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SPECIAL REPORT

What an Individual EU Country Can Do Unilaterally to Counteract BEPS

by Gustav M. Obermair and Lorenz Jarass

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In June 2015 the European Commission presented proposals for ''A Fair and Efficient Corporate Tax System in the European Union,'' which need EU unanimity for realization. In this article, Obermair and Jarass present tax measures that can be implemented unilaterally by individual EU member states without prior international harmonization. The measures would increase national tax revenue and improve the competitiveness of a country's enterprises, which could encourage other EU member states to take similar action.

I. Base Erosion and Profit Shifting

Recently, there has been growing public awareness that multinational enterprises can plan their worldwide production and trade chains so that they avoid nearly all taxation in most countries.

Base erosion and profit shifting are the two components of tax avoidance strategies, made possible by the lack of worldwide standards and regimes for enterprise taxation.

The OECD's July 2013 action plan to address BEPS outlines many harms:

- governments are harmed because a lack of tax revenue leads to critical underfunding of public investment, and overall resource allocation, affected by tax-motivated behavior, is not optimal;
- individual taxpayers are harmed because tax rules that let businesses reduce their tax burden by shifting their income away from jurisdictions where income-producing activities are conducted result in other taxpayers in that jurisdiction bearing a greater share of the burden; and
- businesses are harmed because corporations, including family-owned businesses, that operate only in domestic markets have difficulty competing with MNEs that can shift their profits across borders to avoid or reduce taxes.

''Fair competition is harmed by the distortions induced by BEPS,'' the OECD said.

But there is more at stake than the (considerable) loss of tax revenue and damage to fair competition: Even though immersed in a global economy, it is still up to the national states to provide and ensure most of what people need for their welfare — that is, infrastructure in the widest sense. The revenue from legitimate, fair taxation is needed for that; hence, the monopoly of the modern state to levy taxes on the proceeds of the economic activities within its legal regime.

Angel Gurría, secretary general of the OECD, clearly expressed the motives, goals, and methods of the action plan, saying the OECD wanted to avoid double taxation and double nontaxation and created a set of laws and regulations to ensure taxes are paid where value is created and the economic activities take place.[1]

In 2013 Gurría told the G-20, ''Right now, income goes untaxed anywhere because it is reported in jurisdictions different from those where activities take place.''[2]

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[1]Interview with Angel Gurría, *Handelsblatt*, Feb. 13, 2013.

[2]Gurría, in remarks to G-20 Finance Ministers and Central Bank Governors in Washington (Apr. 19, 2013), *available at* http://www.oecd.org/unitedstates/taxtransparencyandbepspresentationtog20financeministersandcentralbankgovernors.htm.

At its 2014 meeting, the G-20 again emphasized the reform program that the OECD and the G-20 countries had begun to pursue, saying, ''Profits should be taxed where economic activities deriving the profits are performed and where value is created.''[3]

The OECD action plan (to be finalized in late 2015) is a collection of well-founded tax proposals for the working groups organized by the OECD. However, neither the OECD nor the G-20 has authority over any resulting legislation, and the EU has authority only if its 28 member countries reach unanimous decisions.[4] Moreover, the actual collection of taxes remains in the hands of national tax authorities that are often reluctant to change their traditional practice.

In December 2013 the European Parliament passed a resolution demanding binding commitments against tax evasion and tax avoidance within the EU[5] and in July 2015 stressed ''that tax avoidance by some Multinational Corporations can result in close-to-zero effective tax rates for the profits generated in European jurisdictions, highlighting the fact that such Multinational Corporations, while benefiting from various public goods and services where they operate, do not pay their fair share, thereby contributing to national tax base erosion.''[6] In June 2015 the European Commission published an action plan for ensuring effective taxation where profits are generated.

The EU action plan, the OECD action plan, and the G-20 resolution show that relevant international organizations monitor and support attempts to fight tax avoidance and evasion.

A. Untaxed Interest and License Fee Payments

This article concentrates on what a country or group of countries can do to legislatively tax proceeds of economic activities and value production and thus obtain the revenue to maintain public infrastructure needed for that activity and production.

But how can the tax base for created value be identified? The difficulties become evident in Figure 1, which is a sketch of a typical global value chain of some MNEs.

On the right, the figure displays a hypothetical percentage split of the worldwide value creation supposedly produced in the various countries involved. It shows the complexity of the global economy with the additional problems of adequate exchange rates, correct transfer prices within the enterprise, and so on. But a national tax authority doesn't need estimates of value production as a base for taxation — it needs figures that only the enterprise can give and declare on its manifest earnings and how they are split:

- One share of the earnings will be spent to pay interest on loans, license fees, and so forth, representing the compensation for external capital.
- What remains is ''profit'' as compensation of equity.

