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Tackling the modern fiscal challenges: taxing economic value where it is generated

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Tackling the modern fiscal challenges:

taxing economic value where it is generated

Affrontare le moderne sfide fiscali:

tassare il valore economico dove è generato

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Summary

Introduction

Our modern society is the result of a strong transformation connected to the globalization process and to the advent of the digital economy. The propeller engine of these two forces has been fed up by the creation of a common international market and by the sum of all the progressive improvements in information and communication technology. Their innovative nature has shaped a completely new economic framework, radically changing the business activities and the entrepreneurial choices, in particular those of multinational entities. The possibility of operating in an extremely interconnected market has in fact allowed multinational groups to break down the pre-existing barriers to integration, conducting their business on a worldwide scale. Therefore, multinational enterprises have assumed the connotation of global value chains, positioning their activities in the most suitable geographical places and coordinating them in order to maximize the opportunities provided by the global economy.

The innovative scale of these transformations has also had an impact on taxation, posing some relevant tax challenges. In fact modern companies run their business today in a largely different way than at the time in which international tax rules were introduced. The most important change is connected to the creation of a completely new wealth paradigm. In the old economy wealth was in fact mainly deriving from tangible assets, while in the new economy it is circulating in a much more immaterial and mobile form. The value for the companies is today mainly included in intangible and hard-to-value assets, which become vehicles of economic growth and real "containers" of income. This evolution has marked the passage from the so-called "brick-and-mortar economy" to the digital one.

In this context the tax challenges are mainly oriented to erode multinational groups' taxable base and to shift their profits towards low-tax Countries, the BEPS activities. These practices are favored by the high mobility of the intangibles' related profits, since these latter do not typically have a clear geographical location and result easy to be moved. The wealth flow deriving from the intangible assets perfectly matches with the "stateless income" definition. According to Kleinbard the main feature of the stateless income is discoverable in the fact that it is "subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income is derived and is not the domicile of the group's parent company".[1] The high mobility of the stateless wealth opens to the possibility of easily

[1]Kleinbard E., 2011, *Stateless Income*, Florida Tax Review. The term "stateless income" has been used for the first time in the author's essay "*Throw Territorial Taxation From the Train*", 114 Tax Notes 547, 549 (Feb.5, 2007). Stateless income is qualified as a special tax attribute common to all multinational enterprises.

moving taxable profits within the international articulations of the multinational groups, from high-tax to low-tax jurisdictions. Such shift of income would be only relevant for fiscal purposes, because the value-creating activities would not experience any change in their location. For these reasons, the **core of the modern fiscal challenges** takes the form of a **mismatch between the place where the value is generated and the one where it is taxed.**

The relevance of the modern fiscal challenges is widely boosted by the ever-increasing pervasiveness of the digital economy. Today in fact digital economy is becoming the economy itself, thus making impossible any attempt to ring-fence it from the rest of the economy for fiscal purposes.

Moving in this context, this dissertation aims at analyzing the **modern fiscal challenges** associated with the birth of the digital economy and to present a **set of tools to adequately tackle them**.

Chapter I will focus on the "economic engine" of the modern fiscal challenges, namely the rise of the new economy. It will describe how the global value chain structure and the growing importance of the intangibles have grafted new business models for the multinational enterprises, rendering obsolete the previous ones.

Chapter II will instead adopt an evolutionary approach with the goal of describing the need to adapt the tax systems to the fiscal challenges posed by the new economy. In particular the analysis will start from the presentation of the traditional tax systems, through an historical and doctrinaire excursus. Subsequently, the transition to new tax systems will be guided by the introduction of the BEPS Plan in the international landscape. The Chapter will portray the BEPS Plan as an "architecture of fifteen measures": some of them will be considered as the groundwork of the Project, others as supporting pillars. A specific section will be dedicated to Action 1, one of the two founding measures, where a presentation of the modern tax challenges, in the form of BEPS risks, is provided.

The BEPS Project, which has originated within the Organization for Economic Cooperation and Development (OECD) and on the G20 request, acts as a beacon to "light" the process of adaption to the fiscal challenges posed by the digital economy. This project has arisen as a natural counter-response to a growing concern about the use of aggressive tax planning practices by multinational groups. The latter in fact, by exploiting gaps in international tax legislation and the ever-larger immateriality of the income, were particularly able to escape the fair taxation.

