made to change the way in which an account balance appears in the financial statements, rather than reflect the reality of an actual event that has taken place. These transactions are often recorded around balance date and often appear unduly complex.

Examples:

The management has recorded one transaction in a group of transactions as a sale to a customer. Another transaction records a loan to the same customer for a similar amount. In this case, when the transactions are considered together, the sale may be without substance as it has been funded by the company.

The seller has therefore sold goods or services to a particular customer on the undisclosed understanding that the company itself will purchase a similar value of goods or services from the customer.

The group of transactions have the form of an outright purchase of capital equipment, whereas in fact the substance of the transactions is a lease of (or perhaps an option to purchase) the equipment. As mentioned among the slightly diffused tax arbitrage transactions, this is the "traditional" cross-border financial leasing that gives the benefit of double dip since it is based on different assets and income classification. By way of the substantial view and representation applicable with IAS accounting principles, this beneficial inconsistency between the lessor and lessee, to the extent both are using IAS, will disappear.

A well-known example from the past was the Enron Group's use of over 3000 Special Purpose Entities (SPEs) structured in such a way as to enable the company to avoid

including extensive debt in the consolidated financial statements of the group. This has led to suggested/actual revisions of various accounting standards throughout the world. These revisions require SPE's (such as trusts, partnerships and non-incorporated entities) to be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity.

The concept of substance over form is relevant to the *management's assertions* that the financial statement items are complete, valid and accurate, and in particular that the financial statement items are accurate as to presentation and disclosure.

The primary aim of IAS implementation as mentioned above is to allow the comparability of financial statements and therefore the possibility of following a consistent and coherent interpretation of the same transaction along the different sides of the counterparties involved, based on the substantial effects related to the transactions that have occurred.

The implementation of IAS, especially with reference to cross-border and complex transactions, has enhanced the matching information that was once lacking due to potentially different representation based on accounting principles that was and still is the basis for benefiting from tax arbitrage.

The most evident change of the IAS viewpoint regards any accounting and valuation of financial instruments in accordance with a strict interpretation of the substance over the form principle.

The Standard is to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows.

This Standard contains requirements for the presentation of financial instruments and identifies the information that should be disclosed about them. The presentation requirements apply to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset. The Standard requires disclosure of information about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to those instruments. This Standard also requires disclosure of information about the nature and extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them, and management's policies for controlling those risks.

The principles in this Standard complement the principles for recognizing and measuring financial assets and financial liabilities in IAS 32 and 39, Financial Instruments: Recognition and Measurement.

The aforesaid Principles are particularly relevant in disclosing cross-border transactions based on hybrid structure which brings significant tax benefits by relying upon the different classification of the same financial instrument as equity versus liability between the parties involved; therefore as in the case of financial leasing, based on the substantial terms and conditions of the financial contracts, IAS application from both sides of the transaction will imply a consistent interpretation.

The fundamental principle of IAS 32[82] is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form.

A financial instrument is an equity instrument only if (a) the instrument includes no contractual obligation to deliver cash or another financial asset to another entity and (b) if the instrument will or may be settled in the issuer's own equity instruments, it is either: a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Examples:

a) Preference shares

   If an enterprise issues preference (preferred) shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and, therefore, should be recognized as a liability. In contrast, normal preference shares do not have a fixed maturity, and the issuer does not have a contractual obligation to make any payment. Therefore, they are equity.

b) Financial instrument where one party has a choice over how an instrument is settled

   When a derivative financial instrument gives one party a choice over how it is settled (for instance, the issuer or the holder can choose settlement net in cash or by

[82] IAS PLUS on Deloitte website

exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

c) Compound Financial Instruments

Some financial instruments - sometimes called compound instruments - have both a liability and an equity component from the issuer's perspective. In that case, IAS 32 requires that the component parts be accounted for and presented separately according to their substance based on the definitions of liability and equity. The split is made at issuance and is not revised for subsequent changes in market interest rates, share prices, or other events that change the likelihood that the conversion option will be exercised.

To illustrate, a convertible bond contains two components. One is a financial liability, namely the issuer's contractual obligation to pay cash, and the other is an equity instrument, namely the holder's option to convert into common shares. Another example is debt issued with detachable share purchase warrants.

Interest, dividends, gains, and losses relating to an instrument classified as a liability should be reported in the income statement. This means that dividend payments on preferred shares classified as liabilities are treated as expenses. On the other hand, distributions (such as dividends) to holders of a financial instrument classified as equity should be charged directly against equity, not against earnings.

IAS 32 also prescribes rules for the offsetting of financial assets and financial liabilities. It specifies that a financial asset and a financial liability should be offset and the net amount reported when, and only when, an enterprise: has a legally enforceable right to

set off the amounts; and intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

For each class of financial asset, financial liability, and equity instrument, IAS 32 discloses the following information about the extent and nature of the financial instruments, the interest or credit risks, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and the accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied.

"Terms and conditions" include:

- the principal, stated, face or other similar amount on which future payments are based;
- the date of maturity, expiry or execution;
- early settlement options;
- conversion options;
- the amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including installment repayments and any sinking fund or similar requirements;
- rate or amount of interest, dividend, or other periodic return on principal and the timing of payments;
- collateral held, in the case of a financial asset, or pledged, in the case of a financial liability;
- for an instrument whose cash flows are denominated in a foreign currency, the currency in which receipts or payments are required.

According to IAS 39[83] also when an asset other than a financial one contains or has as collateral what can be substantially defined as derivative, the latter should be evaluated and accounted accordingly in respect of the hosting contract.

For example, a contract to purchase a commodity at a fixed price for delivery at a future date has embedded in it a derivative that is indexed to the price of the commodity.

An embedded derivative is a feature within a contract, such that the cash flows associated with that feature behave in a similar fashion to a stand-alone derivative.

If an embedded derivative is separated, the host contract is accounted for under the appropriate standard.

Examples of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- the equity conversion option in debt convertible to ordinary shares (from the perspective of the holder only);
- commodity indexed interest or principal payments in host debt contracts;
- cap and floor options in host debt contracts that are in-the-money when the instrument was issued;
- leveraged inflation adjustments to lease payments;
- currency derivatives in purchase or sale contracts for non-financial items where the foreign currency is not that of either counterpart to the contract, is not the currency in which the related good or service is routinely denominated in commercial transactions around the world, and is not the currency that is commonly used in such contracts in the economic environment in which the transaction takes place.

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[83] IAS PLUS on Deloitte website

Based on the explained advantages of sharing a common accounting principles basis, IAS might lead easily to comparability of companies' financial statements as well to the elimination of inconsistencies in qualification and recognition of assets, liabilities, revenues and losses; therefore a major part of the items that are playing the most significant role in tax opportunities which are still looking for legal and accounting differentials among jurisdictions.

Any accounting system based on the "substance over the form principle" that would be widely adopted will progressively achieve the effect of publicly disclosing inconsistencies and timing differences will therefore reduce the tax arbitrage without real business reasons and purposive activity behind it. The progress made in widening the IAS application[84] will, in my opinion, dramatically improve the process of accounting harmonization and consequently the representation of companies' facts, regardless of the form, on which tax computation is based without requiring tax harmonization in the sense of uniformity regime, rates and policy.

Lack of tax harmonization is often due to national policy underlying the tax rules, to different legal frameworks, and to different perceptions of how urgent and dangerous the tax arbitrage problem might be, which obviously impacts the individual national commitment to solving the problem; therefore in a relatively short period of time potential convergency on the main and general principles in building global governance around international taxation rules could be sustainable in the light of cooperation rather than the achievement of real tax harmonization or common tax basis goals.

[84] In USA, SEC has been recently announced on 15 November 2007 that for small listed companies and private foreign issuers, IAS compliance, the reconciliation form into US GAAP is no longer necessary . In the meantime by the end of 2007, SEC would hold two roundtables on whether US companies should be allowed to use IAS/IFRS as published by IASB.

In this respect mention should be made of the European efforts made particularly by the Directorate-General, Taxation and Customs Union Tax Policy, toward reducing costs and providing greater certainty for taxpayers, as well as enhancing coordination among Member States, by way of the Consultation Document, to have written comments from the Business Community[85], to propose IAS also for company tax purposes and the implications for the introduction of a consolidated tax base for companies' EU-wide activities issued in February 2003. The Consultation Document explores the possibilities that the introduction of IAS as a common set of accounting standards in the EU might afford for the establishment of a common consolidated tax base.

The Consultation Document acknowledges that IAS accounts would serve, at most, as a starting point for arriving at a tax base and not the tax base itself.

One example highlighting the importance of such an approach would be using consolidated accounts after the elimination of inter-company transactions as a common tax base. This would radically depart from the arm's-length principle, which is the basis of the tax conventions drawn up in accordance with the OECD model tax treaty, and from the agreement upon basic tax principles.

Nevertheless, the use of IAS at the subsidiary level will probably be widespread for statutory purposes, which has great merit of its own since the statutory accounts generally form the basis for the tax accounts, with dependency varying among Member States; the adoption of a common tax base utilizing IAS to any degree will be greatly simplified if the Member States allow the use of IAS for statutory accounts to be

[85] Based also on TEI's International Tax Committee letter dated February 2003

adjusted to determine the tax accounts. If there were a common set of tax accounts, the mapping of the IAS accounts to the tax accounts would only be necessary once. Assuming a common tax base is established for subsidiary accounts, the common tax accounts of individual EU subsidiaries could be more readily applied. For example, this could be the aggregation of the net taxable income of the individual companies, the consolidation method used in most Member States offering a form of tax consolidation or transfers of losses/group contributions.

Nevertheless, stated simply, dependency on an accounting standard is not desirable and cannot be achieved with regard to all accounting issues. Indeed, accounting issues encompass a broad range of subjects; for example, revenue recognition, asset capitalization, appropriate use of provisions, and the deductibility of specific expenses.

It is necessary to achieve a complete set of standard tax accounting rules formulated and proposed starting from the adjustments to the statutory accounts once the accounting principles are a shared concrete reality.

The current implementation procedure of IAS provides States with the necessary level of "control" over accounting standards within the EU, but frequently there are sound policy reasons for divergence between tax and accounting principles and a separate deliberative process for assessing tax changes to prevent unintended and undesirable side effects.

The process for reaching the common tax basis should be the one that has the greatest likelihood of creating a set of rules that will be consistently applied regardless of different States policies.

To achieve the goal of significantly reducing the compliance costs for the multinational companies as well as the costs for tax administration checks on tax compliance, and also to refrain the tax arbitrage phenomenon associated with dealing with different tax systems within the International Market, it is important that the rules both begin and remain truly consistent. To maintain this tax-rule consistency over a long period of time, Supranational Legislation such as EU Directives, though time-consuming might be the only feature, if possible without conflicting with the sovereignty of each single State in the taxation field.

3. International tax adjudication on tax arbitrage

3.1 Needs of international tax courts

The cost of internationalization is essential to the efficiency of the free market and this is the pillar for arguing that there is no possibility of passing from a domestic prospective to a global one by merely applying a Country's own local business or legal model, even if outstanding, to other partners. To abolish those elements which are considered as "de facto" barriers is a long run and is significantly costly in terms of resources to be invested not only for dealing with the process but primarily to bring and share a common culture, Country by Country, towards International obligations and rights.

The consistency of international rules and the interpretation of those rules also in the case of conflicting situations will represent the crucial point to be solved in the near future in order to build the Global Playing Field of the Business Community.

The analysis of specific anti-abuse law provision as well as the existence of anti-abuse rights principles within certain Countries leads to the conclusion that those Countries are progressively reacting in a very restrictive way, working on a stand alone basis or at least on a Regional one, without any convergence or coordination.

The powers of domestic legislators and Courts are countless in creating a ring fencing situation to give subsidies and to enhance cross-border activities to reinforce the national economic policy. In the meantime it is clear that those actors might play a different and significant role in implementing a fair view of cooperation, transparency, reciprocity and good faith application of International principles. This dream will

become reality only when there is global governance passing through the enactment of stabilized and consistent juridical framework based on the definition of general rules and commonly recognized principles, applied and sanctioned in the case of non compliance.

Efficacy of the principles and their coordination depends on the force in discouraging the avoidance of those principles. This goal can not be reached by way of issuing additional set of rules which implies further controls but, particularly when conflicts arise, by way of enhancing at international level a common and consistent global principle statement, which would be subsequently "translated" into the different domestic contexts, in order to progressively reach a coordination both at local and international levels.

Starting from this undoubted concept, within the international context the lack of congruity between decision makers and the claims of the Tax payer is particularly problematic in finding an effective body entitled to settle disputes that might arise at international level on taxation matters, the timing involved in reaching the final outcome, if any, and the legal nature of that settlement (binding or not).

Particularly, any arbitrage or abusive transaction realized by a Country outside the treaties network becomes practically unobjectionable by any other Country and this evident impossibility to establish a relationship on a legal basis becomes quite frustrating to build a cooperation field.

The real question to answer is if it is acceptable that the use of judicial interpretation should go beyond statutory interpretation to reach ultimate principles of rights and

rationale, to be subsequently codified into a “code of conduct” within the Countries by way of bilateral or multilateral agreements.

Both governments and taxpayers would agree that judicial anti-avoidance mechanisms should exist to prevent economic distortions in the market and to establish equal and fair rules for all players.

Judicial doctrines such as economic substance might be used to interpret the statutes where enacted, or at least when the statute does not indicate otherwise.

An abusive transaction attacked through the economic substance doctrine will be defended on the grounds that the transaction is supported by the statute's text, and generally also by some combination of intent and purpose.

Another goal of rights certainty by way of judicial doctrine is to make sure that interferences from environment changes do not cause economic distortion.

Traditionally, this has led to concerns about how to make the principles underlying the judicial doctrines clear and their application consistent. Possible ways[86] to mitigate such an adverse effect and avoid inconsistent application of the doctrines by tax administrations and courts would be either to codify them and rely on their mechanical application or allow the courts to interpret and apply the code and interpret the intentions of the legislature at their discretion.

The court is the last resort where taxpayers may seek protection against tax authorities based on the form of a transaction and literal interpretation of the statute. In this context,

86 Nadia Havard, THE COMPARATIVE ANALYSIS OF TAX INCENTIVES PROVIDED BY THE UNITED STATES, THE UNITED KINGDOM, AND RUSSIA TO DOMESTIC AND FOREIGN BUSINESSES, 67 Alb. L. Rev. 1159, 2004

when it comes to tax avoidance and application of court-made doctrines, the line between civil and case-law countries becomes irrelevant.

Codification could empower the government to issue comprehensive and detailed regulations to provide the certainty that is widely desired. Empirically, however, as practice has shown, detailed regulations implementing a codification of the business purpose and economic substance doctrines would create their own ambiguities, uncertainties, and loopholes. Thus, simplification is the rule and principles are the only contents.

