

# Starbucks versus the People

**In this article, the author provides his opinion on the current debate on tax avoidance by multinational enterprises.**

## 1. Introduction

Even in the face of opposition to tax evasion and tax avoidance from a rising number of states, more and more other states are trying to create all kinds of agreeable tax incentives to attract more companies. The result is a deadlock. The President of the European Council, Van Rompuy, talks about a trillion euro in revenue losses.<sup>1</sup> More and more citizens are turning against companies and governments that permit or take advantage of massive tax reductions. This article takes a closer look at all these developments.

## 2. Who Are the Key Players in this Discourse?

At the time of the writing of this article, the newspapers were full of stories about companies trying to reduce their effective tax burdens through all kinds of structures. This is not a new phenomenon. In the last few years, angry citizens have been the driving force behind movements that express their vehement discontent with companies paying as little tax as possible. Non-governmental organizations (NGOs), such as SOMO, Tax Justice Network, ActionAid, Christian Aid, Robinhoodtaxes.org, are waging war against the behaviour of these companies. Some NGOs have published articles and reports on their fight against tax systems like the one in place in the Netherlands – with incentives like the participation exemption being branded “antisocial”.

Other organizations, on the other hand, have opted for a sort of “preventive approach”: “We are not saying your company is doing something wrong, but just tell us what you are paying.” They simply protest against the company until it answers the question on what it effectively pays in taxes and in which country. Vodafone was faced with various groups occupying its shops in protest against tax avoidance amounting to GBP 6 billion.<sup>2</sup> Robinhoodtaxes.org even uses professional actors to make impressive short movies to influence public opinion.<sup>3</sup> The Dutch beer brand Grolsch was beset by a professionally set up action that received worldwide attention.<sup>4</sup> Many tax consultants consider these NGO-induced agitations to be a rearguard

action on a road to nowhere. But, are they really? Is this a movement fed by public outcry befitting the spirit of the crisis when some companies still generate quite magnificent profits that are totally out of proportion to the tax they pay every year? A movement that implodes once the crisis has ended? This author does not think so.

The world is going through a lot more. People in the western world have become accustomed to solving international tax law issues using the OECD Model.<sup>5</sup> And when any western company invests in non-western economies, it is immediately assumed that those countries will follow the OECD interpretations. By including mutual agreement procedures in tax treaties, any risk of double taxation should be avoided.

The economy’s globalization has not been beneficial in all respects. New countries have risen, with far more financial and economic power than many of those in the West. The most important countries are grouped under the umbrella title “BRIC countries”: Brazil, Russia, India and China.<sup>6</sup> While Russia’s real economy may not exactly count as huge, the opposite is true of the other three countries. Their size means that a globally operating company must be present: either for business-to-business operations or simply because they are home to a vast number of consumers whose income is growing strongly – income they are eager to spend.

These are exactly the countries that the western countries should be concluding tax treaties with. However, this is difficult as BRIC countries are not likely to accept the OECD Model. The following example illustrates this:

### Example

Company A establishes a sales company in India. The sales company is converted into a stripped distributor to avoid the margin generated in that country from becoming too large. This means that certain functions of the sales company will be performed by another group company outside India. This company does not just manage the risks for the sales company, it actually bears them. Since the sales company bears little or no risks and a group company outside India performs most functions, much less profit is allocated to India based on the OECD Models and the OECD Transfer Pricing Guidelines.<sup>7</sup>

As these structures are considered to be artificial, many countries no longer accept them. They think that the pres-

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1. Euronews, *Van Rompuy urges action on tax* (Apr. 2013), available at [www.euronews.com/2013/04/12/van-rompuy-urges-action-on-tax/](http://www.euronews.com/2013/04/12/van-rompuy-urges-action-on-tax/).  
 2. See [www.youtube.com/watch?v=FCkCQraoedc](http://www.youtube.com/watch?v=FCkCQraoedc).  
 3. See [www.youtube.com/watch?v=qYtNwmXKlVtM](http://www.youtube.com/watch?v=qYtNwmXKlVtM).  
 4. See [www.youtube.com/watch?v=alcKsti\\_8QQ](http://www.youtube.com/watch?v=alcKsti_8QQ).

5. Most recently, *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.  
 6. “BRICS” is the more common term since South Africa’s tremendous growth. A second layer of growing economies is on the rise (e.g. Indonesia). Most of these countries rely heavily on the *UN Model*. Most recently, *UN Model Tax Convention on Income and on Capital* (1 Jan. 2011), Models IBFD.  
 7. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), International Organizations’ Documentation IBFD.

ence of a distributor in their country is the reason why the company generates profit there. They simply want to tax this profit, irrespective of any tax treaties. Companies facing this issue are frequently forced to take their case to national courts where the outcome is uncertain, to say the least.