The first traces of the BEPS Project date back to July 2013, when an Action Plan on Base Erosion and Profit Shifting was published. The plan was translated in a Final Report in 2015, proposing fifteen actions to address BEPS practices and setting deadlines for their implementation.

In September 2013, a full endorsement of the BEPS Plan was expressed by the G20 leaders, during their meeting in Saint Petersburg. In that circumstance they severely underlined the necessity that all the taxpayers pay their fair share of taxes, declaring that "tax avoidance, harmful practices and aggressive tax planning have to be tackled. Profits should be taxed where economic activities deriving the profits are performed and where value is created"[2].

Always in September 2013 a subsidiary body of the Committee of Fiscal Affairs was created, named Task Force on the Digital Economy (TFDE), in which non-OECD G20 Countries participate as Associates on equal footing with OECD Countries. Its action aims at going beyond the BEPS risks, through the identification of the broader tax challenges, proposing a first set of solutions by September 2014.

Chapter III will instead operate as a "magnifying glass" on the three pillars of the Project. A simple overview will be provided with reference to Pillar 1 (Consistency) and to Pillar 3 (Transparency). A deeper analysis will instead be conducted for the Actions included in Pillar 2 (Substantial Profile), having the purpose of countering practices designed to avoid withholding tax, to escape a taxable presence or to locate income in the most favorable tax jurisdictions. The higher level of detail is motivated by the consideration that the fiscal challenges faced by Pillar 2 are the most significant in the context of international taxation, given their capacity to artificially weaken the alignment between the place in which the value is generated and the place in which it is taxed. For these reasons, Pillar 2 aims to tackle them decisively, through the identification of precise instruments to be used both in the drafting of international tax treaties and in the realization of intra-group transactions.

Chapter IV is designed to present those modern fiscal challenges which, because of their greater breadth, are able to go beyond the BEPS risks set out in Chapter 2. Each of the broader tax challenges will be combined with a specific innovative feature of the new business models, from the remoteness to the strong interaction with customers, passing for the high use of technology.

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[2] OECD, 2015, *Addressing the Tax Challenges of the Digital Economy- Action 1.* The complete extract of the declaration is available in the first chapter of Action 1 of BEPS Project. In particular the G20 leaders have welcomed the establishment of the Plan and they have encouraged all the interested parties to participate. G20 leaders have particularly appreciated the ambitious and comprehensive nature of the Project launched by OECD.

Successively the chapter will focus on the OECD and EU positions on these broader fiscal challenges. Both the organizations have today matured the conviction that a consensus-based solution is the most desirable in the international arena. This solution is expected to be found by the end of 2020. In particular, the EU, after a long journey made of own initiatives and sometimes even of burning failures, due to the lack of common agreement between all Member Countries, has decided to refer the matter back to the OECD, in hope of a multilateral and shared solution.

The dissertation will conclude with *Chapter V*, dedicated to a real case, the Google case. Its purpose consists in providing a real and concrete application to the modern fiscal challenges presented in the previous more "theoretical" chapters. The Google's fiscal strategy, known under the name of Double Irish with a Dutch sandwich and adopted for many years until the recent abandonment, has in fact represented a comprehensive container of BEPS risks and broader fiscal challenges. After presenting the functioning of the strategy, the objective will be to understand the determinants of the associated tax savings and to isolate the modern fiscal challenges that belonged to it.

The last section will be devoted to the explanation of the reasons for the abandonment by the US giant. The main explanation lies in a series of legislative interventions, inspired and guided by the innovative scope of the BEPS Plan, coming from the jurisdictions involved in the tax avoidance scheme.

The Google Case therefore aims to support the thesis that only a joint and shared international effort, conducted under the wise aegis of the OECD, can adequately tackle the modern fiscal challenges posed by the advent of the digital economy, weakening any form of tax cunning.