Codification would make sense only if basic anti-avoidance principles are established regarding tax avoidance.

Obviously it would be extremely sensitive for any Country to allow only the courts to interpret the intent of the legislature with the aid of judicial doctrines, due to their powerful role.

In the absence of codification, it is up to the courts and the tax administration to search for uniformity and standards and those can only be achieved by converging at supranational level towards basic principles, such as if a transaction had any objective economic effect on the taxpayer, apart from tax and then to perform a subjective analysis of the taxpayer's intent.

The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code[87]. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by

[87] COLTEC INDUSTRIES, INC., Plaintiff-Appellee, v. UNITED STATES, COURT OF APPEALS FOR THE FEDERAL CIRCUIT, July 12, 2006,

engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.

Courts are organs with historic antecedents which bring with them well-defined powers to enforce statutory obligations, to decide what remedies are appropriate in the light of the statutory language and purpose and of the traditional modes by which courts compel performance of legal obligations relying on the findings that it made in connection with the statutory tax avoidance test.

A review of that determination requires us to consider the basic principles such as abuse of rights and the economic substance doctrine, to empower the judicial approach to international discrepancies.

The need for an International Court is a real exigency looking at the increasing disputes[88] at the WTO which involve the Dispute Settlement Body (DSB) on direct and indirect taxes as prime source of interpretation.

As outlined by a prominent Scholar,[89] the WTO is one of the most attractive world tax organization candidates, it has a much broader membership than the OECD and developing countries are well represented. Moreover under WTO rules all dispute settlement rulings are binding unless there is a consensus not to implement them. Nevertheless the problems connected with the lack of direct tax expertise within the organization and the typical difficulties connected to tax- context interpretation,

[88]United States – Tax treatment for Foreign Sales Corporation" report of the panel WT/DS108/RW2 adopted on 30 September 2005.

[89]Avi-Yonah, the WTO, Export subsidies and tax competition, paper presented at Bocconi University November 2004

including how to deal with Countries' sovereignty over the tax matters, necessarily imply the analysis of the proper and main characteristics of an international organization and dispute settlement body deputed to create the international best practices, also by linking with the domestic judicial network, even though it is already well-known that any attempt to establish a "world wide court" has failed[90] since States are extremely reluctant to give up any part of their sovereignty[91].

3.2 International arbitration on tax arbitrage

The wider set of dispute settlement provisions to deal with tax competition among Countries is provided by the OECD and this is the most reputable organization which extensively works, and is still working, on finding appropriate solutions to the growing evolution of economic and taxation systems, where tax arbitrage, tax treaty interpretation, transfer pricing rules and double taxation are a few of the matters on the table of OECD Working parties and *ad hoc* Committees; most of them in fact are able to create conflicting issues in a cross-border context.

Treaty States have entered into mutual agreement procedures (MAP) for sorting out their differences in interpreting[92] and applying the tax treaties in individual instances in which double taxation was not effectively relieved. The aim of these procedures is to solve issues and to agree on the best interpretation of a treaty rule, and the main MAP limitation is the non-binding nature of the outcomes.

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[90]Since 1920s.,

[91] Raad van Kees, Tax treaty interpretation and application,

[92] Raad van Kees, Tax treaty interpretation and application within International and Comparative Taxation, essays In honour of Klaus Vogel, 2000

Therefore, the successful experiences gained on the best practice within supranational organizations such as the OECD, the European Union etc. on International tax matters disputes should be looked at in order to build, if necessary, a new interpreting panel.

According to the OECD Transfer Pricing guidelines, International arbitration on tax matters has been introduced for resolving conflicting governmental views. *In the context of international[93] trade and investment, the General Agreement on Tariffs and Trade and its successor, the World Trade Organization, have developed increasingly sophisticated procedures and institutions to resolve international trade disputes. The basic mechanism has been the use of what is essentially an arbitral panel composed of independent persons who produced a reasoned ruling as to the issue in question…In the tax area as well, there has been some interest in the use of arbitration to resolve tax disputes. Not publicized is the " Convention dealing with Transfer Pricing agreed by member States of the European Community ("the arbitration Convention"), which came into force on January 1, 1995, but in addition, some bilateral tax conventions have provisions for arbitration.*

The main and essential limitation to such a procedure is the fact that Arbitration Conventions of these bilateral treaty provisions have not yet been applied. In this respect, the Committee on Fiscal Affairs, conscious of the emerging issue, has agreed to undertake a study of this topic and consequently to supplement the treaty guidelines.

[93] OECD Transfer pricing guidelines Charter IV

One of the main limitations to the implementation of the above mentioned Arbitration Clause, as well as Convention, is the applicable law in the arbitration provision in the event of doubtful situations. Since the treaty has to be interpreted in line with general interpretation rules for international law as they are codified in the Vienna Convention on the Law of Treaties, the arbitrators must apply international law and rely exclusively upon treaty content and interpretation. Reference to domestic law is allowed only when the recourse is made by the treaty94.

Vienna Convention principles have the merit of introducing legal principles in interpreting International treaties and, in a broader sense, in establishing points of reference within an International context where local rules and judicial doctrines might be significantly different.

Art 26, Pacta sunt servanda means that every treaty in force is binding upon the parties to it and must be performed by them in good faith.

Art 31, The general rule of interpretation implies that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of their context and in the light of its object and purpose using: … letter c) any relevant rules of international law applicable in the relations between the parties.

Considering that since the 2004 IFA congress seminar entitled “How Judges judge on International cases” it has been a common experience that national judges, also from so-called advanced countries, only in a very few case have been involved in International tax matters, it is easy to argue that until International tax law competence does not support the judgement, Arbitration is still a suitable but useless means.

[94] “Resolution of Tax Treaty Conflicts by Arbitration”, 1993 IFA Congress.

It is interesting to note that in the event of failure of the Arbitration Clause, States can use also International Courts instead of Arbitration boards to settle tax treaty disputes. The International Court is regarded as a sort of special arbitration procedure. Also in this case, lacking a concrete intention of contracting States to grant authority to special courts for tax issues, no further progress has been made on this matter.

The success of tax treaty arbitration will depend upon the control mechanism adopted to guide arbitrators and to enhance uniformity in treaty interpretation.

Therefore, to improve the resolution of tax treaty disputes on 27 July 2004 the OECD Committee on Fiscal Affairs released a progress report on its work on improving the resolution of cross-border tax disputes. The report, entitled "Improving the Process for Resolving International Tax Disputes", included 31 proposals aimed at improving the way in which tax treaty disputes are resolved through the mutual agreement procedure.

One of the proposals included various draft changes to the OECD Model Tax Convention, dealing primarily with the addition of an arbitration process to solve disagreements arising in the course of a mutual agreement procedure, as well as a proposal for developing a Manual on the Effective Mutual Agreement Procedure. (MEMAP)

The aim of the proposal mainly regards dealing with unresolved issues that prevent competent authorities from reaching a mutual agreement, particularly based on interaction between the proposed arbitration process and domestic legal remedies.

Within the Arbitration proposal, the Committee has decided that the person who makes the arbitration request (or any person affected by the case) will not be required to waive

rights to domestic remedies as a condition for requesting arbitration, as per MAP requirements

The proposal for an Arbitration of unresolved issues in an MAP case has been suggested by a number of unsatisfactory results from the existing MAP to solve international tax disputes. Due to the fact that MAP, as currently structured, does not require the countries to come to a common understanding of the treaty, but only that they endeavour to agree, the result can be unrelieved double taxation or “taxation not in accordance with the Convention” where the countries cannot agree.

The inability of the current MAP to provide for all steps possible to facilitate a final resolution of issues arising under treaties is due to the lack of any incentive for competent authorities to take all steps necessary to ensure a speedy resolution of the issues involved.

In addition, the introduction of supplementary dispute resolution techniques to MAP will reduce the likelihood of costly, time-consuming and possibly conflicting domestic judicial proceedings.

Following the suggestions summarized within, the 2004 Progress Report indicated that a proposal related to the mandatory resolution of unresolved MAP issues should be developed. As a result of that work proposal, the Committee has concluded that the arbitration of unresolved issues that prevent competent authorities from reaching an agreement on a MAP case within 2 years should be added to Article 25 of the OECD Model Tax Convention.

ANNEX 1

Proposed new paragraph

The following is a revised version95 of the proposed new paragraph that was included in the Public Discussion Draft of 1 February 2006. The changes to the paragraph mainly reflect the decision not to require a waiver of domestic remedies as a condition for initiating the arbitration process.

Add the following new paragraph 5 to Article 25:

"5. Where,

a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State, any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding

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on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.1.

In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the paragraph should only be included in the Convention where each State concludes that it would be appropriate to do so based on the factors described in paragraph 47 of the Commentary on the paragraph. As mentioned in paragraph 54 of that Commentary, however, other States may be able to agree to remove from the paragraph the condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals."

ANNEX 2

Proposed Commentary on the new paragraph

The following is a revised version of the Commentary on the new paragraph (other consequential changes to the Commentary will be made when the following paragraphs are included in the Model Tax Convention).

Replace paragraphs 45 to 48 of the Commentary on Article 25 and the heading preceding them by the following new heading and paragraphs 45 to 69 (and renumber existing paragraphs 49 to 54 as paragraphs 70 to75).

"IV Final observations

On the whole, the mutual agreement procedure has proved satisfactory. Treaty practice shows that Article 25 has generally represented the maximum that Contracting States were prepared to accept. It must, however, be admitted that this provision is not yet entirely satisfactory from the taxpayer's viewpoint. This is because the competent authorities are required only to seek a solution and are not obliged to find one (cf. paragraph 26 above). The conclusion of a mutual agreement depends to a large extent on the powers of compromise which the domestic law allows the competent authorities. Thus, if a convention is interpreted or applied differently in two Contracting States, and if the competent authorities are unable to agree on a joint solution within the framework of a mutual agreement procedure, double taxation is still possible although contrary to the sense and purpose of a convention aimed at avoiding double taxation.

It is difficult to avoid this situation without going outside the framework of the mutual agreement procedure. The first approach to a solution might consist of seeking an advisory opinion: the two Contracting States would agree to ask the opinion of an impartial third party, although the final decision would still rest with the States.

The provisions embodied in this Convention, as well as the Commentary related thereto, are the result of close international joint work within the Committee on Fiscal Affairs. A possibility near at hand would be to call upon the Committee on Fiscal Affairs to give an opinion on the correct understanding of the provisions where special difficulties of interpretation arise as to particular points. Such a practice, which would be in line with the mandate and aims of the Committee on Fiscal Affairs, might well make a valuable contribution to arriving at a desirable uniformity in the application of the provisions.

Another solution is that of arbitration. This is the solution adopted by the Member States of the European Communities through their multilateral Arbitration Convention, which was signed on 23 July 1990 and which provides that certain cases of double taxation that have not been solved through the mutual agreement procedure must be submitted to an arbitration procedure. Also, some recent bilateral conventions provide that the Contracting States may agree to submit unresolved disagreements to arbitration.

Paragraph 5

This paragraph provides that, in the cases where the competent authorities are unable to reach an agreement under paragraph 2 within two years, the unresolved issues will, at the request of the person who presented the case, be solved through an arbitration process. This process is not dependent on a prior authorization by the competent

authorities: once the requisite procedural requirements have been met, the unresolved issues that prevent the conclusion of a mutual agreement must be submitted to arbitration.

The arbitration process provided for by the paragraph is not an alternative or additional recourse: where the competent authorities have reached an agreement that does not leave any unresolved issues as regards the application of the Convention, there are no unresolved issues that can be brought to arbitration even if the person who made the mutual agreement request does not consider that the agreement reached by the competent authorities provides a correct solution to the case. The paragraph is, therefore, an extension of the mutual agreement procedure that serves to enhance the effectiveness of that procedure by ensuring that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration. Thus, under the paragraph, the resolution of the case continues to be reached through the mutual agreement procedure, whilst the resolution of a particular issue which is preventing agreement in the case is handled through an arbitration process. This distinguishes the process established in paragraph 5 from other forms of commercial or government-private party arbitration where the jurisdiction of the arbitral panel extends to resolving the whole case.

It is recognised, however, that in some States, national law, policy or administrative considerations may not allow or justify the type of arbitration process provided for in the paragraph. For example, there may be constitutional barriers preventing arbitrators from deciding tax issues. In addition, some countries may only be in a position to

include this paragraph in treaties with particular States. For these reasons, the paragraph should only be included in the Convention where each State concludes that the process is capable of effective implementation.

In addition, some States may wish to include paragraph 5 but limit its application to a more restricted range of cases. For example, access to arbitration could be restricted to cases involving issues which are primarily factual in nature. It could also be possible to provide that arbitration would always be available for issues arising in certain classes of cases, for example, highly factual cases such as those related to transfer pricing or the question of the existence of a permanent establishment, whilst extending arbitration to other issues on a case-by-case basis.

States which are members of the European Union must co-ordinate the scope of paragraph 5 with their obligations under the European Arbitration Convention.

The taxpayer should be able to request arbitration of unresolved issues in all cases dealt with under the mutual agreement procedure that have been presented under paragraph 1 on the basis that the actions of one or both of the Contracting States have resulted for a person in taxation not in accordance with the provisions of this Convention. Where the mutual agreement procedure is not available, for example because of the existence of serious violations involving significant penalties, it is clear that paragraph 5 is not applicable.

Where two Contracting States that have not included the paragraph in their Convention wish to implement an arbitration process for general application or to deal with a specific case, it is still possible for them to do so by mutual agreement. In that case, the

competent authorities can conclude a mutual agreement along the lines of the sample wording presented in the annex, to which they would add the following first paragraph:

"1. Where,

a) under paragraph 1 of Article 25 of the Convention, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 of the Article within two years from the presentation of the case to the competent authority of the other Contracting State, any unresolved issues arising from the case shall be submitted to arbitration in accordance with the following paragraphs if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, the competent authorities hereby agree to consider themselves bound by the arbitration decision and to resolve the case pursuant to paragraph 2 of Article 25 on the basis of that decision."

This agreement would go on to address the various structural and procedural issues discussed in the annex. Whilst the competent authorities would thus be bound by such process, such agreement would be given as part of the mutual agreement procedure and

would therefore only be effective as long as the competent authorities continue to agree to follow that process to solve cases that they have been unable to resolve through the traditional mutual agreement procedure.

Paragraph 5 provides that a person who has presented a case to the competent authority of a Contracting State pursuant to paragraph 1 on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention may request that any unresolved issues arising from the case be submitted to arbitration. This request may be made at any time after a period of two years that begins when the case is presented to the competent authority of the other Contracting State. Recourse to arbitration is therefore not automatic; the person who presented the case may prefer to wait beyond the end of the two-year period (for example, to allow the competent authorities more time to resolve the case under paragraph 2) or simply not to pursue the case. States are free to provide that, in certain circumstances, a longer period of time will be required before the request can be made.