Brazil and India are countries with their own distinct tax interpretations. They are the foremost examples of countries that refuse to accept the tax standards that the western countries find acceptable. Even if all the transfer pricing models show that eliminating functions and risks means that no more than 10% profit needs to be generated over the costs, these countries' tax authorities regard such a distributor as an ordinary sales company and they feel that 30% is a more reasonable percentage. Many legal proceedings involving India relate to this issue. Brazil follows a different approach. It was the first country in the world to require an electronic corporate income tax return. However, it started to amend the forms very often, so that few companies could be compliant, which resulted in heavy penalties. Brazil also has its own view on what constitutes a reasonable profit allocation. If any model treaty provides guidance for such interpretation, it is the model treaty drafted by the United Nations. However, even this will not stop countries like Brazil from applying a much broader source state approach than the United Nations has ever intended.

What is the response of the Western world? As early as 2007, the OECD set up a Steering Group to tackle aggressive tax planning. Part of the strategy is creating a database solely accessible to tax authorities. The idea is to record as many examples of aggressive tax planning as possible, so that the participating states can share a great deal of knowledge. In addition, the OECD has published several reports.<sup>8</sup> The western world has awakened to the growing pressure from the rest of the world on tax structures solely designed to minimize tax liabilities. In particular, the BEPS Report (OECD 2013) stirred up a hornet's nest. Although an OECD report is not binding, this report is likely to influence multinationals' tax structures. Their corporate social responsibility makes companies anxious about newspaper reports on investments in poorer countries because the wages there are still conveniently low, about tax avoidance through debt financing and about all kinds of transfer pricing structures. Companies are increasingly aware of what it means to be living in an information society in the year 2013. The internet is a sure-fire way to have anything happening on the other side of the world revealed immediately.

And the European Union? Of course, the European Union had to act. In December 2012, the European Commission issued an Action Plan to reinforce the fight against

tax fraud and tax evasion.<sup>9</sup> One of the tax planning instruments subject to scrutiny is the hybrid loan.

EU legislation would have to be enacted to make it impossible for the income from a hybrid loan to be tax free in one country and for interest on such a loan to be deductible in another one, but is this a realistic solution? In other words: what are the chances of the European Union being able to change the Member States' tax laws, knowing the strong focus on taxation of some of these countries and knowing that some of them will unequivocally reject any interference in their tax systems.

Ultimately though, these questions need not be answered. In a world where NGOs force companies to act responsibly vis-à-vis the global society, major investment countries no longer stomach the erosion of their taxable bases, and, as the political call to arrive at a more equitable taxation grows ever louder (in Western countries too), it seems impossible to reverse these processes. The European Union has one additional instrument available to challenge the tax systems of the Member States which are "too competitive"; namely the State aid provisions.<sup>10</sup> It is expected that we will see more cases investigating the question of State aid in the future.

Section 3. describes an example of a company with what is called a fully tax efficient structure. It discusses whether such a company engages in culpable behaviour and the role of governments in this respect. How much blame should companies shoulder for paying no tax on very high profits? As long as states continue to create legislation while proclaiming the adage "every man for himself and the devil take the hindmost", the culpability, at the very least, is shared.

### 3. How Google Optimizes Its Tax Position<sup>11</sup>

#### 3.1. Introductory remarks

The choice of Google is a random one. Being able to find a wealth of information about the structure's elements by simply googling around a bit helps. However, instead of Google, the author could equally have picked Starbucks, Vodafone or Amazon, which are merely a limited sub-collection of a mammoth group of companies that know how to find extremely innovative ways of reducing their tax burdens.

Over the years, Google has carried out a solid expansion of its operations. It has evolved from merely administrating the largest internet search engine in the world to being the owner of YouTube. In some parts of the world, Google is now also known as the organization where you can book the cheapest plane tickets and holidays.

Google was incorporated in California in 1998. In 2011, its revenue reached nearly USD 38 billion and its profit USD

8. See, for example, OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD 2012), International Organizations' Documentation IBFD, also available at [www.oecd.org/ctp/aggressive/HYBRIDS\\_ENG\\_Final\\_October2012.pdf](http://www.oecd.org/ctp/aggressive/HYBRIDS_ENG_Final_October2012.pdf); OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013), available at [www.oecd.org/tax/beps.htm](http://www.oecd.org/tax/beps.htm); OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), available at [www.oecd.org/tax/beps.htm](http://www.oecd.org/tax/beps.htm).

9. European Commission, *An Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion* (COM(2012) 722 final), EU Law IBFD.

10. Articles 7-1 of the Treaty on the Functioning of the European Union (TFEU) (consolidated version), OJ C83 (2010), EU Law IBFD.

11. The author would like to thank Nicole Rode, Phd student at Maastricht University, for her support with fact finding regarding Google.

10 billion. The effective tax rate was 2.4% in that year, while the statutory tax rate in the United States was 35%. The big question is how Google, rooted in the American business community, managed to realize this fantastic result: normally the part of the profit paid out as a dividend should effectively have been taxed at 35%.