Chapter I: Digital economy, a totally new economic framework

The fundamental features of digital economy

The modern society is characterized by the birth and the development of a completely new economic framework, denominated digital or new economy. The digital economy is the result of a transformative process brought by information and communication technology, which has made technologies cheaper, more powerful and widely standardized, improving business processes and bolstering innovation across all the sectors of the economy. In this radically different landscape, a completely new paradigm of wealth has started to circulate.

This new era has begun at the end of the twentieth century in the US market to develop later in all the industrialized Countries. The term "new economy" was first provided by the American author Kevin Kelly in 1998.[3] According to Kelly, new economy is founded on three fundamental features: it is global, it favors intangible things, ideas, information and relationships and it is intensely interlinked.

Nowadays the digital revolution represents the most important source of change that economic organizations have to face. Their survival is in fact only possible by developing the proper capacities to adapt, so confirming the Darwin's theories according to which the survival is direct consequence of the adaptability to external changes.

The growth of the digital economy has been characterized by the high speed and the strong pervasiveness. In a very short time in fact the digital economy has expanded from being only a small slice of the economic landscape to be the economy itself. Its spread has made impossible to precisely define the digital economy boundaries, imposing to companies and authorities to adapt to this structural shake-up.

Dealing with the sources of the digital economy it is possible to observe that it is the result of the technological advances occurred in recent times. This tech improvement has caused the necessity to evolve the traditional business models schemes, radically modifying products and services offered. The technological progress on which the new economy is based can be analyzed in the light of the Schumpeterian theories[4]. In fact Schumpeter distinguished "mere inventions" from "innovation", where the latter was considered the result of an

[3] Kelly K., 1998, *New Rules for a New Economy.* In its book the author presents ten fundamental principles of the new economy that reverse the traditional wisdom of the "brick-and-mortar economy". In addition, the author suggests a set of clear and specific strategies that may guarantee the success in the network economy.

[4] Joseph Schumpeter's theories are described in his "magnum opus" *Capitalism, Socialism and Democracy* published in 1942 by Harper & Row, in which the author describes for the first time the capitalism as a dynamic and continually evolving system.

entrepreneurial process. In particular, according to the author's theories, entrepreneurs do not innovate just by making usable their inventions but also by introducing new products, services and organizational frameworks that are able to go beyond the concept of "mere invention". This theory appears to perfectly foresight the nature of the digital economy, whose main features can be summed up in three fundamental pillars: innovation, entrepreneurship and "creative destruction".

Innovation and entrepreneurship are strictly related given that the innovation is the result of the entrepreneurial capacity to change and to adapt to the modifications of the economic landscape. Differently from the old economy, the figure of the entrepreneur has become much more important in the digital economy, given the stronger emphasis on the figure of the company's founder. The entrepreneur plays in fact the role of the "founding father" of the digital firm, allowing to a digital venture to become a successful and solid business. The entrepreneurial figure is particularly relevant because it provides the strategic idea to launch and start up the digital venture project in the embryonic phase but also because it sustains and nurtures the business to promote its growth and development in the maturity phase. The strict link between entrepreneurship and innovation can be noted by observing the successful story of modern entrepreneurs and digital companies, like Zuckerberg and Facebook or Jobs and Apple.

The third pillar of the new economy is represented by its creative destruction, referring to the capacity of the innovation to make obsolete the previous innovations and the business models anchored on them. This element implies the high volatility of the digital landscape and the necessity of companies to develop dynamic capabilities to face the continuous changes.

The three pillars of the new economy allow to describe the main features of the digital economy. These can be summarized in: reliance on data and user participation, network effects, high volatility and tendency towards monopoly or oligopoly.

By focusing on the first key feature it is possible to observe that active collaboration with customers is a critical value driver for digital enterprises, incentivizing companies to collect data about the clients' attitudes and to analyze them. These data gathering activities have shifted firms to a "participatory culture", making customers central in the value creation process. In the new economy in fact consumers are playing a fundamental role not only because they buy and use the digital services but because they contribute to the design and to the creation of such services. This strong and valuable cooperation with the digital companies has permitted to define the active users as “prosumers”[5] (Toffler, 1980), underling their simultaneous participation in the production and consumption process.

The active behavior of users inserts the modern company into a network of connections with them. Network effects mainly arise from users’ marginal utility to each other, implying that the more users there are, the higher the value created is. This means that the decisions of consumers may have a direct impact on the benefits received by other consumers.