In most countries, only the residual ''profit'' category is taxed at the source — that is, at the enterprise. The share transferred as interest, license fees, and other royalties is supposedly eventually taxed at the receiver and hence not at the source.

Here is the loophole that in a global economy allows the so-called tax planning — that is, systematic tax avoidance. If the receiver resides abroad, the national tax administration has no way to know or control whether that part of the MNE's earnings is taxed abroad at all.[7] We have indeed arrived at Gurría's double nontaxation, which of course is what the BEPS project ultimately hopes to eliminate.

Table 1 sketches the effects of globalization on the economic structure and taxation of enterprises, comparing the current situation with that of 40 years ago, when domestic business still prevailed:

- today, MNEs operate with or through their affiliates around the world, particularly in tax havens;
- tax-driven enterprises are more and more often financed by loans from the international capital market; and
- MNEs increasingly operate as licensees of some worldwide brand (for example, IKEA) or do business-to-consumer deliveries from a low-tax country without a permanent establishment in the country of the consumer (as Amazon.com Inc. did until May 2015 from Luxembourg to Germany).

In that way, MNEs avoid almost all taxation.

In Table 1, a comparison of lines (4a), (4b), and (4c) in columns A and B shows the effect that statutory tax rate decreasing in combination with BEPS has had on tax revenues from MNEs in large, industrialized countries.

[3]G-20 communiqué from the February 22-23, 2014, meeting of Finance Ministers and Central Bank Governors in Sydney, at para. 9.

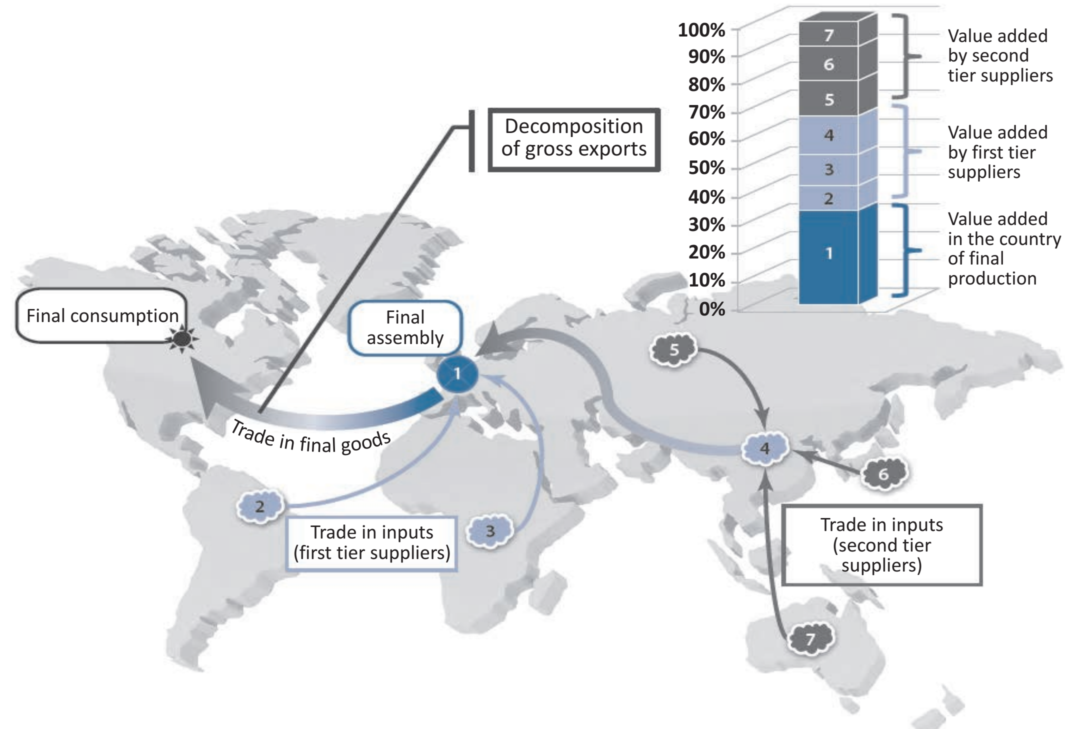
[4]Unanimity on how to address BEPS will hardly be achieved in the European Union because those members that benefit from the situation cannot be forced to agree to the respective measures.

[5]European Parliament, ''Resolution on the Call for a Measurable and Tangible Commitment Against Tax Evasion and Tax Avoidance in the EU,'' 2013/2963(RSP) (Dec. 12, 2013).