Under paragraph 2 of Article 25, the competent authorities must endeavour to resolve a case presented under paragraph 1 with a view to the avoidance of taxation not in accordance with the Convention. For the purposes of paragraph 5, a case should therefore not be considered to have been resolved as long as there is at least one issue on which the competent authorities disagree and which, according to one of the competent authorities, indicates that there has been taxation not in accordance with the Convention. One of the competent authorities could not, therefore, unilaterally decide that such a case is closed and that the person involved cannot request the arbitration of unresolved issues; similarly, the two competent authorities could not consider that the

case has been resolved and deny the request for arbitration if there are still unresolved issues that prevent them from agreeing that there has not been taxation not in accordance with the Convention. Where, however, the two competent authorities agree that taxation by both States has been in accordance with the Convention, there are no unresolved issues and the case may be considered to have been resolved, even in the case where there might be double taxation that is not addressed by the provisions of the Convention.

The arbitration process is only available in cases where the person considers that taxation not in accordance with the provisions of the Convention has actually resulted from the actions of one or both of the Contracting States; it is not available, however, in cases where it is argued that such taxation will eventually result from such actions even if the latter cases may be presented to the competent authorities under paragraph 1 of the Article. For that purpose, taxation should be considered to have resulted from the actions of one or both of the Contracting States as soon as, for example, tax has been paid, assessed or otherwise determined or even in cases where the taxpayer is officially notified by the tax authorities that they intend to tax him on a certain element of income.

As drafted, paragraph 5 only provides for arbitration of unresolved issues arising from a request made under paragraph 1 of the Article. States wishing to extend the scope of the paragraph to also cover mutual agreement cases arising under paragraph 3 of the Article are free to do so. In some cases, a mutual agreement case may arise from other specific treaty provisions, such as subparagraph 2 b) of Article 4. Under that subparagraph, the competent authorities are, in certain cases, required to settle by mutual agreement the question of the status of an individual who is a resident of both Contracting States. As

indicated in paragraph 20 of the Commentary on Article 4, such cases must be resolved according to the procedure established in Article 25. If the competent authorities fail to reach an agreement on such a case and this results in taxation not in accordance with the Convention (according to which the individual should be a resident of only one State for purposes of the Convention), the taxpayer's case comes under paragraph 1 of Article 25 and, therefore, paragraph 5 is applicable.

In some States, it may be possible for the competent authorities to deviate from a court decision on a particular issue arising from the case presented to the competent authorities. Those States should therefore be able to omit the second sentence of the paragraph.

The presentation of the case to the competent authority of the other State, which is the beginning of the two-year period referred to in the paragraph, may be made by the person who presented the case to the competent authority of the first State under paragraph 1 of Article 25 (e.g. by presenting the case to the competent authority of the other State at the same time or at a later time) or by the competent authority of the first State, who would contact the competent authority of the other State pursuant to paragraph 2 if it is not itself able to arrive at a satisfactory solution of the case. For the purpose of determining the start of the two-year period, a case will only be considered to have been presented to the competent authority of the other State if sufficient information has been presented to that competent authority to allow it to decide whether the objection underlying the case appears to be justified. The mutual agreement providing for the mode of application of paragraph 5 should specify which type of information will normally be sufficient for that purpose.

The paragraph also deals with the relationship between the arbitration process and rights to domestic remedies. For the arbitration process to be effective and to avoid the risk of conflicting decisions, a person should not be allowed to pursue the arbitration process if the issues submitted to arbitration have already been resolved through the domestic litigation process of either State (which means that any court or administrative tribunal of one of the Contracting States has already rendered a decision that deals with these issues and that applies to that person). This is consistent with the approach adopted by most countries as regards the mutual agreement procedure and according to which:

a) A person cannot pursue simultaneously the mutual agreement procedure and domestic legal remedies. Where domestic legal remedies are still available, the competent authorities will generally either require that the taxpayer agree to the suspension of these remedies or, if the taxpayer does not agree, will delay the mutual agreement procedure until these remedies are exhausted.
b) Where the mutual agreement procedure is first pursued and a mutual agreement has been reached, the taxpayer and other persons directly affected by the case are offered the possibility to reject the agreement and pursue the domestic remedies that had been suspended; conversely, if these persons prefer to have the agreement apply, they will have to renounce the exercise of domestic legal remedies as regards the issues covered by the agreement.
c) Where the domestic legal remedies are first pursued and are exhausted in a State, a person may only pursue the mutual agreement procedure in order to obtain relief of double taxation in the other State. Indeed, once a legal decision has been rendered in a particular case, most countries consider that it is impossible to override that

decision through the mutual agreement procedure and would therefore restrict the subsequent application of the mutual agreement procedure to trying to obtain relief in the other State.

The same general principles should be applicable in the case of a mutual agreement procedure that would involve one or more issues submitted to arbitration. It would not be helpful to submit an issue to arbitration if it is known in advance that one of the countries is limited in the response that it could make to the arbitral decision. This, however, would not be the case if the Country could, in a mutual agreement procedure, deviate from a court decision and in that case paragraph 5 could be adjusted accordingly.

A second issue involves the relationship between existing domestic legal remedies and arbitration where the taxpayer has not undertaken (or has not exhausted) these legal remedies. In that case, the approach that would be the most consistent with the basic structure of the mutual agreement procedure would be to apply the same general principles when arbitration is involved. Thus, the legal remedies would be suspended pending the outcome of the mutual agreement procedure involving the arbitration of the issues that the competent authorities are unable to resolve and a tentative mutual agreement would be reached on the basis of that decision. As in other mutual agreement procedure cases, that agreement would then be presented to the taxpayer who would have to choose to accept the agreement, which would require abandoning any remaining domestic legal remedies, or reject the agreement to pursue these remedies.

This approach is in line with the nature of the arbitration process set out in paragraph 5. The purpose of that process is to allow the competent authorities to reach a conclusion on the unresolved issues that prevent an agreement from being reached. When that agreement is achieved though the aid of arbitration, the essential character of the mutual agreement remains the same.

In some cases, this approach will mean that the parties will have to expend time and resources in an arbitration process that will lead to a mutual agreement that will not be accepted by the taxpayer. As a practical matter, however, experience shows that there are very few cases where the taxpayer rejects a mutual agreement to resort to domestic legal remedies. Also, in these rare cases, one would expect the domestic courts or administrative tribunals to take note of the fact that the taxpayer had been offered an administrative solution to his case that would have bound both States.

In some States, unresolved issues between competent authorities may only be submitted to arbitration if domestic legal remedies are no longer available. In order to implement an arbitration approach, these States could consider the alternative approach of requiring a person to waive the right to pursue domestic legal remedies before arbitration can take place. This could be done by replacing the second sentence of the paragraph by "these unresolved issues shall not, however, be submitted to arbitration if any person directly affected by the case is still entitled, under the domestic law of either State, to have courts or administrative tribunals of that State decide these issues or if a decision on these issues has already been rendered by such a court or administrative tribunal." To avoid a situation where a taxpayer would be required to waive domestic legal remedies without any assurance as to the outcome of the case, it would then be important to also

modify the paragraph to include a mechanism that would guarantee, for example, that double taxation would in fact be relieved. Also, since the taxpayer would then renounce the right to be heard by domestic courts, the paragraph should also be modified to ensure that sufficient legal safeguards are granted to the taxpayer as regards his participation in the arbitration process to meet the requirements that may exist under domestic law for such a renunciation to be acceptable under the applicable legal system (e.g. in some countries, such renunciation might not be effective if the person were not guaranteed the right to be heard orally during the arbitration).

Paragraph 5 provides that, unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision that decision shall be binding on both States. Thus, the taxation of any person directly affected by the case will have to conform with the decision reached on the issues submitted to arbitration and the decisions reached in the arbitral process will be reflected in the mutual agreement that will be presented to these persons.

Where a mutual agreement is reached before domestic legal remedies have been exhausted, it is normal for the competent authorities to require, as a condition for the application of the agreement, that the persons affected renounce the exercise of domestic legal remedies that may still exist as regards the issues covered by the agreement. Without such renunciation, a subsequent court decision could indeed prevent the competent authorities from applying the agreement. Thus, for the purpose of paragraph 5, if a person to whom the mutual agreement that implements the arbitration decision has been presented does not agree to renounce the exercise of domestic legal remedies, that person must be considered not to have accepted that agreement.

The arbitration decision is only binding with respect to the specific issues submitted to arbitration. Whilst nothing would prevent the competent authorities from solving other similar cases (including cases involving the same persons but different taxable periods) on the basis of the decision, there is no obligation to do so and each State therefore has the right to adopt a different approach to deal with these other cases.

Some States may wish to allow the competent authorities to depart from the arbitration decision, provided that they can agree on a different solution (this, for example, is allowed under Article 12 of the EU Arbitration Convention). States wishing to do so are free to amend the third sentence of the paragraph as follows:

"[…] Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision or the competent authorities and the persons directly affected by the case agree on a different solution within six months after the decision has been communicated to them, the arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States."

The last sentence of the paragraph leaves the mode of application of the arbitration process to be settled by mutual agreement. Some aspects could also be covered in the Article itself, a protocol or through an exchange of diplomatic notes. Whatever form the agreement takes, it should set out the structural and procedural rules to be followed in applying the paragraph, taking into account the paragraph's requirement that the arbitration decision be binding on both States. Ideally, that agreement should be drafted at the same time as the Convention so as to be signed, and to apply, immediately after

the paragraph becomes effective. Also, since the agreement will provide the details of the process to be followed to bring unresolved issues to arbitration, it would be important that this agreement be made public. A sample form of such agreement is provided in the annex together with comments on the procedural rules that it puts forward.

Use of other supplementary dispute resolution mechanisms

Regardless of whether or not paragraph 5 is included in a Convention or an arbitration process is otherwise implemented using the procedure described, it is clear that supplementary dispute resolution mechanisms other than arbitration can be implemented on an ad hoc basis as part of the mutual agreement procedure. Where there is disagreement about the relative merits of the positions of the two competent authorities, the case may be helped if the issues are clarified by a mediator. In such situations the mediator listens to the positions of each party and then communicates a view of the strengths and weaknesses of each side. This helps each party to better understand its own position and that of the other party. Some tax administrations are now successfully using mediation to resolve internal disputes and the extension of such techniques to mutual agreement procedures could be useful.

If the issue is a purely factual one, the case could be referred to an expert whose mandate would simply be to make the required factual determinations. This is often done in judicial procedures where factual matters are referred to an independent party who makes factual findings which are then submitted to the court. Unlike the dispute resolution mechanism which is established in paragraph 5, these procedures are not

binding on the parties but nonetheless can be helpful in allowing them to reach a decision before an issue would have to be submitted to arbitration under that paragraph.

Applicable legal principles

An examination of the issues on which competent authorities have had difficulties reaching an agreement shows that these are typically matters of treaty interpretation or of applying the arm's length principle underlying Article 9 and paragraph 2 of Article 7. As provided in the sample agreement, matters of treaty interpretation should be decided by the arbitrators in light of the principles of interpretation incorporated in Articles 31 to 34 of the Vienna Convention on the Law of Treaties, having regard to these Commentaries as periodically amended, as explained in paragraphs 28 to 36.1 of the Introduction. Issues related to the application of the arm's length principle should similarly be decided in light of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Since Article 32 of the Vienna Convention on the Law of Treaties permits a wide access to supplementary means of interpretation, arbitrators will, in practice, have considerable latitude in determining relevant sources for the interpretation of treaty provisions.

In many cases, the application of the provisions of a tax convention depends on issues of domestic law (for example, the definition of immovable property in paragraph 2 of Article 6 depends primarily on the domestic law meaning of that term). As a general rule, it would seem inappropriate to ask arbitrators to make an independent determination of purely domestic legal issues and the description of the issues to be resolved, which will be included in the Terms of Reference, should take this into

account. There may be cases, however, where there would be legitimate differences of views on a matter of domestic law and in such cases, the competent authorities may wish to leave that matter to be decided by an arbitrator who is an expert in the relevant area.

Also, there may be cases where the competent authorities agree that the interpretation or application of provision of a tax treaty depends on a particular document (e.g. a memorandum of understanding or mutual agreement concluded after the entry into force of a treaty) but may disagree about the interpretation of that document. In such a case, the competent authorities may wish to make express reference to that document in the Terms of Reference.

Arbitration decision

Sample agreement provides that where more than one arbitrator has been appointed, the arbitration decision will be determined by a simple majority of the arbitrators. Unless otherwise provided in the Terms of Reference, the decision is presented in writing and indicates the sources of law relied upon and the reasoning which led to its result. It is important that the arbitrators support their decision with the reasoning leading to it. Showing the method through which the decision was reached is important in assuring acceptance of the decision by all relevant participants.

The arbitration decision must be communicated to the competent authorities and the person who made the request for arbitration within six months from the date on which the Chair notifies in writing the competent authorities and the person.

Publication of the decision

Decisions on individual cases reached under the mutual agreement procedure are generally not made public. In the case of reasoned arbitral decisions, however, publishing the decisions would lend additional transparency to the process. Also, whilst the decision would not be in any sense a formal precedent, having the material in the public domain could influence the course of other cases so as to avoid subsequent disputes and lead to a more uniform approach to the same issue.

Sample agreement therefore provides for the possibility to publish the decision. Such publication, however, should only be made if both competent authorities and the person who made the arbitration request so agree. Also, in order to maintain the confidentiality of information communicated to the competent authorities, the publication should be made in a form that would not disclose the names of the parties nor any element that would help to identify them.

Implementing the decision

Once the arbitration process has provided a binding solution to the issues that the competent authorities have been unable to resolve, the competent authorities will proceed to conclude a mutual agreement that reflects that decision and that will be presented to the persons directly affected by the case. In order to avoid further delays, it is suggested that the mutual agreement that incorporates the solution arrived at should be completed and presented to the taxpayer within six months from the date of the communication of the decision. This is provided in the sample agreement.

Paragraph 2 of Article 25 provides that the competent authorities have the obligation to implement the agreement reached notwithstanding any time limit in their domestic law. Paragraph 5 of the Article also provides that the arbitration decision is binding on both Contracting States. Failure to assess taxpayers in accordance with the agreement or to implement the arbitration decision through the conclusion of a mutual agreement would therefore result in taxation not in accordance with the Convention and, as such, would allow the person whose taxation is affected to seek relief through domestic legal remedies or by making a new request pursuant to paragraph 1 of the Article.