Another relevant feature of the new economy is represented by the high volatility of the technologies, requiring the companies to continuously evolve and develop their business model. The lack of attention on the volatility issue can explain the fast decline of companies that appeared to control significant portions of the market and that, in a short period of time, have found themselves quickly losing market shares to challengers proposing more powerful technologies, more attractive value offer or more sustainable business models.

At the same time, if the company is able to gain traction on a immature market, operating as a first actor and if it is able to dynamically adjust its own business model, it will succeed in dominating that market, creating a sort of monopolistic or oligopolistic presence.

The digitalization process has implied a multiplicity of benefits, from the economic and social point of view. Moving in the economic perspective the digital revolution has largely increased the firms’ productivity, the process effectiveness and the speed of communication with clients and suppliers. On the social perspective the main benefits are instead connected to the faster access to information and the higher possibility to participate in the social community life.

The handover from the old economy to the new economy has brought a radical change in the life of the companies, in particular with reference to multinational groups. The most important transformations can be summarized in the new connotation of the multinationals as global value chains and the increasing importance of the intangibles in the value creation process.

[5] Toffler A., 1980, *The third wave.* The author is widely known for his “Wave theory”, according to which the modern society is the result of an evolutionary path based on the wave concept. Toffler has identified three types of societies, each one of these associated to a specific wave. Each wave causes the overcoming of the previous cultural and social model. The first wave is associated with the agricultural society that, after the Neolithic Revolution, has replaced the cultures based on hunting and gathering. The second is instead the Industrial Age society, born in Western Europe during the Industrial Revolution. The third, and the most recent, consists in the Post-Industrial society, qualified as the Information Age.

Multinational enterprises as global value chains

The digital economy revolution has radically changed the business model of the multinational enterprises, whose structure has moved from being horizontally to vertically developed.

A multinational group can be thought as the evolution of the largest national companies for its capacity to cross the domestic boundaries and to collect the most important global challenges. In order to be classified as a multinational enterprise (MNE) a business should satisfy two fundamental requirements:

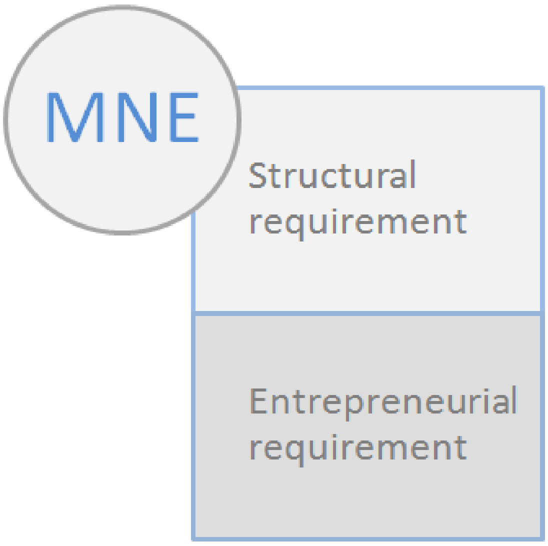

Figure 1: MNE requirements (own elaboration)

- structural requirement, according to which the firm shall be organized in the form of a group with an holding company playing the role of the parent. This holding company should own a majority stake in the voting rights of the other group's entities or it should have the right to appoint the majority composition of the executive and administrative bodies of the other companies belonging to the group;
- entrepreneurial requirement, according to which the activities of the group, even if managed in different places of the world, should maintain a strong relationship and integration to achieve value-creation objectives.

Therefore, the key essence of a multinational group can be identified in the multiplicity of the juridical parties and in the uniqueness of the economic player. From the formal point of view in fact the group is composed by a multiple number of legal entities, while the decision making function is substantially attributed to a single player, the holding company. The latter has the power to take decisions for the whole multinational structure, focusing on the maximization of the group's net utility.

It is possible to classify the multinational businesses in three categories depending on their productive features:

- horizontal multinational groups, whose different entities are focused in the realization of similar or equal products;
- vertical multinational groups, taking the connotation of a global value chain in which each ring represents a company with the function of realizing an output that is the input of the following company in the chain;
- diversified multinational groups, whose entities do not show any type of horizontal or vertical relationships among them, implying the possibility to create very different outputs.