### 3.2. Building blocks

#### 3.2.1. Initial comments

Section 3.2. provides an outline of some of the features of the US tax system corresponding to the four principles that Google's tax structure is based on. The US tax system has always predominantly followed the maxim that with respect to large countries it should make no difference to companies whether they invest in the United States or elsewhere (capital export neutrality). The tax burden will always relate to the rate levied on domestic profits. Nevertheless, this maxim exists only in theory.

#### 3.2.2. Principle 1

The United States taxes US companies on their worldwide income. The US tax rate of 35% is quite high compared to the applicable rates in other Western countries. Profits of non-resident companies are taxed only if they are repatriated to the United States.

#### 3.2.3. Principle 2

The United States, like any country, has rules for the avoidance of double taxation. The first option is a system of deducting foreign taxes from the US taxable base, which does not eliminate double taxation in full. The second option (the credit system) is more effective in avoiding double taxation. Under this system, foreign profits are included in the US taxable base on which the related US tax is calculated. The foreign tax charged is deducted from the US tax liability. The deduction cannot exceed the US tax due on those profits (ordinary tax credit). This is why most companies opt for the tax credit method instead of the deduction system.

Companies have an obligation to reduce their foreign tax burden as much as possible.<sup>12</sup> Companies should seize any opportunity to go to court if valid reasons exist to dispute the application of a tax rule in the foreign country. Failure to do so will result in the losses involved being qualified as voluntary taxes, which are unavailable for a set-off.

#### 3.2.4. Principle 3

Like many credit systems, the US set-off system is fairly easy to get around. To counter this, the United States has implemented tax legislation to prevent tax avoidance: Subpart F rules target foreign passive income and income generated through inter-company transactions. This legislation seeks to safeguard the US taxable base from taxable revenues being artificially transferred to third countries at

the cost of the US taxable base. Since the introduction of the check-the-box-regulations in 1997, the application of the US CFC legislation can easily be avoided.

#### 3.2.5. Principle 4

The fourth basic assumption is the application of the OECD Transfer Pricing Guidelines. This means the remuneration in inter-company transactions should be at arm's length.

### 3.3. Google's tax planning toolkit

#### 3.3.1. Shifting of intellectual property rights

Some years ago, Google directors anticipated that the value of their intellectual property (IP) rights would rise in the period ahead of them. As exploiting these rights in the United States would result in a high tax burden, transferring IP rights to another country through a sharing agreement seemed to be perfectly reasonable. Ireland became the country of choice, inspired by an agreeable tax rate of 12.5% and the availability of appropriate personnel.

The cost sharing agreement involved two elements. The first was to have the parties bear the costs for the IP development in proportion to the opportunity to develop this right. In other words: from that time on, the IP right was enhanced with value from locations all across the globe. Since the value was no longer created solely in the United States, this left the US Internal Revenue Service (IRS) largely empty-handed.

The new group companies outside the United States could acquire the entitlement to the existing IP rights at an arm's length price. After some negotiation, the IRS agreed to the proposed transfer prices.

The next question was how all of this should be structured effectively. Google set up a subsidiary in Ireland (Ireland Holdings Limited, IHL). This new subsidiary acquired the rights to exploit Google's IP rights for Europe, Middle East and Africa (EMEA) through the cost sharing agreement. In 2006, Google concluded an advance pricing agreement, obtaining certainty on the price for the relevant transfer prices. All profits generated within the EMEA were to be taxed in Ireland and no longer in the United States, except if repatriated.

#### 3.3.2. The Double Irish

The Double Irish involved the incorporation of a second Irish company (Google Ireland Limited, GIL) which was responsible for managing royalties earned in EMEA countries and coordinating activities for the EMEA region. The company was to be incorporated by a Dutch intermediate holding company. Ireland Holdings Limited, which holds the intellectual property right, granted the Dutch intermediate holding company a licence and, in turn, this company granted Google Ireland Limited a sub-licence.

As a result of this structure, Google enterprises within the EMEA pay Google Ireland Limited for the right to use the IP rights. In Ireland, those payments are taxed at 12.5%,

12. See [www.forbes.com/sites/lowellyoder/2012/03/06/beware-of-double-taxation-of-foreign-profits/](http://www.forbes.com/sites/lowellyoder/2012/03/06/beware-of-double-taxation-of-foreign-profits/).

whereas in other EMEA countries they are deductible at the local regular rate. Newspapers report that 88% of the non-US royalties are directed through this Irish sub-subsidiary.<sup>13</sup>

### 3.3.3. Checking the box

The US tax system allows foreign companies to choose their status (check-the-box rules): they can be treated either as transparent entities or as corporations.<sup>14</sup> Some companies are not allowed to choose a transparent status (per se corporations). The IHL is not a per se corporation and may opt for being treated as a transparent entity.