[6]European Parliament, ''Draft report on tax rulings and other measures similar in nature or effect,'' 2015/2066(INI) (July 20, 2015), p. 10.

[7]Incorrect transfer prices are another important loophole. Prices for imports from related enterprises are set higher (and exports priced lower) than arm's-length prices, thereby decreasing the profit shown in the high-tax country.

Figure 1. A Simplified Representation of a Global Value Chain



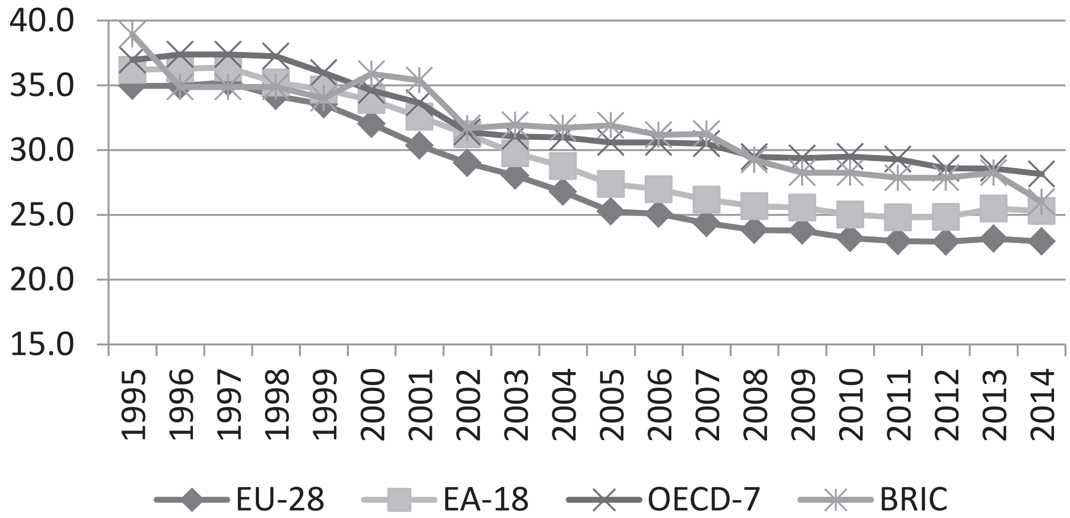
Source: OECD, "Addressing Base Erosion and Profit Shifting" (Feb. 12, 2013), at 26.

Table 1. Interest and License Fee Payments Remain Increasingly Untaxed in EU Countries

		(A) Up to Around 1980		(B) Today		
(1)	Tax systems unchanged	Traditional uncoordinated tax systems of EU countries				
(2)	Structure of typical enterprise	Companies in traditional national economies		Multinationals in today's global economy		
(3)	Origin of capital	Equity	Loans	Equity	Loans	Licenses
(3a)	Invested by	Domestic shareholders	Local banks, partners, etc.	International capital market		
(4)	Compensation of capital	⇩ Profit	⇩ Interest	⇩ Profit	⇩ Interest	⇩ Royalties
(4a)	Thereof taxable in EU member states	All	Most	All	Little	Little
(4b)	times statutory tax rate	⇩ 50%	⇩ 40%	⇩ 25%	⇩ 0%	⇩ 0%
(4c)	= Tax paid in EU countries	By company and by domestic shareholders	By domestic creditor	By company and by domestic shareholders	Goes largely untaxed abroad to international capital markets	

Typically, the tax actually paid is much less than it was 30 years ago, not only because of growing tax-avoiding possibilities but also because of drastic reductions of the statutory corporate tax rates from above 35 percent in 1995 to around 25 percent in 2014. Compare Figure 2.

Figure 2. Statutory Corporate Tax Rates, 1995-2014



Source: European Commission, "A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action" (June 17, 2015), graph 1.

That loss has been made up by wage earners and consumers who have had to pay increased VAT rates. And of course, the winners were not ordinary people in tax havens and less affluent countries but instead were mostly worldwide speculators.

B. Taxing All Earnings Produced Domestically

To comply with the OECD's BEPS action plan, individual countries have been admonished to take appropriate measures to ensure taxation where value is created. The phrase ''value created'' as used in OECD publications is a concept from economics that for tax purposes translates to earnings and thus is made suitable for tax law proposals.

It should be emphasized that taxing all earnings without deduction for interest and license fee payments in and by the source country could and should be at the center of any measures against tax avoidance.[8]

Table 2 gives an overview of two options intended to reduce BEPS incentives by extending taxation at the source while avoiding double taxation.