The first traces of the multinational enterprises phenomenon could be found during the second half of the 1960s in the US market. These large companies adopted a country specific model through an horizontal structure. Their purpose was to penetrate new markets by developing foreign branches or subsidiaries sharing many similarities with the features of the parent company. These organizational units had the possibility to maintain a certain degree of operational autonomy being perfectly integrated with the local market in which they were established. The horizontal expansion was arranged mainly to face the difficulties of penetrating new and protected markets. In fact, by developing a stable positioning in the new market, the group had the possibility to escape the application of significant custom duties on products.

After this first phase the economic landscape started to change significantly and, by consequence, the features of the multinational groups. The main focus of this second period, which has reached its climax with the birth of the European Union (1992), was the creation of a global market characterized by the principles of the openness and of the freedom of movement of productive factors, such as goods, people, capitals and services. All these factors, combined with the birth of the new economy, have led the multinational companies to change their structure, replacing the horizontal focus with the vertical one.

The rise of the new technologies has in fact allowed multinationals to reduce the cost of organizing and coordinating activities over long distances, permitting businesses to manage their global operations on a integrated basis from a central location. As a consequence multinational enterprises have the possibility to maintain mobility and flexibility over the location of business functions, spreading assets and activities worldwide, in the place of highest convenience. This choice permits the group to exploit the economies of scale coming from the international expansion and to take advantage of the local sources of competitive advantage, such as low input cost or low regulation level. At the same time the creation of network effects among the different activities allows the group to develop valuable economies of experience.

This structural transformation has permitted multinational groups to take the connotation of an integrated value chain, oriented to the profit creation. According to Verlinden "the value chain is not simply a collection of independent activities but rather a system of interdependent activities"[6], where each activity is specifically run by a company of the group. Value chain activities represent the building blocks of the firm's competitive advantage and they can be subdivided in primary activities when involved in the material creation and in the subsequent sale of the product and in secondary activities, when providing a support to the primary ones.

The high level of interdependence makes the multinationals' structure much more integrated, by creating a network of interrelated organizations that, by working together and by combining their own activities, allow the group to manage and control the input flow and to reach the final clients for the output distribution.

Therefore, vertical integration has represented the way through which multinational companies have accepted the challenges posed by the globalization phenomenon, widening their own boundaries, expanding abroad and assuming a much more international dimension of their income. As a consequence, the multinational enterprises' income, being expression of the group's unitary direction, has become much more mobile and much more difficult to collocate on a specific territorial basis.

[6] Verlinden I., 2019, *Grappling with DEMPEs in the Trenches: Trying to give it the meaning it deserves,* Intertax, Volume 47, Issue 12
A first formalization of the value chain concept dates back to the work of Michael Porter "*Competitive Advantage: Creating and Sustaining Superior Performance*". Porter distinguished the chain's activities in primary and secondary. In the primary class he included: internal logistics, operations, external logistics, marketing and sales and post-sale services. On the other side, in the category of the secondary ones, he classified activities with a supporting nature: procurements, technology, human resources management and infrastructures.

The increasing importance of the intangibles

The increasing importance of the intangibles represents the essence of the new economy transformation. Intangibles are assets that do not have a physical or financial embodiment and that can be classified in at least three categories: computerized information (such as software and databases), innovative property (such as R&D, trademarks, copyrights, designs) and economic competencies (brand equity, human capital, networks joining people, firm-specific know-how). Intangible assets have become resources and vehicles of economic growth in the global trade mainly thanks to the rise of the information technologies, in particular Internet.

The focus on the intangible dimension has occurred in parallel to a decrease in the investments on fixed assets, such as plant and machineries, farm lands or mineral resources. This shift to intangibles sources of value properly represents the "silent industrial revolution"[7] (Haskel, Westlake, 2018) occurred in the digital economy. The term "silent" underlines that many companies are today running their business and generating profits with a scarce amount of tangible assets, given that the value is today much more incorporated in the know-how rather than the material dimension (so called "scale without mass"). As observed by Tom Goodwin in a famous interview in 2015 "the world's largest taxi firm, Uber, owns no cars. The world's most popular media company, Facebook, creates no content. The world's most valuable retailer, Alibaba, carries no stock. And the world's largest accommodation provider, Airbnb, owns no property. Something big is going on"[8].