The activities of the Dutch intermediate holding company and GIL are attributed to IHL. This holding company is a passive company subject to US Subpart-F legislation, since its activities do not go beyond receiving royalty payments. It is basically subject to US legislation on controlled foreign companies (CFC) and the profits are deemed to have been distributed to the US based holding company, where they are taxed at 35%.

By choosing the transparent status, GIL's activities can be attributed to IHL. Since GIL effectively coordinates the activities within the EMEA region, this company is active. This attribution means the core activities of IHL become "active operations". Hence, the profits can continue to be amassed in Ireland, making the holding company lose its passive character.

### 3.3.4. The hybridization of IHL

The next step was to prevent income from being taxed within IHL at the rate of 12.5%. For this purpose, IHL's place of effective management was moved to Bermuda, where the rate is 0%. This decreases further, the tax difference between the tax savings due to deducted royalties (in countries where the rate is usually higher than 12.5%) and the amount of tax that is finally paid on the right to use IP.

### 3.3.5. The fiscal relationship between the Netherlands and Ireland

Transferring the effective management of IHL to Bermuda does not lead to any tax consequences in the United States. The United States still deems IHL to be an Irish company, while Ireland considers that company to be a Bermudan company. And then the interposition of a Dutch company suddenly makes sense: Ireland has not concluded a tax treaty with Bermuda, so the royalties can be subject to 20% withholding tax.

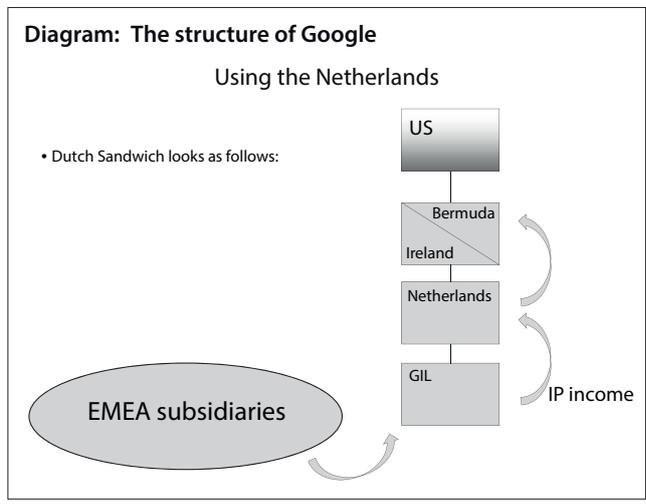
Having the royalties flow through the Netherlands means that the benefits of both the EU Interest and Royalties Directive<sup>15</sup> and the Netherlands-Ireland Income and

Capital Tax Treaty (1969) can be reaped.<sup>16</sup> The royalties flow to the Netherlands without any withholding tax and, as the Netherlands does not levy withholding tax on outgoing royalties, they enter Bermuda tax free.

The Dutch intermediary company (NLH) is a *besloten vennootschap* [private limited liability company] (BV), which may choose a transparent status in the United States. In practical terms, it is a conduit company. According to the *Vraag en Antwoordbesluit Dienstverleningslichamen* [Decree on Questions and Answers relating to Financial Services Entities], the requirements of section 8c of the Dutch Corporate Income Tax Act 1969<sup>17</sup> cannot be applied directly to a situation in which royalties flow through the Netherlands. If this occurs, agreements with companies are concluded on a case-by-case basis.<sup>18</sup> With revenue exceeding EUR 40 billion, 88% of which flows through GIL, an agreement with Google would appear to be a very interesting opportunity for the Netherlands.

The question is often raised as to whether the Netherlands can be held liable for the culpable behaviour of companies. The Dutch substance requirements have been amended in 2001 to be in line with the international standards. While the Dutch tax regime offers many attractive features (tax treaty network), lack of withholding tax on interest and royalties, those features also benefit "legitimate" companies.

The following diagram illustrates the Google structure. The table shows how this structure caused the effective tax burden to drop to  $21.96/1,000 = 2.2\%$ . For simplification purposes, it assumes hypothetical revenue of EUR 1,000.



The calculation of the effective tax burden	
Google Ireland Limited receives	1,000.00
Assumption: 2% remains in Ireland	- 20.00
The Netherlands receives	980.00
Assumption: 0.2% is paid in the Netherlands	- 1.96
Net to Bermuda	978.04

13. See [www.businessweek.com/magazine/content/10\\_44/b4201043146825.htm](http://www.businessweek.com/magazine/content/10_44/b4201043146825.htm).  
 14. Treas. Reg. 301.7701-2.  
 15. Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States, OJ L 157 (2003), EU Law IBFD [hereinafter EU Interest and Royalties Directive].