Sample agreement deals with the case where the competent authorities are able to solve the unresolved issues that led to arbitration before the decision is rendered. Since the arbitration process is an exceptional mechanism to deal with issues that cannot be solved under the usual mutual agreement procedure, it is appropriate to put an end to that exceptional mechanism if the competent authorities are able to resolve these issues by themselves. The competent authorities may agree on a resolution of these issues as long as the arbitration decision has not been rendered.

4. EU “abuse of law” and “substance test” experiences to limit cross-border tax arbitrage

The analysis of the working progress on tax arbitrage within the European Union should necessarily start from the institutional role of the ECJ and its relevant impact and orientation guide process with reference to each single jurisdiction of Member States.

To narrow down the search and bring the attention within EU Countries to the most interesting developments over the last years in the “abuse of law” and “substance test” requirements, both from the perspective of new laws and case law rulings, Countries such as France, Germany, Italy and UK have been selected. These are the Countries which are usually ranked among other EU Member States as the ones with a high level of effective income tax burden and therefore it is important to consider the work done by them during these years in elaborating best practices to face the emergence of progressive taxable base erosion, also in connection with the competitiveness among those EU Countries that definitively propose lower tax rates without infringing fundamental EU freedoms and without implementing any harmful tax practice.

4.1 Cadbury Schweppes C196/04, ruled by ECJ on 12 September 2006: interpretation of anti-avoidance rules and company substance test

As mentioned in the communication by the European Commission, in its recent case law the ECJ has given more explicit guidance on the criteria for detecting abusive practices. As will be seen in the Cadbury case, the ECJ held that an establishment is to be regarded as genuine where, based on an evaluation of objective factors which are ascertainable by third parties (the genuineness should be evaluated mainly from the

point of view of objective factors, giving very limited influence to elements related to subjective justifications), in particular evidence of physical existence in terms of premises, staff and equipment, it reflects economic reality, i.e. an actual establishment carrying on genuine economic activities and not a mere "letterbox" or "front" subsidiary giving the opportunity to the taxpayer to provide evidence of any commercial justification for the arrangement.

The detection of a wholly artificial arrangement thus amounts in effect to a substance-over form analysis. Application of the relevant tests in the context of EC Treaty freedoms and corporate tax directives necessitates an evaluation of their objectives and purposes against those underlying the arrangements entered into by their prospective beneficiaries (taxpayers). In the context of corporate establishment there are inevitably difficulties in determining the level of economic presence and commerciality of arrangements. Objective factors for determining whether there is adequate substance include such verifiable criteria as the effective place of management and tangible presence of the establishment as well as the real commercial risk assumed by it. However, it is not altogether certain how those criteria may apply in respect of, for example, intra-group financial services and holding companies, whose activities generally do not require significant physical presence.

The ECJ has clarified the permitted scope of certain types of anti-avoidance rules and set out a number of criteria to assess the genuineness of establishment and the commercial character of arrangements entered into by taxpayers. While the application of the principles flowing from the case law will ultimately depend on the facts of particular cases, the Commission nevertheless considers that it would be worthwhile

exploring the practical application of those principles to different types of business activities and structures.

Definition of substance evidences that guidelines based on different industries should be proposed soon cooperating with the Member States and the Business Community.

In the case-file, named Cadbury Schweppes, Inland Revenue challenged a UK company with the establishment of a subsidiary in the Irish International Financial Centre Services, benefiting from 10% taxation, under the assumption that the United Kingdom legislation on CFCs was adopted to counter a specific type of tax avoidance by means of the artificial diversion of profits made in the United Kingdom. According to that Member State, it is to counter the diversion of the profits of a resident company by establishing a subsidiary in a low-tax Country and carrying out intra-group transactions whose primary objective is to transfer those profits to that subsidiary, and therefore the crucial question has been referred to ECJ of whether the national legislation in question can be justified by that objective.

As ruled several times, counteraction of tax avoidance is one of the overriding reasons in the public interest which can justify a restriction on the exercise of the fundamental freedoms within the proportionality principle 96 and in any case subject to specific constraints.

It is essential to note for the purpose of this doctoral thesis that in the ECJ's opinion concepts such as "abuse of law" and "substance test" frequently recurred as commonly shared meanings to refer to; Countries might at any time have conflicts in defining when cross-border structures or transactions should be considered mere tax shelter or

[96] *ICI*, paragraph 26; Case C-436/00 *X and Y*, paragraphs 60 and 61; *Lankhorst Hohorst*, paragraph 37; and *De Lasteyrie du Saillant*, paragraph 50.

legitimate tax arbitrage and consequently the legal counteraction of Countries to prevent and to prosecute one situation instead of the other would be viewed, in the first case if enacted against tax shelter as absolutely legitimate, whereas in the other case it would be viewed as restriction to competition and therefore aimed by single Country protectionist intent.

The ECJ reaffirmed that according to a phrase habitually used in the case-law, a hindrance to a freedom guaranteed by the EU Treaty can only be justified on the grounds of counteraction of tax avoidance if the legislation in question is specifically designed to exclude from a tax advantage wholly artificial arrangements aimed at circumventing national law.

ECJ uses the language which reproduces the deep meaning of the doctrine of 'abuse of rights" applicable to tax law.

Within the case under examination it has, however, been affirmed that the harmful effects of a total absence of harmonisation of the rates of taxation of company profits, as we have seen, call for a political solution, they do not appear to justify calling into question the scope of the rights conferred by Articles 43 EC and 48 EC, as defined by case-law; therefore the establishment by a company which is resident for tax purposes in a Member State of a subsidiary in the International Financial Services Centre for the avowed purpose of enjoying the more favourable tax regime applicable there, does not, in itself, constitute an abuse of freedom of establishment and therefore CFC rules instead of being understood as intended to prevent the counteraction of tax avoidance, might be used as a pretext for protectionism. Application of Community law may be

refused only when the company in question relies on it abusively because it has set up an artificial arrangement in order to avoid tax.

Obviously this statement should not be generally applied to any situation since **national courts** may, case by case and on **the basis of objective evidence**, take account of abuse or fraudulent conduct on the part of the persons concerned, in order to deny them the benefit of the provisions of Community law on which they seek to rely[97].

It follows that, in order to be capable of being justified by counteraction of tax avoidance, national legislation must not merely refer to a given situation in general terms but must enable the national court to refuse, case by case, the benefit of Community law to certain taxpayers or certain companies which have made use of an artificial arrangement for the purpose of avoiding tax.

The Court's examination of the justifications thus put forward contains matters that are useful to note.

The Court reiterated its settled case-law, according to which a reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom. Nevertheless, the tax regime applicable in Ireland to companies established in the International Financial Services Centre was cited in the report of the 'Code of Conduct' group, responsible for evaluating national measures which may come within the scope

97 In the absence of Community harmonisation it must be accepted that there is competition between the tax regimes of the various Member States. That competition, which is reflected in particular by great disparity between the Member States in the rates of taxation of company profits, may have a significant impact on the choice of location made by companies for their activities in the European Union. It may be regrettable that competition operates between the Member States in this field without restriction. That is, however, a political matter.

of the code, as being a harmful measure. Therefore according to “Code of Conduct” that tax regime had to be progressively abolished.

According to its preamble, the code of conduct is a political commitment and does not affect the Member States’ rights and obligations or the respective spheres of competence and sovereignty of the Member States and the Community resulting from the Treaty. The binding role of this “Code of conduct” should preserve the fundamental freedom rights among Member States by avoiding any distortion and inviting States to remove any obstacle to these freedoms.

It is a matter of fact that the disparity in rates of taxation which are fixed in the laws of the Member States is always considered a debatable problem[98]. On the other hand, the assessment carried out by the ‘Code of Conduct’ group of tax measures deemed harmful and scheduled to be abolished, is restricted to individual or specific regimes.

The Court has been asked to take a decision on whether, and to what extent, transactions between a CFC and its parent company which result in the reduction of the latter’s taxable profits, constitute tax avoidance and if general restriction provided by UK CFC law is balanced per se without infringing the above mentioned freedoms.

The answer for the ECJ is within in the meaning of Article 43 EC et seq., (freedom of establishment) which involves the actual pursuit of an economic activity in the host State. If the subsidiary is actually carrying on such an activity in that State and, in relation to that, it provides genuine and actual services to the parent company, AG does not view this situation, in itself, as tax evasion or avoidance, even if payment for those

[98] To date, no measure to that effect has been taken and none appears likely in the near future based on Member States hearings

services leads to a reduction in the taxable profits of the parent company in the State of origin to the extent that group companies determine price transaction at arm's length.

Finally ECJ touched the crucial point: the assessment of whether there is a wholly artificial arrangement intended to circumvent national tax legislation must entail a case-by-case examination of whether the subsidiary is genuinely established in the host State and carries on its activities in that State with regard to the services provided to the parent company, the payment for which has resulted in a reduction in the tax due by that company in the State of origin.

The United Kingdom and the Commission cited in that regard three criteria of "substance test" which appear extremely relevant also for expanding such a definition to any other cross-border transaction which might lead to tax arbitrage savings. First, the degree of physical presence of the subsidiary in the host State, secondly, the genuine nature of the activity provided by the subsidiary and, finally, the economic value of that activity with regard to the parent company and the entire group.

The first of those criteria relates to whether the subsidiary is genuinely established in the host State. It means examining whether the subsidiary has the premises, staff and equipment necessary to carry out the services provided to the parent company which have resulted in the reduction of the tax due in the State of origin. If that is not the case, the subjection of those services to the tax sovereignty of the host State does appear to be a wholly artificial arrangement designed to avoid tax.

The second of those criteria relates to the genuine nature of the services provided by the subsidiary. In that connection, it is a question of looking at the competence of the subsidiary's staff in relation to the services provided and the level of decision-making in

carrying out those services. If, for example, the subsidiary proves to be nothing but a mere tool of execution because the decisions necessary to carry out the services it has paid for are taken at another level, it is also right to consider that the subjection of those services to the tax sovereignty of the host State constitutes a wholly artificial arrangement.

The third criterion, relating to the value added by the subsidiary's activity, is no doubt trickier to apply where the services provided by it in fact reflect the exercise of genuine activities in the host State. This criterion seems to be relevant, however, in so far as it might make it possible to take account of an objective situation in which the services provided by the subsidiary have no economic substance in the light of the parent company's activity. If that were the case, it can be accepted that there is a wholly artificial arrangement because there appears, in effect, to be no consideration for the payment by the parent company for the services in question. Payment for such services could therefore be viewed quite simply as a transfer of profits from the parent company to the subsidiary.

On the other hand the motives for establishing a subsidiary and for the choice of Country in which to establish should not be itself a relevant criterion. In other words, the existence of a wholly artificial arrangement cannot be inferred from the parent company's avowed purpose of obtaining a reduction of its taxation in the State of origin.

As we have seen, the subjective reasons for which an economic operator has exercised the rights conferred on it by the Treaty cannot call into question the protection it derives from those rights once the objective pursued by them is fulfilled. Where that is the case,

the fact that a parent company decided to relocate certain services necessary for the pursuit of its activities in a low-tax State for the purpose of reducing its tax burden is not relevant to a finding of tax avoidance.

A wholly artificial arrangement intended to avoid national tax law can therefore be established only on the basis of objective factors.

The same conclusion is also arrived at by referring once again to the case-law of the Court on the doctrine of ‘abuse of rights’. According to that case-law, it is on the basis of objective circumstances that an abusive practice must be established. As the Court held recently in the judgement in Halifax and Others, such a practice can be found to exist only if, in the light of ‘a number of objective factors’, the essential aim of the transactions concerned is to obtain a tax advantage the grant of which would be contrary to the objective pursued by that legislation.

The competent national authorities which are responsible for making that finding are not therefore called upon to inquire into the parties’ subjective intentions, which would be very difficult to prove and would give rise to legal uncertainty. They are to take into account circumstances such as collusion between an exporter and an importer or the wholly artificial nature of the transactions in question and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden.

In such a case, it would be essential the examination based on objectively verifiable factors of whether the subsidiary is genuinely established in the host State and whether those transactions are genuine, without there being any need to address the motives and subjective intentions of those concerned.

4.2 France: International tax shelters disclosure vs. widening application of "abuse of law" concept, recent cases law: Janfin and Royal Bank of Scotland

France several times attempted to introduce the reporting tax shelters disclosure.

The French government circulated a preliminary draft of legislation that would introduce disclosure rules for tax avoidance strategies in 2005 and 2006

Tax authorities issued a draft modelled partly on US and UK legislation. According to the government, the purpose of the legislation would be to provide operators with clear guidance regarding their exposure on tax-sensitive operations and to be dissuasive, and the disclosure requirement would provide significant information about tax strategies implemented by operators, enabling tax authorities to identify potential loopholes in French tax legislation[99].

The disclosure obligation would cover one-step transactions and steps in integrated transactions that combine at least two designated features among various sets of features listed in the draft legislation. There would be various tests. For example, some tests would focus on the characteristics of the transaction, such as the use of a structure in a low-tax jurisdiction, the abusive use of differences in the characterisation of income between France and another jurisdiction, or the short timing within which the transaction is implemented. Other tests would focus on the potential tax advantages derived from the transaction, for example, tax deferral, the offsetting of losses, or the availability of a tax credit under a tax treaty.

The disclosure obligation generally would apply to trade or business income realised by persons or entities resident in France or subject to income tax in France in accordance

[99] Tax analyst worldwide 13 October 2006, Tax Analysts 2007. All Rights Reserved

with the provisions of the French General Tax Code (Général des Impôts). VAT and business tax would be outside the scope of the legislation.

The same disclosure obligation would be imposed only on the persons or entities that enter into the transaction.

The legislation was not included neither in the draft Finance Bill 2007 nor in the Financial Bill 2008 .

France has implemented Art 119 French Code with the specific anti-treaty shopping purpose mainly related to withholding tax application and the general Fraud law Art 64 of Tax Procedure Code[100].

Art 119 has a very narrow field of application and several exceptions are available where it can be proved that the chain of EU control has not been implemented for artificial purpose and the overall withholding tax burden is equivalent to that if the dividend were paid directly to a non-EU company.

Under the Fraud law content the French tax Authorities are entitled to deny tax treaty benefits in case of fictitious transactions or transactions which take advantage of the possibility made available by the law in a way opposite to the intention of the legislator, which have as their only purpose to avoid or reduce the tax which would otherwise be due.

This theory has recently been applied by the French Administrative Supreme Court both to the benefit of the tax treaty between France and UK and to a domestic case of "Fraud law".