The European Parliament ''encourages further action at national level to tackle tax avoidance, within the EU and OECD frameworks.''[9]

Sections II and III of this article show that any individual EU country could unilaterally enforce both withholding taxes and conditioned limitations on deductions without EU harmonization.[10] We will especially show that comprehensive taxation at the source, including earnings paid for interest, license fees, and the like, is by no means ruled out by the relevant EU directive. On the contrary, this EU directive proposes measures to avoid both double taxation and double nontaxation, but attempts to comply with national tax law have made that complicated, to the advantage of international tax law specialists.

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[8]*See* Jarass, ''Brühler Empfehlungen zur Reform der Unternehmensbesteuerung. Unternehmensteuerreformkommission der Deutschen Bundesregierung, Anhang 7: Zinsbesteuerung,'' German Commission for Enterprise Tax Reform (1999) and German Federal Ministry of Finance (July 1999); Jarass and Obermair, *Unternehmenssteuereform 2008 — Kosten und Nutzen der Reformvorschläge*, MV-Verlag (2006), at Chapter 6; and Jarass and Obermair, ''Tax on Earnings Before Interest and Taxes Instead of Profit — Fair, Simple and Competitive. A Conceivable Initiative of EU Member States for a Common Consolidated Corporate Tax Base,'' 17 *EC Tax Review* 111 (June 2008).

(Footnote continued in next column.)

The 2008 German enterprise tax reform was based on the concepts of conditioned limitation for tax deduction of interest payments (*Zinsschranke*) and unconditioned limitation for German trade tax deduction of interest and license fee payments.

[9]European Parliament, ''Draft report on tax rulings and other measures similar in nature or effect,'' 2015/2066(INI) (July 20, 2015), p. 10.

[10]For details, see Jarass, ''Gewinnverkürzung und Gewinnverlagerung (BEPS): Nationale Massnahmen sind möglich und hilfreich,'' *IStR*, Heft 20/14; and Jarass and Obermair, *Faire und Effiziente Unternehmensbesteuerung — International geplante Massnahmen und national umsetzbare Reformvorschläge gegen Gewinnverkürzung und Gewinnverlagerung,* MV-Verlag (2015), at Chapter 4.

Table 2. Unconditioned Withholding Tax and Conditioned Limitation for Taxation Deduction

		(1) Unconditioned Withholding Tax	(2) Conditioned Limitation for Tax Deduction
(1a)	Source country	Withholding tax on all interest and license fee payments	Part of interest and license fee payments are not tax deductible
(1b)	Recipient country	Foreign withholding taxes may be credited or refunded	Disallowed deductions for interest and license fee payments may be reclassified as tax-free dividends
(2)	Result	Ensures a minimum taxation in the source country	Ensures a minimum taxation in the source country
(3)	Tax revenue consequences	Reallocation from recipient to source country	Reallocation from recipient to source country if final beneficiary is in tax haven

Source: Based on Jarass and Obermair, ''Tax on Earnings Before Interest and Taxes Instead of Profit — Fair, Simple and Competitive. A Conceivable Initiative of EU Member States for a Common Consolidated Corporate Tax Base,'' 17 *EC Tax Review* 111 (June 2008), Figure 1.

II. Interest and License Fee Payments

A. Withholding Taxes Often Reduced to 0 Percent

Many countries have introduced withholding taxes, in particular for interest and license fee payments to related parties. Compare Table 3.[11]

In many cases, however, existing tax treaties considerably reduce the withholding tax rate.[12] Within the EU, no withholding taxes are levied on payments between related parties with a stake of at least 25 percent or between unrelated parties.[13]

German tax treaties with emerging and developing countries do provide for withholding taxes. The March 2014 treaty with China includes a withholding tax rate of 10 percent for interest and license fee payments, the February 2014 treaty with Costa Rica includes a 5 percent rate. Tax treaties between Germany and industrialized countries generally disallow withholding taxes. To include them, Germany would first have to change its official position and then adapt or renegotiate its treaties with industrialized countries.

B. EU Directive Allows Withholding Tax

In contrast to a common opinion, the EU directive on interest and royalty payments generally does not forbid source taxation of all earnings produced by an enterprise, whether declared as profit or transferred to another enterprise domestic or abroad as payment for interest or license fees. In fact, the directive clearly states that it is intended to prevent double taxation while guaranteeing that all income is taxed once in some tax regime. It therefore provides that when source taxation is provided in some country, enterprises there must apply for exemption from withholding tax on their payments of interest and license fees, with proof that those payments will be taxed at the receiver at an adequate tax rate.[14]

For clarification, the European Commission has said it plans to ''amend the legislation so that Member States are not required to give beneficial treatment to interest and royalty payments if there is no effective taxation elsewhere in the EU.''[15] Therefore, opponents of withholding taxation can no longer refer to the 2003 EU directive as a general argument against withholding taxation.