16. *Convention between the Government of the Kingdom of the Netherlands and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* (11 Feb. 1969), Treaties IBFD.  
 17. NL: Corporate Income Tax Act (Wet op de vennootschapsbelasting, Vpb) 1969, sec. 8c, National Legislation IBFD.  
 18. See Decree of 11 Aug. 2004, IFZ 2004/126M.

### 3.3.6. *And Bermuda?*

Two directors have been appointed for INL in Bermuda to effectively manage this company. Although both of them are also lawyers at a trust office in Hamilton, they have already showed that they can act in Google's best interest. One of the first actions these gentlemen took was to convert the legal form of limited liability company into unlimited liability company, which means that the financial statements no longer need to be published.

### 3.4. "All's well that ends well" for Google's shareholders?

Once the money has reached Bermuda's shores, the shareholders will still not be able to get their hands on it. If they wish to have their dividend and enjoy it, profit should first be repatriated from Bermuda to the United States. However, this comes at a cost of 35%. Thus, their profits have turned into what is referred to as "locked-out profits". A fantastic tax structure has been implemented, but nobody can get to the money. This outcome is definitely not one that the shareholders had in mind. It may seem that as a consequence of the chosen structure, a deferred tax liability could be recognized in the amount of the overseas tax profits. However, according to the US rules, an exception is made for income which will be reinvested overseas (permanently reinvested earnings). It is clear that this exception is being used by the companies.

How could shareholders obtain their dividends? The simple way is to sell shares, realize a capital gain and then buy back the shares. However, these shares are expensive (the value of one share exceeds USD 1,000). Companies would need money to implement this solution (e.g. loans from overseas banks).

Google is not the only company to have this problem. Together, US multinationals apparently have accumulated between USD 1.3 and USD 1.6 trillion in tax havens.<sup>19</sup> If repatriated to the United States, this money would alleviate the high national debt by at least 33%. Regrettably, the shareholders do not want to accept this consequence. Having gone through much effort to concoct a wonderful tax structure, one does not want to find out that it is useless if one wishes to obtain dividends. Companies like Google are doing well in the eyes of stock exchange analysts because of their tax optimization. But what is the point in performing well if the gains cannot be realized?

It would be strange if the United States had not tried to solve this issue. Over the last couple of years, multinationals with a Google-like structure spent more than USD 1 billion<sup>20</sup> on lobby organizations to push for a repatriation tax holiday (a one-off voluntary disclosure scheme to be able to distribute dividends stashed away in Bermuda or elsewhere without having to pay the US tax). The first time a repatriation tax holiday was allowed was in 2004:

19. See <http://americanactionforum.org/research/ending-the-lockout-of-overseas-earnings-an-update>.

20. See <http://usaction.org/2011/11/new-report-fool-me-twice-corporations-pay-congress-to-rip-off-taxpayers-again/>.

companies had to pay only 5.25% in taxes, provided the amounts repatriated to the United States would be used for creating new jobs, research and development activities, and other socially desirable expenditures. The 2004 American Jobs Creation Act was one of the results of this deal. The idea behind the repatriation tax holiday was to bring USD 312 billion to the United States.<sup>21</sup> However, the deal between the government and businesses could hardly be regarded as a success. Companies took advantage of this one-off tax reduction, but failed to uphold their part of the bargain.<sup>22</sup> Despite being highly successful in providing reasons as to why they were unable to do so, they managed to antagonize President Obama: a strong advocate of a fair tax system. In March 2011, the Obama administration announced that it would refrain from introducing another repatriation tax holiday. Later on, Obama changed his mind and is now considering this.<sup>23</sup>

Low-taxed profits belonging to US multinationals are in limbo in the tax havens. Companies failed to capitalize on the chance they had in 2004 of repatriating them at a favourable tax rate in exchange for proper investments. It remains to be seen which way the wind blows under the next government.

## 4. Companies versus Governments

Companies like Google, which employ sophisticated tax planning structures, have evidently crossed the lines of what is acceptable. Once they have committed themselves to using such structures, they should accept the consequences. If the shareholders want their dividends, they should have them distributed and pay the US tax due. In view of these events, it is, nevertheless, annoying to see that some elements of the tax system (like the participation exemption in the Netherlands), which were designed to promote economic development of businesses, are now allegedly used for avoiding income tax.<sup>24</sup> Since corporate income tax has usually already been paid in the country where the subsidiary is established, there is no need to do so in the Netherlands. Recently, a Dutch newspaper reported that this participation exemption is disadvantageous for developing countries.<sup>25</sup> In the author's view, this is incorrect. If a developing country is trying to create employment, the common practice would be to reduce its corporate income tax rate. If the Netherlands did not have the participation exemption, the benefits granted in

21. See [www.rhsmith.umd.edu/smithbusiness/fall2012/KnowledgeTransfer/TaxHoliday.aspx](http://www.rhsmith.umd.edu/smithbusiness/fall2012/KnowledgeTransfer/TaxHoliday.aspx).