[100] Introduced by Law n. 63-1316 dated 27 December 1963

As outlined by several Scholars [101] France has a wider experience of jurisprudence and doctrine debates with reference to the “abuse of law” (fraude à la loi) concept on which they rely as an effective means to discouraging and disregarding tax benefits from abusive structure; as recently proved and confirmed, France seems to enhance general and wider *principle of abuse of law* instead of introducing new detailed tax avoidance rules or new compliance obligations.

The above mentioned “principle approach” interpretation route has been reaffirmed within the following Supreme Court cases law: Janfin vs. French Ministry of Finance and Economy ruled on 27 September 2006, and Bank of Scotland vs. French Ministry of Finance and Economy ruled on 29 December 2006.

Particularly, on 29 December 2006, the French Supreme Administrative Court overturned an earlier decision from the Court of Appeals of Paris dealing with the concept of beneficial ownership under the France-UK tax treaty. The Supreme Administrative Court concluded that a Scottish bank, which had acquired dividend coupons under a usufruct agreement with a US company, was not the beneficial owner of the dividends distributed by the French subsidiary of that US company and was, therefore, not entitled to the reduced treaty rate and transfer of the *avoir fiscal* imputation credit. Details of the decision are summarized by facts below.

In 1992, a US parent company concluded a usufruct agreement with a UK bank, under which the bank acquired for a 3-year period dividend coupons attached to the shares of the French subsidiary of the US parent company. In 1993, the French company distributed a significant amount of dividends to the bank, which was subject to a 25%

[101] AA.VV, The Business purpose and abuse of rights, British Tax law, 1985

withholding tax. By the end of 1993, the bank requested a refund of the French withholding tax levied in excess of the maximum rate of 15% provided for in Art. 9(6) of the France-UK tax treaty and the transfer of the *avoir fiscal* tax credit (Art. 9(7) of the treaty).

The French tax administration rejected the claim of the bank, arguing that the beneficial owner of the dividend distribution was not the UK bank but still the US parent company. According to the tax administration, the price paid by the UK bank to the US company to acquire the dividend coupons corresponded to the amount of the net dividends, before withholding tax. Consequently, the transaction had to be reclassified as a loan, granted by the UK bank to the US parent company for 3 years, and remunerated by the payment of the *avoir fiscal* tax credit to the UK bank. The bank brought the case to the Lower Court of Paris, which rejected the claim on 4 July 2001. The bank appealed before the Court of Appeals of Paris, which ruled in its favour considering the UK bank as the beneficial owner of the dividends distributed by the French subsidiary of that US company within the meaning of Art. 9(6) of the France-UK tax treaty.

The Supreme Administrative Court examined the usufruct agreement and concluded that the transaction implemented by the contracting parties in reality concealed a loan agreement between the UK bank and the US company, which was effectively reimbursed by the French subsidiary of the US company.

The Supreme Administrative Court started by referring that the advantages of the France-UK tax treaty, i.e. reduced withholding tax and transfer of the *avoir fiscal*, could only be granted to the effective beneficial owner of the dividends. The Court then

believed that the usufruct agreement was exclusively motivated by tax reasons, with the sole aim of benefiting from the transfer of the *avoir fiscal* tax credit, which was available under the France-UK tax treaty and not under the France-US tax treaty. According to the Court, the analysis of the agreement and the economic effects related to, revealed that the beneficial owner of the dividends was, in fact, the US parent company, which delegated to its French subsidiary the repayment of the loan contracted with the UK bank.

The Court considered that the case in question did not arise from a tax reassessment procedure but merely from the denial of a claim for withholding tax refund and transfer of *avoir fiscal* tax credits. Accordingly, the tax administration was entitled to scrutinize the agreement and to reclassify the transaction as a loan agreement.

As a result, the Supreme Administrative Court concluded that the bank was not the effective beneficial owner of the dividends distributed by the French company within the meaning of Art. 9(6) of the treaty and was, therefore, not entitled to the refund of the excess withholding tax and the transfer of the *avoir fiscal* tax credit.

On a different basis, it is interesting to analyse the developments following the so-called Janfin case law, where the French Administrative Supreme Court in relation to Janfin SARL disregarded the capital losses on the sale of shares realized for the purpose of offsetting revenues: dividend and tax credit so-called "avoir fiscal", coming from the same shares that were sold afterwards.

The Court held that the shares acquisition and the subsequent sale was a mere financial structure put in place to benefit from the possibility of offsetting revenues, particularly from the shares with the capital losses deriving from the sale of those shares after the

distribution of dividends related to them, and therefore the court denied the resulting tax benefits.

This sentence is extremely important within the French context as well as for the analysis of International tax developments concerning the "abuse of rights" concept.

In particular, the comments of the French President of Financial Department of Supreme Court[102], should be mentioned, when he said that the statement coming from the recent Supreme Court cases, overturned the doctrinal debates and any previous interpretation of the relationships between the provisions of Art 64 of LFP, its application field and powers of the Tax Authorities in disregarding abusive tax structures.

In both the Janfin and Bank of Scotland cases, the Court ruled that outside the scope of special provision provided by Art 64 of LPF, the Tax Authorities can draw aside the acts which, seeking the benefit of the literal application of the provisions against the aims in the view of their authors, could be inspired by the sole intent of avoiding or attenuating the tax burden of the taxpayer and therefore the "fraud of law" concept is a general principle that can be opposed to avoiders by the Tax Authorities in circumstances outside of the scope of Art 64 of LPF which treats disputes related to taxable basis issues.

It has been argued[103] that the wider application of the abuse of law concept is grounded on the legal habit to combine and properly mix law provisions and principles of rights, good faith interpretation neither included into a specific law nor referred to taxation

[102] Fouquet Olivier, Fraude à la loi et abuse de droit, Droit fiscal n. 47, 23 November 2006
[103] Fouquet Olivier, supra

matters but deriving from the shared common meaning and expectations of legal obligation compliance based on whole rules and procedures enacted by laws.

The tax law, even though characterized by specialized issues, cannot be viewed as autonomous from the Commercial and Corporate law and Codes, therefore the principles which inspired those laws and Codes should not be disregarded within the relationship of the taxpayer and tax laws in the name of specialized matters relating to taxation.

Abuse of rights is the one.

Therefore, according to recent case law, in any case such an abuse can be assessed by Tax Authorities too who are empowered also without referring to a specific tax provision which treats abusive transactions both at International and at domestic level; then it will be the Court duty to evaluate based on concrete evidence if the charge based on abuse of rights is sustainably regrettable and consequently subject to a proportioned penalty.

The sentence ruled in the Janfin case reaffirmed that the any abuse with reference to tax matters is part of the *general abuse of rights principle* of administrative law and therefore the lesson learned is based on the fact that sources of the law, their inspired principles as safeguard of public and private interests, are becoming more and more relevant in those contexts that are progressively widening by crossing the national borders such as economy including taxation, where meaning or wording of the law might be different but those principles as a foundation of civilized nations are the same.

No distortion or violation of those principles by abusive intentions of an individual can be allowed in order to preserve the uniformity and consistency of those rules.

4.3 Germany: Recent international tax anti-abuse provisions in the light of Cadbury Schweppes, case law: Hilversum II

The German General tax Code has a provision (AO) § 42 to challenge abuse of law under the substance-over-form-rules, a legal structure or set-up only aimed at tax savings shall be ignored for tax purposes, and the transaction shall be taxed as if an adequate legal structure had been implemented. While the entire BFH and lower tax court jurisprudence on the German anti-abuse rules is characterized by very case-specific decisions, there are some overriding and general principles that can be derived from the BFH's cases on AO § 42:

The provision will only apply if the taxpayer designs and implements a structure that is directly or substantially aimed at circumventing an enacted and specific provision of German tax law[104], therefore the general anti-abuse law mentioned has a domestic filed of application.

With regard to its wording and intended scope, AO § 42 is typically applied, to "artificial" structures without any business reasons since it is primarily (or only) tax driven.

A typical aspect of abusive structures is that the same economic result, apart from the tax benefits generated by the taxpayer's implemented structure, might have been

[104] BFH of 20 June 2000, DB 2000, 2098

achieved by implementing a much simpler, more straightforward and less complex structure or transaction. Therefore the transaction and its ultimate goals would be scrutinized looking for the good reason behind the single step; nevertheless, as already mentioned, even without inserting an extra step or entering into a very sophisticated structure, an abusive transaction can be implemented equally in the absence of purposive activity and significant economic benefit compared with the tax one.

This approach is comparable to the “step-transaction-doctrine” applied in other jurisdictions, under which a series of formally separate steps may be collapsed and treated as if they consisted of a single integrated transaction for tax purposes.

For multi-step cases, the BFH also looks at whether, in a series of steps, each individual step has a warranted business purpose. If this is found to be the case, the German authorities cannot arbitrarily challenge a structuring as “abusive” only because the structure supposedly occurred based on an “overall plan” (Gesamtplan). For this reason, if all individual steps of a restructuring process evaluated on a stand-alone basis cannot be qualified as abusive in the sense of AO § 42, the mere interdependence or interlock (Ineinandergreifen) of these separate steps of this overall plan cannot be qualified differently and will generally not be held to be abusive.

On the other hand, even if a transaction is done in an unusual way or process, it will nevertheless not be abusive to the extent the taxpayer is able to demonstrate substantial economic reasons and the intentional rationale behind the structuring choice which has to be far away from the mere tax advantages derived from it.

If the taxpayer within a legally permitted structure framework, among other possible alternative and eventually simpler structures, decides for a transaction that will result in

substantial tax benefits, the mere existence of such tax savings does not automatically make this structure per-se abusive within the scope of AO § 42. despite the several attacks made by the German tax authorities[105]

The German anti-abuse provisions have a wide general content but cannot be narrowed down to specific cases that are already treated by different laws and not with reference to potential cross-border tax treaty abuse; in several cases in which taxpayers had implemented structures that worked around specific anti-abuse provisions, enacted by the German legislator to deal with presumed "abuse", the BFH has regularly rejected using AO § 42 to remedy legal mistakes in German legislation or bad law drafting by the German government when trying to introduce special anti-abuse provisions. The BFH has, for example, rejected to challenge anti-treaty-/anti-Directive-shopping cases relying on AO § 42 106

To cover this legislative loophole, the German anti-treaty-shopping rule was enacted in 1994107. Sec. 50d(3) of the EStG stated that foreign companies or individuals were not entitled to a reduction of the withholding tax under a tax treaty or the EU Parent-Subsidiary Directive where they were owned by persons and/or entities who would not have been entitled to the reduction if they had earned the income directly (a kind of

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[105] Tax Court of Munich of 29 August 2000, EFG 2000, 1426; appealed by the tax authorities to the BFH and rejected by the court: BFH of 17 October 2001, BFH/NV 2002, 240

[106] BFH of 31 May 2005, DB 2006, 370; arguing that the German legislator had enacted EStG § 50d(1a) -old- (now EStG § 50d(3)) as a special anti-abuse provision), has refused to apply AO § 42 to generally "complement" the German CFC rules (BFH of 23 October 1991, BStBl. II 1992, 1026; of 10 June 1992, BStBl. II 1992, 1029; and of 20 March 2002, BStBl II 2003, 50), and has also rejected to apply AO § 42 to "dividend stripping structures" (BFH of 15 December 1999, NZG 2000, 1093; again arguing that the German legislator had enacted EStG § 50c(7)[2]

[107] Sec. 50d(1a) EStG. Act for the prevention of abuse and adjustment of tax law (Gesetz zur Bekämpfung des Mißbrauchs und zur Bereinigung des Steuerrechts, Mißbrauchsbekämpfungs- und Steuerbereinigungsgesetz, StMBG), Federal Tax Gazette I 1994

fictitious interposition). This was provided that the following two requirements were satisfied:

(1) the interposition of the foreign company was not supported by economic or other significant reasons; and

(2) the foreign company did not itself carry on an economic business activity.

There were no official decrees or other statements of the tax authorities with regard to the interpretation of these anti-treaty abuse rules, no ruling.

From a practical point of view, the granting of withholding tax reductions often depended on purely formal criteria[108], such as the

- number of employees, telephones or fax machines. It was, therefore, not easy to advise on international holding structures.
- Economic or other motives were, for example, denied by the tax jurisdiction in the following circumstances:

(1) in respect of purely tax saving motives;

(2) in respect of the pure limitation of liability;

(3) the securing of the assets in a financial crisis of a company; and

(4) the pure holding of share capital without any further activities.

The cases law in respect of this specific issue started from 2001 and the most significant ones are the Hilversum decisions: so-called Hilversum I and II

The decisions Hilversum I and II concerned Dutch holding companies located in Hilversum, which is a centre for television and film production in the Netherlands. The

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[108] Petra.Eckl ,Tightening of the German Anti-Treaty-Shopping Rule, CPE march 2007, IBFD

holding companies had subsidiaries in Germany that distributed dividends and claimed for refunds of withholding tax. After a refund had been rejected in the "Hilversum I" decision in 2002, only three years later, in the "Hilversum II" decision the Federal Tax Court seemed to jump to a different conclusion: that the preconditions in the anti-abuse provision of Sec. 50d (1a) of the EStG 1990/1994 had not been satisfied. Both of the decisions referred to exactly the same group of companies. In this respect, the shares in the German companies were held by Dutch holding companies that were held by holding companies located in Bermuda and the Netherlands Antilles. The ultimate shareholders were individuals who were subject to taxation in Bermuda, Australia and the United States.

The Dutch holding companies used Netherlands OpCo's office equipment located in Hilversum, its telephone and fax machines. The director of Netherlands OpCo ran the business of all of the holding companies. The holding companies had no personnel. In Hilversum I, the Federal Tax Court denied a refund of German withholding tax relating to a dividend distribution of German Co I since in its opinion, the interposition of Netherlands HoldCo was only artificially for the purpose of receiving German tax refunds. The fact that Netherlands OpCo, an associated company in the same State as the holding company, performed active business and the fact that the further active business of the group was centralized in other companies located in the Netherlands was considered to be irrelevant. Together with the argument that the interposition was justified by reasons of coordination, organization and a combined corporate concept.

Only three years later, in 2005, the Federal Tax Court, however, concluded that Netherlands HoldCos II and III did not qualify as letterbox companies that were

interposed without any economic or other relevant motives within the meaning of Sec50d(1a) of the EStG 1990/1994.24. The Court also held that even interposed zero-substance entities with no office and personnel could claim the benefits of the EC Parent-Subsidiary Directive, provided that: other companies in the same State (as the zero-substance entities) had an active economic business, so that the interposition of the zero-substance entities was not obviously intended to reduce the withholding tax.

As the active entertainment business of the whole group was concentrated in the Netherlands, the interposition of Netherlands HoldCos II and III was considered to be only a question of organization. Accordingly, the Federal Tax Court in case law named Hilversum II confirmed the necessity for the existence of economic or other relevant reasons for the interposition in respect of the Dutch holding companies.