Since 2003, however, many EU countries have themselves developed tax haven status — for example, by providing some kind of so-called interest, patent, and license box with a low or even zero tax rate for the received proceeds.[16] Thus, the guarantee of one-time taxation at an adequate rate can no longer be given; for direct or indirect payments to those boxes, the requirements for general withholding tax exemptions are futile because they can't be accompanied by proof that the final beneficiary (and not only the first receiver of the payment) is indeed taxed at an adequate tax rate.

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[11]For an overview for the statutory withholding tax rates for interest payments between related parties, see C. Spengel and K. Finke, ''Interest Allocation — Issues, Evidence, and Reforms'' (Oct. 16, 2013), at Table 3.

[12]Article 11 of the OECD model tax convention provides a withholding tax rate of 10 percent for interest payments, but article 12 excludes withholding taxes for license fee payments. Articles 11 and 12 of the U.N. model tax convention, however, allow withholding taxes both for interest and license fee payments, with the tax rates determined by bilateral agreements.

[13]*See* Council Directive 2003/49/EC (June 3, 2003).

[14]Jarass and Obermair 2015, *supra* note 8, at 70.

[15]European Commission, ''A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action'' (June 17, 2015), at 9.

[16]In 2014 Belgium, Cyprus, France, Hungary, Liechtenstein, Luxembourg, Malta, the Netherlands, Portugal, Spain, Switzerland (canton of Nidwalden), and the U.K. Antwort der Bundesregierung auf die Kleine Anfrage der Fraktion BÜNDNIS 90/DIE GRÜNEN — Drucksache 18/1125 — Steuergestaltung über Lizenz-bzw. Patentboxen. Deutscher Bundestag, Drucksache 18/1238, 18. Wahlperiode (Apr. 25, 2014), Schreiben des Bundesministeriums der Finanzen (Apr. 24, 2014), at 2.

Table 3. Existing Withholding Taxes on Interest and License Fee Payments, 2014

(1) Withholding Tax on Interest Payments		
(1.1)	No withholding tax	Austria, Cyprus, Denmark, Estonia, Finland, France, Germany, Hungary, Latvia, Luxembourg, Malta, the Netherlands, Norway, Sweden, Switzerland
(1.2)	Withholding tax ≤ 15%	Bulgaria, Croatia, the Czech Republic, Lithuania, Slovenia, Turkey
(1.3)	Withholding tax > 15%	Belgium, Greece, Ireland, Italy, Japan, Poland, Portugal, Romania, Slovakia, Spain, Switzerland, the U.K., the U.S.
(1.4)	Increased withholding tax for tax havens	Croatia, the Czech Republic, Denmark, France, Latvia, Portugal, Romania
(2) Withholding Tax on License Fee Payments		
(2.1)	No withholding tax	Hungary, Latvia, Luxembourg, Malta, the Netherlands, Norway, Switzerland
(2.2)	Withholding tax ≤ 15%	Bulgaria, Croatia, Cyprus, the Czech Republic, Estonia, Lithuania, Slovenia
(2.3)	Withholding tax > 15%	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Poland, Portugal, Romania, Slovakia, Spain, Sweden, Turkey, the U.K., the U.S.
(2.4)	Increased withholding tax for tax havens	Croatia, the Czech Republic, France, Latvia, Portugal, Romania

Source: Jarass and Obermair, *Faire und Effiziente Unternehmensbesteuerung — International geplante Massnahmen und national umsetzbare Reformvorschläge gegen Gewinnverkürzung und Gewinnverlagerung*, MV-Verlag (2015), Table 4.1; based on K. Finke et al., ''Extending Taxation of Interest and Royalty Income at Source — An Option to Limit Base Erosion and Profit Shifting?'' ZEW Discussion Paper (Sept. 2014), figures 2 and 3.

That development only increases the need for countries damaged by that unfair tax competition to introduce unilateral measures against BEPS.

C. The Measure and Its Implementation

In the last few decades, offshore financing from banks and other financial institutions has become a favorite MNE tax avoidance strategy. The part of their earnings paid as interest for credits and going out of the withholding country to creditors abroad is exempt from taxation in the withholding country — at least, in most relevant industrial countries. Once abroad, the payments, using the channels available for large international enterprises, can easily be transferred to a tax haven — that is the double nontaxation Gurría mentioned.