22. See <http://dealbook.nytimes.com/2012/10/03/overseas-cash-and-the-tax-games-multinationals-play> for an example of how a company like HP was able to escape the 5.25% taxation.

23. Recently, President Obama has announced a possible introduction of a tax repatriation holiday. See <http://blogs.marketwatch.com/thetell/2013/07/31/repatriation-tax-holiday-push-resumes-after-obama-proposal-goldman/>.

24. See S.S. Johnston, *U.K. Lawmaker Calls for Tax Inquiry Into \$130 Billion Vodafone-Verizon Deal*, *World Tax Daily*, Tax Analysts (5 Sep. 2013), on Vodafone's sale of its stake in Verizon Wireless via its Dutch intermediary company, which made the capital gain tax free due to the Dutch participation exemption.

25. K. McGauran & I. Romgens, *Nederland stimuleert belastingontwijking* [Netherlands stimulates tax avoidance], *Financieel Dagblad* (5 Apr. 2013).

the developing country would be cancelled out by the application of the Dutch tax rate to profits repatriated from the developing country.

How can bilateral tax treaties play a pivotal role in the tax avoidance system? This does not seem possible even if a company performing some administrative tasks wants to access them. The existing Dutch treaty network may be used to reduce the withholding taxes on interest and royalties, but only if certain (substance) requirements are met. For financing activities, the requirements of article 8c of the CITA 1969 must be satisfied. International tax law is built on the concept of the “ultimate beneficiary”, whereas journalists usually search for the “ultimate ultimate beneficiary”, which is usually the top holding company.<sup>26</sup>

In the author’s opinion, NGOs target the wrong international tax law elements: Google has argued its case with a clean conscience, albeit not accepting the consequences of the game, i.e. taxation upon repatriation. This is what should warrant the attention of the NGOs.

The tax position of companies is one of the issues their stakeholders hold them accountable for. Can those companies be blamed for taking advantage of the differences in rules between the various states to reduce their tax burden? In general, all companies take the opportunities international law offers them. But there is nothing wrong with that. Global organizations would not be efficient if they failed to have a structure under which as little tax as possible is paid. Revenue and cost optimization involves not only tax considerations: many companies relocate to or create subsidiaries in countries where the cost of labour is low. The shareholders have a role to play in testing a company’s corporate social responsibility policy

It seems that it is only a matter of time before some of the traditional tax planning building blocks will be abolished. One of them is the hybrid loan. The problem is not so much the company employing this type of financing arrangement but rather countries not charging tax on the revenue from hybrid loans, even if interest has been deducted in the country where the company paying the interest is established.<sup>27</sup> Both the European Union and the OECD would like to discourage companies from using such structures. It seems that other traditional tax planning options will increasingly be targeted in the coming years.

In the author’s view, companies should stick to all the rules of the game. If a company is deemed to be active, then it should actually be active. A letterbox company with few management meetings a year may be perfectly suited to managing IP rights. Management of IP rights can be undertaken in a relatively simple manner, but establishing an intra-group finance company is considerably more complicated. Even if a finance company based in Switzerland employs 50 people, it is still doubtful whether the effective management of that entity is not located somewhere

26. Companies, such as Philips or HP, are organized in sectors involving a lot of subsidiaries. An “ultimate beneficial owner” approach would lead to major tax disadvantages as far as withholding taxes are concerned.  
27. Sec. 13(4) Vpb 1969.

else. Should the group feel the need to set up a new factory in India and should this partly be achieved through “borrowed” capital from the Swiss financing company, the decision about how much will be funded and at what price is unlikely to be taken in Switzerland, more likely by the CFO in consultation with the Executive Board.<sup>28</sup>

If a company is set to perform activities, those activities should actually take place (which is, however, not always the case).<sup>29</sup> Situations where companies claim to perform activities in certain countries/islands but where those activities are actually non-existent, constitute tax evasion and not tax avoidance. The same can be said of situations where a trust office exercises the control over a company in circumstances in which no reasonable shareholder would leave the company management to such a trust office.

What exactly is the role of states in all of this? They determine both the tax burden they impose on companies and the parties to and conditions of the bilateral tax treaties they conclude. However, their willingness to cooperate is still limited. Where a company has the world as its playing field, countries are only concerned with one thing: having as much of that “world” flowing through their territory as possible, as this generates funds. This outlook has sometimes led to quite extraordinary situations. The British minister, George Osborne has appeared in the headlines for proposing tax changes to make the United Kingdom the most favourable place to do business in the world, with the lowest corporate income tax rate. What is more, an innovation box has been introduced in the United Kingdom and certain withholding taxes have been abolished. Additionally, Osborne has appointed 2,000 new tax inspectors to tackle companies that are utilizing the more favourable tax laws of countries other than the United Kingdom. Thus, the entire world should operate through London; a failure to do so (opting for another favourable country) will, at the very least, create major difficulties with Her Majesty’s Revenue and Customs. This reveals a huge imbalance: enterprises cannot simply change the rules, whereas the states can. Thus, companies should not be blamed for going to other more favourable countries. Even a lot of state-controlled companies optimize their tax positions in this way: Energie de France has a Dutch holding company and the Dutch national railway company which leases train carriages through Ireland.