However, after almost one year, the Federal Ministry of Finance issued a decree reaching a totally different consideration from Hilversum II case law, stating that the Hilversum II decision would not be applied beyond the case.[109]. The decree stated the tax authorities strong opinion, in other words to deny withholding tax reduction, either the lack of economic or other significant reasons are sufficient and therefore, differently from the ruling in the case law under discussion, the above mentioned conditions should not be cumulative for denying the benefit.

To state a definitive German tax position according to the consistent jurisprudence on anti-treaty shopping rules, the legislator reacted to the decision in Hilversum II by amending Sec. 50d(3) of the EStG. The amended version applies from the beginning of the assessment period 2007 onwards.

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[109] Another case law named Hilversum III is actually pending as well as other case law that has been started on the same issues

Under the new version of Sec. 50d (3) of the EStG, a foreign company is not entitled to the benefits of the reduction in the withholding tax due to a tax treaty or the EC Parent-Subsidiary Directive, provided that one of the following three requirements is satisfied:

(1) the interposition of the foreign company is not supported by economic motives or other significant reasons;

(2) the foreign company does not generate more than 10% of its total gross earnings of the relevant business year from its own commercial activities; or

(3) the foreign company does not participate in the general trade with a business with adequate business equipment.

Sec. 50d (3) (2) of the EStG further clarifies that (only) the facts and circumstances of the foreign company are relevant. In contrast to the Hilversum II principles, organizational, economic or other reasonable circumstances of associated entities must be disregarded as well any family successions or financial crisis reorganization reasons. With regard to the 10% quota, the legislator refers to a limitation in the German controlled foreign company (CFC) rules. Specifically, under Sec. 9 of the Foreign Tax Act (Außensteuergesetz), a CFC's passive income is not considered if the passive income is less than 10% of the total gross earnings. A holding company cannot, therefore, be made "active" within the meaning of Sec. 50d (3) of the EStG by allocating to it a small portion of active business. A foreign company has no economic business activity to the extent that the gross earnings are derived from the administration of economic assets or if the foreign company outsources its own essential business activity to other entities. According to the official explanatory statements, the foreign company, however, "participates in the general trade" if it

provides services only for one principal including within the meaning also group companies. The mere administrative holding of shares in one or more subsidiaries is considered as non-commercial business. Holding activities that consist of active management of the subsidiaries are considered commercial activity to the extent there is an effective management for holding more that one subsidiary.

The restrictions in Sec. 50d (3) of the EStG do not apply if the foreign company is listed on a recognized stock exchange and if its shares are regularly traded.

The fact that the restriction of the new version of Sec. 50d (3) of the EStG applies only to foreign entities including those resident within EU, and the rule does not provide for a possibility for the foreign taxpayer to prove that its interposition has no abusive motives, is likely to be viewed, even though motivated by a tax anti-avoidance purpose, as potentially conflicting with the EU fundamental freedoms.

The Annual Tax Act 2008 included a proposal for a complete revision of the current general anti-abuse rules to expand its action, which may add substantial uncertainty for future tax planning, nevertheless the decisive criteria for the future application of the anti-abuse rule would be whether the taxpayer generates a tax benefit from a particular structure and whether that structure is “unusual”, probably the term unusual means that from a real business perspective it sounds as if it is artificial and useless. The burden of proof would be on the tax authorities, but the taxpayer would need to show valid business reasons to justify its chosen structure.

4.4 Italy

4.4.1 General Tax Anti-avoidance rule: Art 37bis of DPR 600/73 and Art 44 CIT against Hybrid instruments

Italian tax law does not provide for a general anti-avoidance rule allowing tax authorities to disregard tax driven transactions. Under the Italian tax system tax avoidance is dealt with exclusively through specific provisions aimed at countering determined tax schemes.

Among said rules, Article 37-bis of Law No. 600/1973 allows the Italian tax authorities to disregard "*acts, facts and transactions, even connected with each other without economic* reasons aimed at *circumventing tax obligations or tax limitations and at obtaining tax savings or refunds otherwise undue*".

Furthermore, the application of Article 37-bis is limited to the specific transactions listed in said provision, which are:

- mergers, divisions, transformations and liquidations and distributions to shareholders of reserves not consisting of profits;
- contributions to companies and transactions for the transfer or utilization of business assets;
- transfers of debt claims and tax credits;
- EU mergers, divisions, transfers of assets and exchanges of shares[110];
- transactions concerning shares, quotas, securities and financial instruments and their recording in the financial statement[111]; or

[110] Anti-tax haven legislation applies to prevent the use of tax haven jurisdictions. In particular, costs and expenses are not deductible if they arise from transactions with companies resident in a non-EU Member State with a preferred tax regime. A list of states and territories with a preferred tax regime has been issued. The deduction is

- transfers of assets between companies within the same consolidated tax group[112].

As a consequence of the above, one of the above-mentioned transactions can fall under Article 37-bis only if all the following conditions are met:

(i) the transaction is not supported by a business purpose;

(ii) the purpose of said transaction is the circumvention of a tax obligation/limitation;

(iii) the structure is aimed at obtaining an "undue" tax refund or saving.

Accordingly, the sole recourse to one of the above-mentioned transactions is not sufficient in itself to give rise to the application of Article 37-bis since the tax avoidance is usually ascertainable by an ensemble of acts, transactions connected with each other113.

In any case the taxpayers may ask for advance rulings on the applicability of these anti-avoidance provisions.

However in a note published in the web site of the Italian Tax Authority, not to be considered as an official interpretation, the potential consequences deriving from the above mentioned Group re-organization have been analyzed and considered. In particular the main hypotheses provided in this note are:

a. the re-organization performed in order to:

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allowed if the resident company can prove that the non-resident company actually and mostly carries on a business activity or that the transactions have a business purpose and have in fact been concluded.

[111] Please note that the words *and their recording in the financial statement* have been introduced by the Legislative Decree 344/03 issuing the Italian tax reform in order to valuate potential transaction performed only to satisfy one of the conditions provided by the Tax reform to benefit from the participation exemption rule

[112] Please note that this condition has been introduced by the Legislative Decree 344/03 issuing the Italian tax reform.

[113] In the Official Government Report to such provision it is stated that "*the tax advantage hardly ever derives from, for example, a mere merger, mere contribution or from another corporate operation. It is far more likely to derive from preparatory or consequential events such as the acquisition or contribution of company shares. It is for this reason that regulation focuses on avoidance entirely built-up by the taxpayer*".

(i) benefit from tax deferral;

(ii) achieve the condition to be met in order to benefit from the participation exemption regime or the exemption of the dividends distributed within the tax consolidated group; and

(iii) match the taxable income realized by the Companies to be included in the tax consolidation;

does not satisfy114 the condition provided by the art. 37 bis, and for this reason these transactions are not subject to the Italian anti-avoidance rules.

b. the re-organization performed in order to:

(i) circumvent (old or new) tax institutes (as thin capitalization or pro rata rules)

could be subjected115 to the Italian tax anti-avoidance rules, showing the necessity of an official interpretation and, in any case, the necessity to perform this valuation case per case.

These conditions could be considered as a business reason of the transaction, to be carefully analysed and valuated, in order verify the effective application of the Italian anti-avoidance rules116.

With reference to point (i) please consider that at present an official interpretation and a consolidated jurisprudence (Supreme Court, Tax Court…) about the real meaning of this wording does not exist.

In the Official Government Report to this provision it is only stated that there is no circumvention of tax obligation/limitation when the taxpayer chooses the more favorable solution for tax purposes between two different structural solutions provided and considered "corrected"117 by the same Law, but only in case the taxpayer "abuses"

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[114] Please note that the Italian words are "*Se il risparmio d'imposta, che l'amministrazione finanziaria reputa che il contribuente abbia perseguito, consiste in un………,* ***non può ritenersi indebito****, cioè in contrasto con i principi del nuovo "sistema", dal momento che sono proprio i suddetti istituti giuridici a consentire tali risultati".*

[115] Please note that the Italian words are "*Se il risparmio d'imposta deriva dall'aggiramento dei principi cardine di un tipico regime impositivo, preesistente o di nuova introduzione……allora i rischi di applicabilità della norma anti-elusiva generale non possono essere scongiurati".*

[116] Please see the conditions mentioned in the paragraph I to apply the Italian anti-avoidance rules.

[117] Please consider that the Italian words are "*…di pari dignità*"

these rules (through manipulation and trickery even if according to the Civil code) - to reach tax benefits – subverting the principles and the structure of the rules.

As mentioned on hybrid structure which relied upon mismatched cross-border taxation based on two different characterizations of revenue and expense concepts relating to the same transaction, among potential solutions mentioned to avoid, prevent this tax arbitrage, the domestic law provisions is the one most broadly applied.
In Italy, in addition to the general rules above mentioned, a new rule Art 44 of Italian CIT has been introduced since 2004 that denies dividend classification and related partial 95% taxation exemption to revenues coming from foreign instruments that might be classified as equity if revenue flows have been deducted in the Country of source.
As regards the typical Hybrid transactions, on the other hand, Italian rules do not cover with a specific anti- avoidance rule the deduction of interest coming from financial instruments that gives right to the interest flows receiver to benefit from the tax treatment on these revenues as dividend and therefore taxable or probably not taxable accordingly. The only Italian limitation applicable, also in the case of hybrids of this kind, is that provided for deduction restrictions on interest amounts.

4.4.2. Recent Italian law changes to corporation tax residence: Art 73 CIT

Italian law, on July 2006, introduced a new rule with reference to Tax Residence of corporation and any other entity which carries on business activity by entering into the "substance" concept of its residence, with the specific purpose of preventing and definitively attacking "paper", empty box structures finalized to shift income taxation deriving from Italian sources in the hands of holding companies resident in a low-tax
25 jurisdictions by way of so-called "estero vestizione" which has often been used to benefit from tax arbitrage.

Art. 35, Paragraphs 13 and 14 of D.L. 4 July 2006, n. 233 (as converted into Law n. 48 dated 4 August 2006), added two paragraphs: 5bis and 5ter to Article 73 of CIT which provides Tax residence of entities subject to IRES (CIT) once one of the following conditions (tests) are met within the Italian territory and for most of the fiscal period:

1. legal seat;
2. place of management;
3. main business activity carried on.

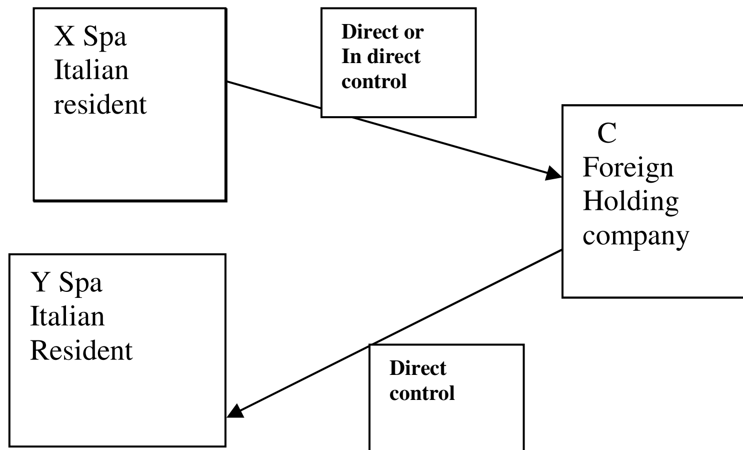
The first criteria is based on the formal content of incorporation deed and by-laws, the other two are related to the company management and operation within the limits of the Corporate purpose, those criteria should be evaluated case by case and for the sake of simplicity: considering where Board of Directors' meetings are actually held or where strategic managerial decisions are taken.

The amended version of Art 73, without changing the main content of the residence concept, enhances the real operative substance check in verifying the Italian Tax residence tests by introducing a legal presumption which considers, *to the extent it is not proved differently*, the place of management within the Italian territory and therefore as an Italian tax resident, any foreign corporation or business entity which directly owns participation control in an Italian company or business entity and
meets one of the following conditions:

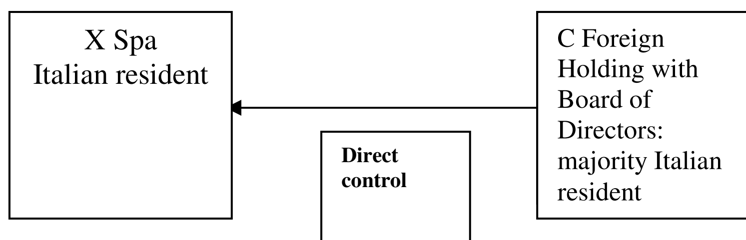
1. is controlled, also indirectly, by an Italian resident (individual or entity) **or**

2. is managed by a Board of Directors or any other equivalent managerial function, the majority of which is represented by Italian residents.

Case 1



Case 2



It is immediately evident that this rule might have a direct impact on foreign holding companies, for which the tax residence in the Country where it is located is not effectively proved and therefore, according to Italian rules for residents, it becomes

taxable on a worldwide basis and subject to the related tax accomplishments such as filing income tax returns and payments accordingly, as well as any potential penalty for failing the above mentioned obligations.
The new rule has been in force as from the 2006 Fiscal period when the law was been implemented.

Clearly this presumption, without changing the contents of tax residence commonly shared on an international basis, shifts onto the taxpayer the burden of proof of foreign tax residence of the company, giving the Italian Tax Authorities the undoubted advantage of avoiding deep and somehow useless assessments of operative key factors linked to the effective place of management usually unknown to them without entering into, for example, cross-border exchanges of information, where possible.

As mentioned above, one of the conditions to be met and that is required, for legal presumption application purposes, by a foreign holding which owns an Italian subsidiary, is the control also indirectly of said foreign company by an Italian resident as of the date of fiscal period end related to the foreign company itself.

It is important to outline that the control meaning refers to the wider concept set forth by Art 2359, paragraph 1of the Civil Code which includes.

- Majority of voting rights in the ordinary shareholders' meeting;
- Availability of voting rights necessary to exercise a dominant influence on the Italian entity (by having a *de facto* control);

- Dominant influence of Italian entity by way of contractual relationships also in case no participation or voting right is available at the level of foreign company.

Therefore it would be extremely important to have a clear understanding of the control chain of an Italian company and particularly to know who is at the top since the above-mentioned condition will be applicable to any tier sub-holding[118] which at the end directly owns the Italian subsidiary regardless of the level at which Italian resident[119] shareholders are located within the Group chart.