The strong role played by the know-how permits to qualify the new economy as a form of "knowledge economy". The knowledge driven economy consists in a new set of competitive resources, such as the ability to innovate, to create new products and to exploit new markets, that applies to all the industries in the economic environment. This new knowledge economic framework is substantially based on the ongoing process of dematerialization of goods and services that society consumes, obtained through continuous technological sophistication and large recourse to intangible resources.

[7] Haskel J., Westlake S., 2017, *Capitalism without capital: The rise of the intangible economy*. The authors underline the "quiet" revolution brought by the digital economy, obtained without the use of physical capital. The work also outlines a series of suggestions for managers, investors and policy makers on how to exploit the characteristics of the digital economy in order to increase the value of their businesses, portfolios and economies.

[8] Tom Goodwin released this quote in March 2015 in TechCrunch, a US blog dealing with computer technology and innovation. The author is famous for his recent publication (2018) "*Digital Darwinism: Survival of the Fittest in the Age of Business Disruption*", demonstrating how the digital revolution must be accompanied by a rapid process of adaption by companies.

The opposite trend in the tangible and intangible assets of the modern companies is visible in the Figure 2 below[9]. The figure provides a graphical representation of the structural transformation occurred in the US economy in the period 1977-2017. The graph describes the evolution of the intangible investment rate in comparison with the evolution of the tangible investment rate. Both the investment rates are calculated as a percentage of the gross value added and the two rates show an exact opposite trend. While the aggregate investment in tangible assets has declined continuously during the period 1977-2017 from 16% to 10% of value added (38% drop), the aggregate investment in intangible assets has almost doubled, from 8% to 15% of value added, with a particular acceleration in the last years of the twentieth century, "the front door" of the new economy.

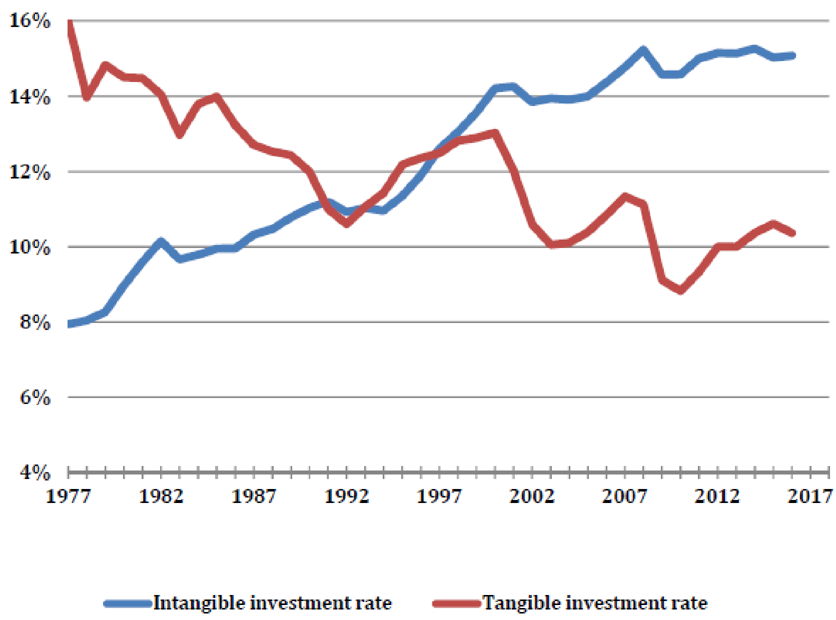

Figure 2: Carol Corrado and Charles Hulten (2010)

The growing importance of the intangibles requires to understand the typical characteristics of the intangible assets and how they deeply affect the business approach of the firms.