Who engages in culpable behaviour? The companies, which exercise the rights created by the states? Or the states with their two-pronged policies of attracting companies, while at the same time coming down on companies trying to explore better alternatives? In any case, the catch-all term “tax avoidance” for companies opting for the most beneficial route to reducing their tax burdens has a strong contender in the term “tax competition”: states trying their best to coax companies into establishing themselves on their respective territories.

28. This will only be different if it has been established that the CFO and the CEO physically attended the important meetings in Switzerland.  
29. See [www.youtube.com/watch?v=XAenLYsV7A4](http://www.youtube.com/watch?v=XAenLYsV7A4).

Both camps should take their fair share of the blame. Companies can be accused of culpable behaviour if their tax structure is perfect to the point that they can no longer distribute dividends at which they want the state – the one party to suffer most from these actions – to help them out, or if their structures for routing of cash flows are not supported by the facts. The latter situation is simply called tax evasion and deserves a tough approach. At the same time, states display similar behaviour. The United Kingdom policy towards tax competition is an example.

## 5. The Changing World

Companies go for the lowest possible tax burden. States have their own reasons for facilitating this. However, these days, people (who are also the customers of those companies) no longer accept that no tax is paid in the countries where the profit is made.<sup>30</sup> The actions of the NGOs have become more forceful and more professional. NGOs increasingly use the possibilities that modern times have to offer. The internet has made the world smaller, so nothing can be kept secret any more. The NGOs' campaigns will not be ignored, as corporate social responsibility is a prominent topic in the boardrooms of many multinationals. No one wants coverage in the press, the risk of being damaged is just too big.

Likewise, there are rising economies to contend with: China, Brazil and India. Not long ago, the BRIC countries were countries whose economies were still burgeoning – which is the reason why many tax treaties with Brazil contain a tax sparing credit. But the world has changed rapidly. Nowadays, the BRIC countries are listed among the more important countries in the world.<sup>31</sup> The BRIC countries and South Africa will join efforts to incorporate their own World Bank because of their discontent with the one in place.<sup>32</sup> The BRIC countries have become major investors in the Western world. They also attract investment, because their economic growth has increased the spending power of their people. These countries start to recognize the superb structures Western countries can create, but fail to accept them, as can be witnessed in the numerous tax proceedings pending in India.<sup>33</sup>

As regards tax matters, the BRIC countries have largely gone their own way. The source state principle seems to be of major influence in this respect.<sup>34</sup> Why should they accept their countries being used for cheap labour without a fair share of corporate income tax? Globally operating companies cannot afford to disregard Brazil or India.

However, other developing countries do not have such a strong position. Companies have high requirements before they establish factories there: the land should be given away preferably for free, the infrastructure needs to be good and the corporate income tax rate should be low. Once again, the NGOs lend a helping hand here.

Recently, the United Nations issued its Practical Manual on Transfer Pricing for developing Countries (the “UN Manual”).<sup>35</sup> In this Manual, the UN aims to take a leadership role in an attempt to draft global transfer pricing guidance that can be used by countries all over the world in developing and implementing transfer pricing regulations. Does it make any sense that the UN takes the lead? It would if it meant that almost all countries around the world will apply the same principles. This would reduce double or non-taxation. Yet in practice, the outcome is not that positive. The principal merit of the UN Manual is that it shows how four of the main UN states (Brazil, China, India, and South Africa) view inter-company pricing. Surprisingly, these four states have four different views, which obviously further complicates the matter, as shown in the examples below.

Brazil argues that the “arm’s length” principle produces immoral results, for instance, where a cost plus arrangement is set up, simply because it does not accept the “plus” that can be determined using the regular comparisons. The country introduced fixed margins for gross profits and markups. Brazil effectively applies a system that has elements of formulary apportionment. The Brazilian perspective is that the conventional use of the resale price and cost plus method implies uncertainty and legal instability, since these are implemented by the taxpayer without previous consent by the tax authorities.

China, on the other hand, has quite different problems, facing certain challenges that are not addressed by the OECD Transfer Pricing Guidelines. The situation in China is believed to be so unique that there is a lack of appropriate comparables coupled with difficulties in quantification and allocation of location-specific advantages, as well as issues relating to the identification and valuation of intangibles. In practice, this means that the Chinese tax authorities will always try to adjust the comparables to create a more reasonable arm’s length price. An example is a Chinese manufacturing plant paying royalties to a Western affiliate since 2003. In ten years’ time, the innovative character of the Chinese company could demand the Western affiliate to pay royalties in China instead.