Payment of license fees is another loophole through which MNEs can easily transfer large parts of their earnings, untaxed in the withholding country, to tax havens. That is the classic example of BEPS and is the business practice of several famous brands such as IKEA.

Obviously, in many countries a considerable share of value production is allowed to go abroad untaxed and remain untaxed at the final beneficiary. A withholding tax with an adequate rate on all interest payments to both domestic and foreign creditors would make that strategy much less rewarding.

We therefore propose enacting a comprehensive withholding tax levied on all interest and license fee payments, including indirect payments, of an enterprise in a country (say, Germany), irrespective of the tax residence of the final beneficiary of those payments. In return, all withholding taxes paid to foreign tax administrations that have tax treaties with Germany would be unconditionally reimbursed by the German tax administration to the German payee.

That change would eventually make taxation simpler and more efficient; however, it would first require renegotiation of tax treaties that do not provide adequate withholding tax rates.

D. Examples

Germany introduces a 10 percent withholding tax for interest and license fee payments and reimburses all withholding taxes paid abroad to the German payee but only if the foreign country has a tax treaty with Germany. When discussing the treaty, it is solely up to the foreign country to decide whether it introduces a 10 percent withholding tax for interest and license fee payments to Germany and reimburses its domestic payees for withholding taxes paid in Germany.

For the evaluation of the effects of the measure, one should distinguish payments of interest from payments of license fees. In both cases, the effects largely depend on the tax residence of the payer and payee, as will be shown below.

In the following examples, the payer owes the payee €100.

1. German Payer, Foreign Payee

Without withholding tax, the payment is exempt from taxation at the payer because it is assumed to be

Table 4. Conditioned Limitations for Tax Deductibility of Interest Payments in EU and Some Other Countries, 2014

(1)	**No regulations**	Cyprus, Estonia, Malta, Slovakia, the U.K.
(2)	**Conditioned limitations depending on debt-status (outside 'safe haven')**	
(2.1)	Debt-equity ratio	Belgium, Bulgaria, Canada, Croatia, the Czech Republic, Denmark, France, Greece, Hungary, Japan, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovenia, Switzerland, Turkey, the U.S.
(2.2)	Debt-asset ratio	Austria, Denmark, Switzerland
(2.3)	EBIT(DA)	Bulgaria, Denmark, Finland, France, Germany, Italy, Norway, Portugal, Spain, the U.S.
(3)	**Conditioned limitations for related-party debt**	
(3.1)	Related-party debt	Belgium, Canada, Croatia, the Czech Republic, Denmark, Finland, France, Greece, Japan, Lithuania, Luxembourg, Norway, Poland, Slovakia, Slovenia, Switzerland, Turkey, the U.K., the U.S.
(3.2)	Debt guaranteed by a related party	The Czech Republic, Denmark, Finland, France, Japan, Luxembourg, Norway, Slovakia, the U.S.
(4)	**General limitations**	
(4.1)	All interest payments	Austria, Belgium, Bulgaria, Germany, Hungary, Italy, Latvia, Portugal, Romania, Spain
(4.2)	Other regulations	Austria, Ireland, the Netherlands, Sweden
(5)	**Consequences**	
(5.1)	Limitation of deduction	Austria, Belgium, Bulgaria, Croatia, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Japan, Latvia, Lithuania, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, the U.S.
(5.2)	Deemed dividend	Canada, the Czech Republic, Luxembourg, Switzerland, Turkey

Source: Jarass and Obermair, *Faire und Effiziente Unternehmensbesteuerung — International geplante Massnahmen und national umsetzbare Reformvorschläge gegen Gewinnverkürzung und Gewinnverlagerung*, MV-Verlag (2015), Table 4.5; based on Finke et al., ''Extending Taxation of Interest and Royalty Income at Source — An Option to Limit Base Erosion and Profit Shifting?'' ZEW Discussion Paper (Sept. 2014), Figure 1.

taxed at the payee. With withholding tax, the German payer pays the foreign payee €90 and the German tax administration €10.

Subcase 1a. Reimbursement of the German withholding tax. The foreign tax administration reimburses the foreign payee for the German withholding tax of €10, resulting in a total income of the foreign payee of €100.

Subcase 1b. No reimbursement of the German withholding tax. The foreign tax administration does not reimburse the foreign payee for the German withholding tax of €10, resulting in a total income of the foreign payee of €90.

It now depends on the relative negotiating power of payer and payee whether the foreign payee can compensate his lower income by successfully demanding a net payment of €100, resulting in a price increase from €100 to €111 (€100 net plus German withholding tax of €11). That price increase reduces the foreign payee's competitiveness because the German payer would try to find a payee (creditor or licenser) in a country that reimburses the German withholding tax (for example, a German supplier). In any case, the foreign country will feel pressure to reimburse the German withholding tax.