As far as the condition which refers to Board of directors or equivalent Corporate body, the majority of whom are Italian residents, is concerned, it has to be outlined that the law directly links the place of management to the residence of foreign Board members, assuming that, unless proved differently, the decisions related to the Italian subsidiary have been made on Italian territory. Therefore, in this latter case it is crucial to be in a position to prove the real and effective management of the company outside Italy by way of documental evidence[120] such as travelling expenses of Board members, management of foreign accounts abroad, binding powers of attorney to foreign people, managers of business strategic Corporate functions located in the foreign jurisdiction, any fact which might enhance the "substance" of foreign entity with regard to its

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[118] These are the same comments reported by Ministerial official guidelines related to the new rule: CM n. 28/E/06.

[119] Either corporation or individual including, for control purpose, in this latter case also the percentage of voting rights/dominant influence of wife/husband, direct or " in law" relatives such as brother or brother in law

[120] Unfortunately in this respect no official guideline has been issued either by the Government and by the Ministry of finance to have better understanding of any fact and document that might represent a proof of "substantial" place of management within the foreign Country .

activity together with certification of foreign tax residence issued by foreign tax Authorities[121], etc.

One of the most interesting discussions on the content and the application of the new rule is related to its compatibility with the OECD model residence clause (Art 4) and with fundamental EU principles, particularly with freedom of establishment.

As previously mentioned, the new rule did not change the contents of tax residence principles that are still in compliance with those accepted at international level mainly based on place of management and its concrete interpretation and application case by case. Therefore there should not be any conflict where potential double taxation might arise since the domestic rule which presumes the Italian tax residence in case of evidence proved to the contrary, according to the OECD model as well, will cease its effectiveness in favour of the real and factual proof of foreign residency outside of Italy.

As a consequence of said principle, to avoid potential double taxation on income earned by the foreign company, to be considered as an Italian tax resident both under the OECD model and the domestic rule, in the Country where it is located, the foreign tax credit to recover taxes already paid abroad will be allowed. This would be particularly useful if the foreign Country sustained the presence of a permanent establishment of the Holding company within its territory, since the same income would be included both in the permanent establishment and in the Italian taxable basis.

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[121] Such a tax residence certification should not be considered as a solution *per se* due to the fact that in certain jurisdiction it would be issued without any check of real company consistency and substance.

Once said Holding company was recognized as an Italian resident, consistently no withholding tax on royalties, interest, dividend flows from the Italian resident could be applicable, and in any case, those withholding taxes if applied could be credited.

As regards compatibility of the new rule with EU principles and potential discriminatory purposes, the taxpayer's opportunity to provide proof, case by case, to the contrary in compliance with the law provision, might represent a condition to respect the proportionality principle of a rule (burden of proof) introduced at local level to reduce the tax avoidance intention by way of the previously mentioned "estero vestizione" of income that actually belongs to Italian resident companies.

As reported by the Ministry of Finance[122], the European Court of Justice sentences (*Centros* C 81/87 and Uberseering BV vs. Nordic Construction Company Baumanagement Gmbh C- 208/00) within compliance with other EU principles, such as the aforementioned proportionality principle, any Member State can locally define based on national competence the facts and items which represent legal presumption, so-called connecting factors of tax residence within its territory even if the Company has been validly incorporated under the law of one Member State : *"It is not inconceivable that overriding requirements relating to general interest, such as the protection of creditors …and even the taxation authorities, may, in certain circumstances and under certain conditions, justify restrictions on freedom of establishment"*.

[122] CM n. 28/E/06.

In any case, the above mentioned conclusions would be reasonably sustainable as long as there had been no approximation of law and its interpretation, and therefore it would be crucial to clarify as soon as possible the content of proof, or better, the “place of management” company concept relating to a Company not incorporated within the Italian territory, in other words to clarify, at international tax level, the recurrent concept of the “substance test”.

4.4.3 Recent case Bell-Telecom: How a Foreign Holding company might be reclassified as an Italian tax resident

One of the most recent debatable cases of the renewed interest on International cross-border structure from the Italian Tax Authorities has been the so-called BELL-TELECOM case that occurred during 2007.

Italian tax authorities assessed as additional taxes : €600 million and as penalty: €1 billion on a gain achieved from the 2001 sale of a controlling stake in Italian telecommunications giant Telecom Italia. Only few years before, Telecom Italia was under State control and then it was purchased by Italian private owners.

The owner and seller of the stock was a Luxembourg holding company controlled by the Italian shareholders. The holding company sold the stock at a gain of €2 billion and immediately distributed the gain to its shareholders as a dividend. The gain was exempt from tax under article 13 of the Italy-Luxembourg tax treaty, while the dividends were exempt from withholding tax in Luxembourg and from Italian tax on the shareholders

under the EU parent-subsidiary directive. The Luxembourg holding company remained in existence, with gross assets of just €34 million to cover its liabilities.

The Italian tax authorities considered the transaction to be tax evasion, saying it was based on the creation of an artificial foreign entity to hold Italian stock solely to avoid the Italian capital gains tax on the sale of the stock. Tax authorities held the Luxembourg holding company's Italian controlling shareholders and directors jointly liable, along with the Luxembourg holding company, for the tax and penalty charged.

The total amount of €1.6 billion, for which a notice of deficiency was issued to the Luxembourg holding company and its directors and shareholders, is equal to 0.1% of Italy's GDP.

Based on the results of an investigation that lasted more than three years, Italian tax authorities concluded that the Luxembourg holding company, which was organized under Luxembourg law and had its registered seat in Luxembourg, was actually managed from Italy, and it is therefore to be regarded as an Italian resident company subject to tax in Italy on its worldwide income under the place of administration test of article 73 of the Italian Tax Code and the place of effective management test of article 4 of the Italy-Luxembourg tax treaty.

The evidence considered included the following facts:

* the Luxembourg holding company had no employees, staff, offices, or assets in Luxembourg;

* the international law firm that represented the Luxembourg holding company and its shareholders prepared all of the company's board resolutions, minutes of meetings, contracts, and so on out of its Italian office (which was also the Italian domicile of the Luxembourg company), and attended meetings and signed contractual documents in Italy; and

* contractual negotiations and discussions concerning the Luxembourg holding company's business were conducted through an office of the company's main Italian shareholder in Italy, and most of the Luxembourg holding company's shareholders (and directors) are Italian-resident companies or individuals.

Italy's Tax Code determines the tax residency of companies and entities based on three criteria: registered seat, place of administration, and principal place of business.

The place of administration is a facts and circumstances test that resembles the place of effective management test used in tax treaties. It looks at the place where the company is actually managed and where the strategic decisions about the company's business are actually made, regardless of the place where the company's registered office is located or where its board of directors meets to formally ratify such decisions.

With the 2007 Budget Law, Italy's legislature reinforced the residency tests of the Tax Code to combat the common practice of holding Italian companies through nonresident companies organized in other EU Member States (typically Luxembourg and the Netherlands) in order to achieve substantial tax benefits, including the exemption of gains and dividends. Gains typically are exempted under article 13 of a tax treaty between Italy and the other contracting State where the holding company is organized,

and dividends are exempt (both from withholding tax and shareholders' tax) under the parent-subsidiary directive.

According to new article 73, paragraph 5-ter of the Italian Tax Code, if a foreign company directly or indirectly controls an Italian company at the end of its fiscal year and the majority of its shareholders or the majority of its directors are Italian-resident individuals or entities, the foreign company is presumed to be an Italian-resident company for Italian tax purposes. That presumption can be rebutted, but the burden of proof is on the taxpayer.

As a result of the reclassification of a foreign company as an Italian-resident company, the foreign company is subject to tax in Italy on its worldwide income.

Because the new provision does not create a new tax residency test, but only a presumption for the operation of the existing place of administration test, it may apply retroactively.

The grounds of the proof and whether the tax administration's conclusions over this Bell-Telecom case investigation seem to be in principle in line with the rationale of the new provision, should be verified under the case law that is still pending.

4.5. UK consultation on financial products avoidance

During 2007 year we witnessed significant and relevant attention being paid by Her Majesty's Revenue & Customs (HMRC) as well by the UK Government to abusive structures, especially relating to cross-border financing structures.

HMRC issued a draft guidance on the meaning of beneficial ownership within the International context and Treaty application after the sentence ruled by the Court of Appeal on 2006 with reference to Indofood International Finance Ltd case v JP Morgan Chase Bank London branch where Court decided based on two of main sensitive issues from an International Tax treaty perspective such as beneficial ownership and conduit structure to avoid withholding tax application. In the Indofood case, the challenge was that a Dutch SPV, suggested by JP Morgan, should have been interposed as conduit simply for the purpose of benefiting from a lower treaty rate on interest loan repayment instead of the domestic 20% provided by the borrower's Country.

The essential point of the judgement to define the Dutch company as conduit was the fact that the latter would have been fully entitled to receive interest but without any freedom regarding what to do with the interest once received.

Therefore the guidance would narrow down the interpretation of beneficial ownership in the context of Tax Treaties to the one who is fully entitled to the revenue flows but who can enjoy the full privilege of directly benefiting from that income.

By continuing to analyse the UK efforts in the process of exploring tax anti-abuse measures, an interesting example of how a consistent tax anti-avoidance approach and

the need for standards are important and urgent points in the agenda, is the fact that the UK government, after having implemented a wide range of rules and tax shelter disclosure obligations, feels that it would probably be more effective to find few and essential, crucial principles on which to consistently and robustly build the attack to any artificial structure created for the purpose of tax saving on cross-border law differences.

Following the Pre-Budget Report in November 2007, HM Treasury published on 6 December 2007 a consultation document 'Principles-based approach to financial products avoidance'.

The consultation document explores the possibility of replacing existing detailed anti-avoidance rules in two areas with legislation which instead applies a principles-based approach. The two areas concerned involve:

- disguised interest - where taxable interest is converted into exempt income or a capital gain; and
- sales of income streams - where taxable income is converted into something that may be treated by tax law as capital

This consultation document has been released by the UK Government, since in the past it often responded to avoidance, as other Countries did, by setting out very detailed rules trying to close loopholes that are inevitably connected to the way in which the rules are set and implemented.

These detailed rules constantly increased complex controls on compliance works and consequently the burden both for taxpayers and the Tax Administration.

Therefore the UK would like to change its approach especially in *tackling and preventing* abuse of cross-border tax arbitrage to exploit distinctions in tax laws in order to pay less than the tax principles regime by way of the so-called “Principle based approach”.

To state principles is simpler and promotes fairness and consistency in tax treatment, and this approach, if shared by the majority of Business Community interests, will repeal in a short period of time the currently existing rules. Comments will be expected by the beginning to middle of 2008.

The aim of simplification based on mere statements of principles is based on the fact that it is more difficult for avoiders to argue that a scheme does not contravene principles than to argue that a scheme meets the literal requirements of the statute.

The principles approach will apply to so-called *disguised interest* avoidance schemes which exploit differences in the tax treatment between interest and other receipts such as dividends and seeks to convert taxable interest into exempt dividends or capital gain.

Example:

Company B issues cumulative preference shares which are treated for accounting purposes as liability and which pay a dividend (grossed up to tax) that equates the interest lending rates (assuming that Company A is out of the scope of the UK 95 ICTA).

Depending on the facts , this transaction may fall within the scope of the new rules if, for instance, the arrangement was one under which company A were accessing company B's losses with the tax benefits shared between companies A and B. This would be considered by HMRC as an unallowable purpose.

The Principles approach will set forth: a return designated to be economically equivalent to interest is to be taxed in the same way as interest without entering into any reason for implementing the structure.

The Principle applies when a company is a party to an arrangement designated to produce for the company a tax privileged investment return, the return is to be treated for the corporation tax as a profit from a loan relationship of the company.

In the case any return is provided the income tax return will include the return according to the recognition accounting principle.

Tax privileged return is a return for money or any other assets which:

- equates in substance to the return on an investment of money at interest and
- It is not charged or not wholly charged to tax on the company as an amount of income and is not brought into accounting when calculating taxes;

The principle also applies to shares if one of the main purposes for which the company owns the shares is:

- The purpose of circumventing section 95 of ICTA (taxation of dealers in respect of distribution or any other purpose that constitutes tax avoidance.

The principle applies to the second main scope of the sophisticated financial instruments represented by sale of income stream as a device to try to turn economic income into a return that is treated by tax law as capital.

The proposed principles-based legislation is designed to provide receipts which derive from a right to receive income and do not involve any loss of capital, economic substitutes of income are to be treated for tax purposes as income.

This principle applies to:

- a person, subject to income tax, transfers a right to receive income to another person and
- if the income arises from an assets but the asset is not transferred to the transferee.

Considerations should be recognized according to the accounting principles.

The principle deals with the sale of income stream in cases where the seller retains the underlying asset from which the income arises or the seller transfers the stripped underlying asset to another person or where there is no underlying asset.

Example

A company has an existing obligation to pay 10 in relation to a purchase of an asset to be used in its business, in discharge of its debt it assigns to the vendor a right to payments from a long term contract which have not yet been recorded as trade receivables.

If the income is not at present charged to tax as a whole, with the application of the new provision this will be done in a proper manner.

5. Emergence of "faithful implementation of international obligations" and "abuse of rights" concepts as binding rules within the International tax law context to be enhanced by the jurisdiction of any Country

The structural changes in the legal order within the international system as well as the ongoing developments of inter-governmental relationships, of international organizations, caused by citizens' movements, multinational corporations, capital market, raise the issue of how this complex phenomenon impacts International law and the role of the single Nation, in looking for global governance as a functional unity between international and domestic law.

Therefore, as stated by the European Commission,[123] it is crucial that single jurisdictions avoid overreacting to the case law. It would be regrettable if, to avoid the charge of discrimination, any Country simply extended the application of anti-abuse measures designed to curb cross-border tax shelters to purely domestic situations where no possible risk of abuse exists and vice-versa. Such unilateral remedies only add unnecessary red flag and thus, they undermine the competitiveness among Countries' economies, and are not in the interest of the International Market belonging to the Business Community as whole.

Moreover, a further issue to debate on this issue would be how all restrictive measures can be rendered effective in line with the Treaties' obligations, and how to enforce them within the meaning of International cooperation when conflicts arise.

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[123] COM 2007/1785 dated 10 December 2007

Moreover, and notwithstanding the guidance laid down, the need to prevent tax avoidance or abuse can constitute an overriding reason in the public interest capable of justifying a restriction on fundamental freedoms. However, in order to be lawful, national anti-avoidance rules must be proportionate and serve the specific purpose of preventing wholly artificial arrangements. It is particularly clear that those rules must not be framed too broadly but be targeted at situations where there is no genuine establishment or more generally where there is a lack of commercial underpinning.

It is clear from the ECJ case law that, for instance, CFC and thin capitalization rules[124] are generally apt to achieve their intended purpose and that they are not per se incompatible with the EC Treaty freedoms. However, such rules must be accurately targeted at situations of abuse and proportionate to the objective of preventing abuse.