India’s approach differs from that of China. Profit allocation is normally based on three factors: functions, assets and risks. India believes that the allocation of risks can be artificial. Contractual risk allocation would imply that an R&D plant in India is operating risk free; consequently, this subsidiary would only be entitled to a lower cost plus remuneration. The Indian tax authorities do not accept this approach. India believes that if the core function or

30. At least, this is how the NGOs portray it. However, if an individual opens a coffee bar next to Starbucks, he will never generate the same revenue as Starbucks does, because the popularity of that brand is the consequence of worldwide investments. Therefore, it is understandable that its profit is not fully taxable in the source country.

31. Similar countries are: Ghana, Indonesia, Korea (Rep.), South Africa, and Taiwan.

32. See [www.bloomberg.com/news/2013-03-25/brics-nations-plan-new-bank-to-bypass-world-bank-imf.html](http://www.bloomberg.com/news/2013-03-25/brics-nations-plan-new-bank-to-bypass-world-bank-imf.html).

33. Companies like Vodafone, Galileo International and Rolls Royce have major legal proceedings pending in India.

34. H. van den Hurk, *Voorwoord en Inleiding* [Introduction] in: *Fiscaal Innoveren in Nederland* [Fiscal innovation in the Netherlands] p. IX (Kluwer 2012).

35. United Nations, *Transfer Pricing: Practical Manual for Developing Countries* (Oct. 2012), available at [www.un.org/esa/ffd/tax/documents/bgrd\\_tp.htm](http://www.un.org/esa/ffd/tax/documents/bgrd_tp.htm).

R&D services are located there, important strategic decisions by management and employees of the subsidiary are required. The Indian subsidiary is deemed to control its operational and other risks, resulting in a higher remuneration.

South Africa has difficulties in determining the proper arm's length prices, for the same reasons as China. It is clear that hardly any comparables are available from South Africa, while Western comparables cannot be applied. Therefore, South Africa uses a more holistic approach with respect to, for instance, service fees. The current two-step OECD approach (has a service been rendered? Is the charge at arm's length?) is applied in an alternative way. The tax authorities investigate whether the recipient has an economic and commercial benefit, whether the services are performed by the recipient and whether the service fees include shareholder services. Hence, they go beyond the paperwork supporting the system and look at what actually happens from their perspective. In many situations, this approach will obviously shift the income and the tax burden to South Africa.

Although the UN Manual aims to take the lead in the transfer pricing world, the whole world does not pursue the same line of argument. Not even all UN countries apply the same approach. Several relatively small upcoming economies have their own perceptions. They have learned to understand the way companies approach pricing and try to prevent their tax bases from eroding.

The application of the OECD Guidelines and commonly used databases will not always help determine an acceptable profit allocation. Most databases do not provide information on developing countries. In particular, inter-company pricing between OECD states and non-OECD states should be tailor-made. The UN Manual provides some guidance but nothing more than that.

Will all these developments result in the end of tax planning? In the author's opinion, some of the structures are based on economic principles and should not be challenged, even if this means that the source state can levy less tax. For example, the right to use a famous brand can be sold at arm's length to a group entity in a tax-friendly country. It can be sufficient to have lawyers who manage

the IP rights in that country and to send an invoice for their use once a year (whether this structure is acceptable depends on the circumstances of an individual case). However, once companies have opted for a structure, they should accept the consequences and not ask the state to help them repatriate profits.

In the Tax Annex to the St. Petersburg G20 Leaders' Declaration, it reads that actions are identified in the area of transfer pricing to put an end to the disparity between the location of profits and the location of real activities.<sup>36</sup> It is not impossible that there will be a move from applying the arm's length principle to a system which will ultimately be close to formulary apportionment. The path would probably go via country-by-country reporting in combination with a full exchange of information to a system where profits are taxed where they are actually generated.<sup>37</sup>

## 6. Conclusions

The author is astonished at the extremely dogmatic nature of the discussion on tax avoidance – the difference between tax avoidance and tax evasion seems to have vanished completely.

This debate on tax avoidance evokes a lot of emotion. Tax law will almost certainly change. But the changes should not mean multinationals will be allowed to perform passive activities in the head office country only – this would really be a step too far. The NGOs have become part of the world of taxation; and there is little wrong in that. Tax evasion should be tackled vigorously, but tax avoidance is a different story. While some things are no longer appropriate, some of the tax structures are perfectly reasonable. And if there is a desire to change this, new laws have to be created, preferably initiated by the OECD and the UN. That which has yet to be changed cannot be used against a company.

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36. G20, *Tax Annex to the Saint Petersburg G20 Leaders' Declaration* (2013), available at [www.g20civil.com/newsg20/4071/](http://www.g20civil.com/newsg20/4071/).  
37. *Id.*, at p. 3 (an analysis of how G20 looks at the automatic exchange of information).