Example: IKEA. IKEA Holding gives a license to its local IKEA shops for an annual fee of €1 million, which goes almost untaxed to IKEA Holding (located in a tax haven). After implementing the proposed measure, the local IKEA shop has to pay €0.1 million withholding tax to the German tax administration, which decreases IKEA's unfair competitive advantage over competing local shops.

2. Foreign Payer, German Payee

Without withholding tax, the payment is exempt from taxation at the payer because traditionally it is supposed to be taxed at the payee. If the foreign country has introduced a withholding tax, the foreign payer pays the German payee €90 and the foreign tax administration €10.

Subcase 2a. Foreign country has a double taxation agreement with Germany. The German tax administration reimburses the German payee for the foreign withholding tax of €10, resulting in a total income of the German payee of €100.

Subcase 2b. Foreign country has no double taxation agreement with Germany. The German tax administration does not reimburse the German payee for the foreign withholding tax of €10, resulting in a total income of the German payee of €90.

Again, it depends on the relative negotiating power of payer and payee whether the German payee can compensate his lower income by successfully demanding a net payment of €100, resulting in a price increase from €100 to €111 (€100 net plus German withholding tax of €11). That price increase reduces the competitiveness of the German payee (creditor or licenser) who would in the future try to find a payer — that is, a customer — in a country that has a tax treaty with Germany. The foreign country will feel pressure to negotiate a treaty to ensure the reimbursement of the foreign withholding tax to the German payee by the German tax administration.

3. German Payer, German Payee

With withholding tax, the German payer pays the German payee €100. After the implementation of the proposed withholding tax, the German payer pays the German payee €90 and the German tax administration €10. The German tax administration reimburses the German payee for the German withholding tax of €10, resulting in a total income of the German payee of €100.

III. Limitation for Deductibility

A. Many Countries Have Limitations

There are two types of conditions that must be applied in the various countries in Table 4: limitations according to the debt-status of the enterprise in question and limitations according to an MNE's cross-border relations.

Since at least 2008, Germany has limited deductions of interest payments (*Zinsschranke*). Payments over €3 million are deductible only up to 30 percent of earnings before interest, taxes, and depreciation. There are several escape clauses — for example, for non-trust enterprises. Many European countries have introduced similar limitations recently. In March 2014 Austria introduced limitations on tax deductions for payments to related parties in a tax regime with rates below 10 percent.[17]

The OECD action plans include the possibility of conditioned limitations of deductions.[18]

All reform to the taxation of cross-border business (in Europe and beyond) must pass the narrow straits between international and national law, guarded by the Court of Justice of the European Union and the German Federal Fiscal Court, respectively, both of which have allowed limitations of tax deductions.[19]

According to the CJEU, the EU interest and royalties directive does not cover tax base and rates for cross-border payments, so a national limitation on deductibility for those payments cannot conflict with the directive.

B. The Measure and Its Implementation

That portion of earnings paid as interest or license fees can leave the source country untaxed, at least in most industrialized countries. Once abroad, the payments can easily be transferred to a tax haven.

The share of nondeductible interest and license fee payments should depend on the final beneficiary's actual tax rate, not on its regulatory or nominal tax rate or on the tax rate of any intermediate receiver. The documented tax payment of the final beneficiary should be relevant for the deductible share of interest and license fee payments.

The payer in the source country (say, Germany) of the interest and license fee payments must prove, or at least make a plausible argument, that the final beneficiary does indeed pay at least a well-defined tax rate (say, 20 percent) on the payments received. That proposal fully agrees with the OECD action plan on BEPS.

The tax administration in the source country would be able to recognize systematic tax avoidance on the receiving side that may use a chain of intermediate traders in low-tax regimes to arrive at close to zero taxation. Under the proposed measure, a minimum paid tax rate on the earnings concerned would be attainable. To avoid double taxation, payments taxed in the source country could be classified as dividends that are tax exempt at the receiver in many countries.

C. Example

The deduction limitation should be applied stepwise according to the proven paid tax rate of the final beneficiaries:

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[17]Wirtschaftskammer Österreich, ''Abgabenänderungsgesetz 2014: Überblick über die wichtigsten Änderungen'' (Mar. 7, 2014); *see also* Sven-Olof Lodin, ''Intragroup Lending in Sweden — A Vehicle for International Tax Arbitrage,'' *Tax Notes Int'l*, July 18, 2011, p. 177; and Lodin, ''Intragroup Royalties as a Vehicle for International Tax Arbitrage,'' *Tax Notes Int'l*, Sept. 30, 2013, p. 1317.