The number of infringement proceedings begun by the Commission has increased over the last few years. It is not always necessary for such cases to end up before the Court because Member States often respond by removing the unlawful restriction.

But while the Commission has the legal obligation to ensure that Member States observe their EC Treaty obligations, it also has a political responsibility to seek and promote constructive tax policy solutions to that end. Possibly to avoid the application of anti-abuse measures designed to curb cross-border tax avoidance to situations where no possible risk of abuse exists, unilateral remedies only undermine the competitiveness within the International Market.

Coordination and cooperation between the Member States can enable them to attain their tax policy goals and protect their tax bases while observing their EC Treaty

[124] With reference to both issues, for instance the German legislator changed its law to be compliant with ECJ principles

obligations and ensuring the elimination of double taxation only by way anti-abuse rules accurately targeted at situations of abuse, that are predictable and proportionate.

Coordination means a flexible approach which can take many forms and which could provide adequate solutions to challenges faced by the Countries in a globalized world. Therefore the Commission considers it useful to explore the scope for possible specific coordinated solutions in the light of:

- developing common definitions for abuse and wholly artificial arrangements (to provide guidance on the application of those concepts in the direct tax area[125]);
- improving administrative co-operation so as to more effectively detect and contain abuse and fraudulent tax schemes;
- sharing best practices that are compatible with EC law, in particular with a view to ensuring proportionality of anti-abuse measures;
- reducing potential mismatches resulting in inadvertent non-taxation; and
- ensuring better coordination of anti-abuse measures in relation to third countries.

Any possible coordinated solutions should enable the Member States to attain their tax policy goals and protect their tax bases while observing their EC Treaty obligations. The key objectives of this initiative are indeed to strike a proper balance between the public interest of combating abuse and the need to avoid disproportionate restrictions on cross-border activity within the EU, as well as to improve the coordination of the application of increased anti-abuse rules widely issued by Member Countries especially over the last decade in relation to international tax avoidance schemes in order to protect their tax bases against the International tax arbitrage phenomenon.

[125] Considering the recent Halifax and other case law, these guidelines are likely to also be extended to indirect taxes.

Coordinated restrictions on cross-border activities will lead to effective tax systems which allow tax and social requirements of equality to be met in the interest of honest taxpayers who do not want to finance the erosion of tax bases due to abusive practices.

On the other hand, in the new political age of cutting the Governmental expenses of people and funds, it is becoming more and more important to find an effective tax system and, therefore, the key factor is to simplify the tax law system as well compliance control, since their complexity will result in additional costly over-structure and the increased possibility of avoiders finding loopholes and the lack of real control on progressive taxable basis erosion attached to the internationalization process of companies.

Albeit still controversial126, the traditional distinction between so-called “hard law” and other non-binding regulatory and judiciary instruments as admissible sources of International law, is recently and increasingly blurred127 towards a concept of International law that has to include a complex blend of customary, positive, declarative and “soft law” principles, not only to simply ratify existing practice but to elevate them to regular accepted international legal obligations to promote and to comply with in order to fulfill the fundamental purpose of comprehensively civilizing international relations.

The primary aims of international law would be a dynamic conformity of this legal order to the ever changing sociological, economic, environmental circumstances for

[126] German Court’s decision (BverfG 2BvR 1481/04 of 14 October 2004) and Brownlie, Principles of Public International Law (Claredon Press Oxford 1990).

[127] Nowrot Karsten, Global Governance and International law, paper from the series “ Beitrage zum Transnationalen Wirtschaftsrecht”, 2004

promoting international community interest standards by way of "constitutionalization of international law"128.

This reconceptualization would bring to the conclusion that the substantive norms of international law provide the underlying values, the goals to be pursued by the various and diverse process of global governance129

By providing these substantive guidelines, international law thereby ensures that global governance will grow within set of rules and serves the purpose of developing standards for the global public good as changed over the last decades.

International law, based on comprehensive analysis of the changing concept of legitimacy and the various approaches adopted in this regard, also creates the basis for disputing the regulatory framework of global governance.

According to this purpose, Art 38 of Statute of the International Court of Justice (ICJ)130 should be necessarily reviewed to assess whether the sources of international law are still an exhaustive list or whether they have to be conceptually expanded in

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128 Tietje Christian, and Norwort Karsten, Forming the Centre of a Transnational Economic legal Order? Thoughts on the current and the future position of Non State Actors in WTO law, 5 European Business organization law review, 2004

[129] Nowort Karsten, supra.

[130] ART 38 of Statute of International Court of Justice

"1. The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:

- the international conventions, whether general or particular establishing rules expressly recognized by the contesting States;
- international custom, as general evidence of a general practice accepted as law;
- the general principles of law recognized by civilized nations;
- subject to the provisions of Article 593, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law.

2. This provision shall not prejudice the power of the Court to decide a case ex aequo et bono, if the parties agree thereto".

order to take into consideration the increasing importance of supranational public interest brought by the non-state actors and International governmental organizations.

The International legal order has always been dependent on conformity to realities and an interdisciplinary approach within the International system on a legal basis; nevertheless the classic definition of sources is progressively widening and the understanding of “state practice” under Art 38 (1) b of the ICJ Statute as one of the constitutive elements of customary international law recently seems open to the contribution of International Organizations through their practice in the formation of customary international law, to the extent there is evidence that such a general practice is accepted as law by the international community.

Therefore the existence of international customary law implies the recognition of international legal obligations that come from the practice of the international community perceived as whole that would be protected by any discretionary nationalist attempt by the constraints of abuse of rights.

States together with International organizations could make their practice contribution to international law only if carefully possible abuse or adverse consequences to the global public good and their related rights were assessed.

Lack of concerted interaction between Countries' tax systems may result in unintended non-taxation and provide scope for abuse, thus undermining their fairness and balance. Mismatches may arise, for example, in relation to the qualification of debt and equity. One Country, as already mentioned with reference to Hybrid structure, may consider a transaction to be an equity injection and thereby exempt the income derived from it (as

profit distribution), whereas another Country may consider the same transaction to be a loan and allow tax deductibility for the consequent payments (as interest). This may result in a deduction in one Country without corresponding taxation in another one. Based on the same disconnected rules is the tax planning around hybrid entities, i.e. entities which are regarded as corporate bodies by one Country and as transparent entities by another. This difference in qualification may lead to double exemptions or double deductions. Such problems are best tackled at source, by reducing the occurrence of mismatches. Failing that, it is desirable to improve administrative co-operation to detect situations in which such mismatches are exploited abusively. Administrative co-operation on fraudulent tax schemes and specific cases of abuse can be of key importance in ensuring the effectiveness of anti-abuse measures. Tax avoidance schemes are often highly complex and can involve operations in many different jurisdictions, which makes it incredibly difficult and costly for any single Country to detect and combat such schemes on its own. Moreover, targeted anti-abuse measures involve a high burden of proof for tax administrations, which makes co-operation between them all the more important best practice as well as improves the consciousness of the taxpayer regarding abusive and regrettable structures from those that are still lawful. It would also be a cultural problem in rendering taxation part of economic cost saving goals by preserving the corporate or individual responsibility towards such practices wherever they play their economic role by contributing to the public growth.

5.1 Abuse of right as a Principle of International law

The good faith principle, as a pillar of International law, is the aim of any International agreement.

There is a document issued by the United Nations[131] relating to Multinational companies where it is stated: "*States which have adopted the Code would not be able to attack as inherently unlawful or improper any action by other States taken in accordance with provisions of the code",* certain Authors[132], if it is still controversial[133] matter, sustain that the good faith principle by way of its natural implication represented by the anti-inconsistency rules which would not allow unlawful or improper action to be taken against common shared belief, represents the meaningful "abuse of right" concept as well. Therefore the "abuse of rights" concept deriving from the lawful respect of International obligations should be considered as standard comparable to an International customary rule based on which there is reasonable expectation of reciprocity acts among Countries that will operate accordingly, even though this concept of "abuse of rights" has not been formally subscribed through a binding agreement at International level but consistently evidenced "de facto" and widely legally implemented at domestic level.

The International Business environment is changing faster than any legal framework; therefore the global governance of this process could not disregard the need to adapt the

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[131] UN Doc E/C.10/AC.2/9, dated 22 December 1978: "Certain Modalities for implementation of a Code of conduct in Relation to its possible Legal nature"

[132] Baade H W, The Legal Effects of Code of Conduct for Multinational Enterprises, in N. Horn, Kluwer 1980.

[133] Brownlie I, supra

International Customary rules to new contents belonging to new economic scenarios and, therefore, it is totally conceivable where laws do not contain the specific provision for dealing with the conflicting matters or achieved results are not yet uniform[134] but there is a discernable trend internationally in the application of *the abuse of rights*, to rely upon such a *general principle* of the International Customary rule as the inspired principles that *uniformly and constantly* have to safeguard the public and private interests regardless the national borders.

If the main interests of civilized nations are the same, such as promoting economic and social welfare, regardless of the different meaning or wording of the law the conclusion could not be shared that violation of the general principle of good faith in preventing unlawful or improper action, should be removed as abusive.

Therefore any abusive structure, also within the taxation field, might represent at International level an attack of legal duties of lawful behaviour such as to pay taxes.

Customary International Law is not immune to changes, even over short period of time. However, as it has been observed, this happens in new areas of law and is usually driven by the newness of the situation, the lack of rules to the contrary and the necessity to preserve a sense of regulation in international relations [135]

[134] Avery Jones, Ward David, The business purpose test and abuse of rights, British law rev, 1985

[135] Engelen F, supra

5.2 Business purpose and Abuse of Rights as effective supranational constraints to tax shelters.

The difficulty in finding proper and detailed anti-avoidance rules that might definitively curb the cross-border tax arbitrage of those structures without any purposive activity, is mainly due to the undetermined possibility of having different forms, implementation schemes, and they are changing by adapting solutions to taxpayers' intentions.

As previously mentioned, tax shelters may or may not rely upon DTC abuse, they could use cross-border inconsistencies depending on different domestic tax treatments of same revenues or different income qualification (interest vs. dividend); therefore there is no *all- in-one* solution from legislative and judicial perspective to those sham transactions.

It is necessary to find a valuable concept for the convergence of Countries to limit their rights to apply their domestic anti-abuse provisions within the general principles stated at International level[136].

Nevertheless, this process to deprive Countries[137] of the right to choose whether and how to counter abusive practices cannot be afforded without an adequate and conscious awareness of the benefit of enjoying the consistency and coherence of lawful obligations assumed by the Governments in the International setting.

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[136] For European Countries these coordination efforts might be slightly easier based on binding principles stated by ECJ

[137] Opinion Statement of the CFE ECJ Task Force, on the concept of the abuse in European law, CFE November 2007

While abuse of rights also in tax matters widely belongs to the Civil law (droit civil) concept, the business purpose test has often been accepted in an extensive number of Common law jurisdictions to counteract the abusive structure without any purposive activity and economic substance except for the tax benefit, or when the taxpayer tries to circumvent the scope of a taxing rule.

The scope similarity in approaching the avoidance and the fairly consistent and uniform rejection of tax shelters might lead to the consideration that *abuse of rights* and the *business purpose test* are the two faces of the same coin. Both concepts are systematically recurrent within the enactment of broad statutory anti-tax-avoidance provisions or through the legal principles used by the Court for interpreting the case even in the absence of specific International anti-avoidance law provisions[138].

The right and the principle behind that has social purpose and therefore it should be considered as *abuse of right* when it has been exercised in a way that is detrimental to that purpose.

Therefore the *abuse of rights* together with the *business purpose test* have become the necessary tools to permit Administrations and Courts to fill the legislative gaps, or better, the loopholes, and to give the legislation and its interpretation a degree of flexibility to meet changing circumstances[139] without constant amendments and giving to the tax payer the necessary juridical certainty, minimizing litigation, to rely upon for the long run of its business challenge concerning the World's Global Playing Field. This is not a mere national self-interest regarding interactions within States facing similar problems, but is a valuable cooperation principle to reach global governance as well as

[138] Janfin vs French Ministry of Finance.
[139] AA.VV The Business purpose and abuse of rights, British tax law rev, 1985

fair competition on the market place that are commonly recognized as necessary conditions by any State within the International landscape.

The legitimate expectation of Countries and their people to rely, within the International context, upon the fair and consistent practice of legal obligation in respecting similar rules against tax avoidance, might be represented by the Customary international law, the supranational effective constraint to the abuse of rights which should be formed by widespread state practice in conformity with a particular norm, coupled with opinio juris or state judgement that such conduct is required by international law itself [140]

[140] Contra Brownlie Ian, Principles of Public International law, Claredon press Oxford 1990, pag446, he concludes that the doctrine of abuse of rights is a useful agent in the progressive development of the law, but, that as a general principle it does not exist in a positive law. Gutzman A.T., A Compliance-Based Theory of international law in Cal. L. Rev, 2002.

6. Conclusions

The analysis of my doctoral thesis led me to a parallelism with a famous Greek legend where the natural desire of any human being to improve living conditions, to pass new frontiers, to find recognition and to share fear and joy with the Community, do not give to humans the immediate understanding of the value related to any discovery and the difference between disobeying for self-interest or for the benefit of the Community.

This legend refers to Prometheus, he was a Titan, a giant-like figure from Greek mythology. He was asked by Zeus to create human beings, and instructed to make them almost god-like in their faculties of speech, reason and understanding. However, Zeus made one exception: human beings were not to have fire.

Knowing what an intelligent being could do with fire, Zeus was afraid that humanity might use it to overthrow the gods.

Prometheus duly created human beings, but was so taken with his creation that he decided to disobey Zeus. He stole fire from heaven and gave it to humanity. This of course gave them just that mastery of the world that Zeus had feared, and gods were indeed overthrown in the most radical sense possible.

So it was through Prometheus that humanity obtained the power not only to understand but also to transform the world. In the words of Aeschylus, the first great poet of the Promethean legend:

Hear the sum of the whole matter in the compass of one brief word, every art possessed by man comes from Prometheus.

Enormous progress has been made thanks to International Organizations, Institutions, Courts, Scholars, in sharing the best practices and improving knowledge of principles within the International tax field.

Therefore it was for the benefit of the Community that fire was stolen to transform the world and dismiss any selfish myth but only rely upon the force coming from the light of the fire that is giving humanity the intelligence to moving forward.

As any given opportunity, we need to understand how to protect the source of our future welfare, how protect it from any abuse or to any thief, the only way to ensure that the light will last forever is to trust Community and strongly believe that our self-interest does not give us greater relief and the sanction for not being compliant with Community rules is not participating and going out of the Trust Circle and feeling alone, much more painful than any potential and temporary benefit reached in violating the Community governance rules.

It was not by chance that Prometheus started the process and it would not be by chance as well that humanity can continue the evolution.

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