[18]R. Pinkernell, ''EU: Bericht der Expertengruppe zur Besteuerung der Digital Economy,'' 13/2014 *IStR-LB* 57. *See also* European Commission, ''Commission Expert Group on Taxation of the Digital Economy'' (May 18, 2014).

(Footnote continued in next column.)

[19]*Scheuten Solar Technology GmbH v. Finanzamt Gelsenkirchen-Süd*, C-397/09 (CJEU 2011); Bundesfinanzhof, ''Verfassungsmässigkeit des Abzugsverbots für Gewerbesteuer — Keine ernstlichen Zweifel an der Verfassungsmässigkeit der Hinzurechnungen nach § 8 Nr. 1 GewStG 2002 n.F. — Kein subjektives Nettoprinzip bei Kapitalgesellschaften,'' Urteil vom, I R 21/12 (Jan. 16, 2014). Entscheidungen online, May 7, 2014, regarding the German trade tax.

- full deduction of interest and license fee payments if the paid tax rate of the final beneficiary meets a specified threshold (for instance, 20 percent)[20];
- no deduction at the payer if the paid tax rate of the final beneficiary is 0 percent; and
- between those limits, the deductible share of interest and license fee payments is determined as the paid tax rate in percent divided by the threshold.

Example: If the paid tax rate of the final beneficiary is 5 percent, the payer in the source country can deduct the equivalent of 5 percent divided by 20 percent, or one-quarter of his interest and license fee payments.

The proposed limitation guarantees a minimum taxation of, for example, 20 percent as the sum of tax payments in the source country and the receiver country. In particular, tax havens lose some of their advantages.

D. Digression: German Trade Tax

The German trade tax comes, at least in principle, close to Gurría's set of laws and regulations that ensure taxes are paid where values are created and the economic activity takes place. That tax generally limits tax deductions to three-quarters of interest payments and 15/16 of license fee payments. Up to €0.1 million in payments is always deductible. Received interest and license fee payments, however, are fully taxable under German corporate and trade tax, resulting in systematic double taxation if both sides are liable for German trade tax.

We have proposed enforced limitations of tax deductibility for interest and license fee payments, and in return, tax reductions for received payments.[21]

Also, the general thin capitalization limit of interest deduction (*Zinsschranke*) applies for corporate and trade tax. The introduction of an additional thin capitalization limit of license fee deduction (*Lizenzgebührenschranke*) has been discussed by the German federal government.

[20]If that threshold were 20 percent, only nine EU countries would be affected (Bulgaria, Cyprus, the Czech Republic, Ireland, Latvia, Lithuania, Poland, Romania, and Slovenia) and the measure could be implemented with low administrative cost.

[21]For details, see Jarass and Obermair 2015, *supra* note 8, at Chapter 4.3.

IV. Economic and Fiscal Results

The two tax reform proposals presented — withholding tax on all interest and license fee payments and limitation of tax deduction for payments to low-tax regimes — increase the tax burden only for MNEs that use tax havens or low-tax regimes.

Both measures would increase a country's tax revenue. Using Germany as an example, below is an estimate of the fiscal effect of the two measures:

- introducing a withholding tax on all interest and license fee payments would bring additional net revenue of more than €4 billion annually, even if the foreign withholding tax on payments going into Germany would be completely refunded by the German tax administration; and
- a limitation of the tax deductibility of interest and license fee payments to low-tax countries would increase German net revenue by more than €2 billion annually.

Even if the initial revenue increase would be lower, the reform would counteract ever-growing tax avoidance:

- the growing tendency of double nontaxation would be reversed, the advantage of tax avoidance countries would be reduced, and tax havens would become less attractive; and
- the tax advantage MNEs have over small and medium-size enterprises and the resulting unfair competition would be reduced.

Despite the harm tax avoidance strategies have on governments, individual taxpayers, and smaller businesses, governments and lawmakers in the countries where that damage occurs have thus far been unable or unwilling to avert it by applying the obvious countermeasure of taxing interest and license fee payments in some appropriate way at the source.

Without powerful measures, an ever-growing share of the earnings of big business will no longer be taxed anywhere, and countries like Germany will lose more and more revenue. Companies still residing in a normal-tax country would be forced to move their headquarters (and the respective high-paying jobs) to low-tax countries. Those tendencies can be reversed with the implementation of our proposed measures. Once a country takes the initiative on those kinds of measures, it becomes easier for other countries to follow and join the struggle against tax avoidance, thereby enabling step-by-step international harmonization by an increasing number of countries. ◆