Dealing with the characteristics, the primary aspect is that intangibles show economic features much different from the tangible ones. In fact intangible assets are non rival goods, implying that they can be enjoyed multiple times and contemporaneously by different subjects. Another relevant feature is that they, differently from material assets, tend to lose their market value in

[9] Corrado C. and Hulten C., 2010, *How do you measure a "technological revolution"?,* The American Economic Review.
The chart has been also proposed by Baruch Lev, Professor of Accounting and Finance at New York University School of Business, in his publication "*Intangibles*", July 2018.

short times, making difficult the recovery of the initial investment through their sale and impacting as a sunk cost for the organization. Intangible assets are also characterized by the capacity to generate spillover effects, weakening the rivals' competition and by the synergies potential, given that they tend to generate much more value when combined with other immaterial resources.[10]

In terms of business approach, the rise of intangibles has radically changed the way in which companies operate in the competitive landscape. In the actual knowledge economy in fact the competition is driven by the capacity of the firms to develop appropriate immaterial assets and internal capabilities, to exploit the opportunities posed by them.

The economic value played by the intangibles is related to four fundamental dimensions: the deep link with the corporate culture, the firm-specificity, the difficulty of imitation and the value-adding capacity in the value chain framework[11].

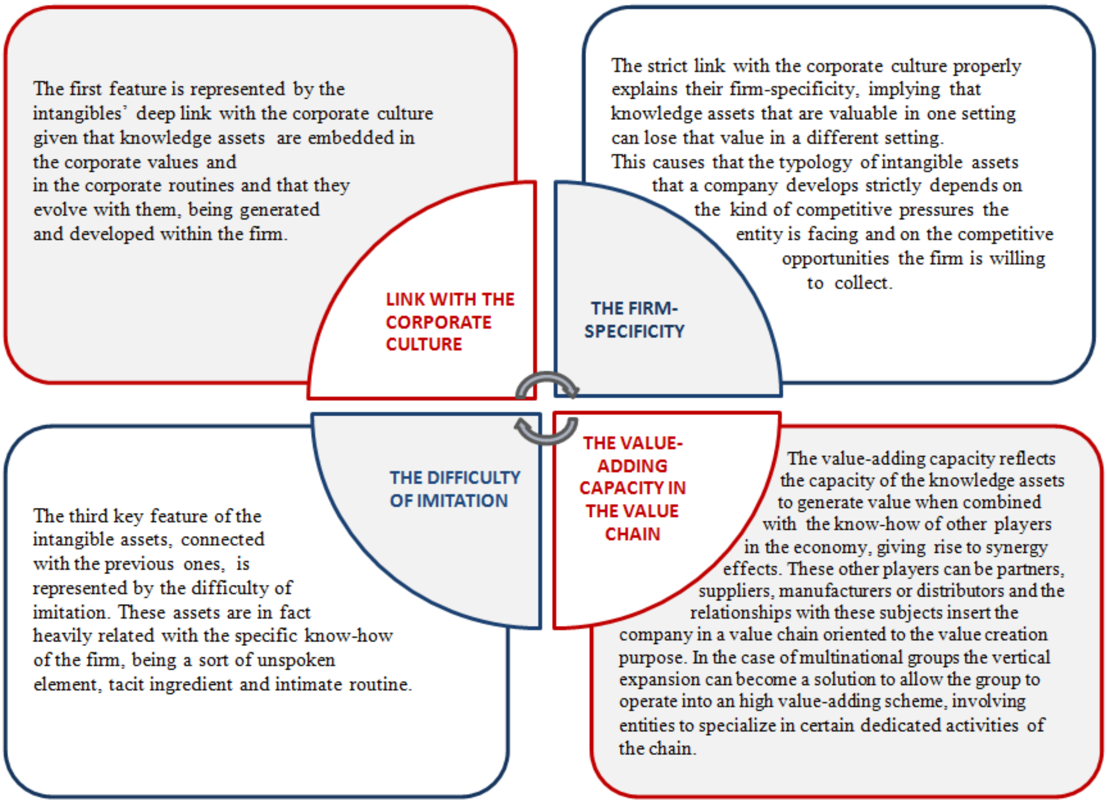

Figure 3: the economic value of intangibles (own elaboration)

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[10] Carpentieri L., Micossi S., Parascandolo P., 2019, *Tassazione d'impresa ed economia digitale*. In their work the authors present the fiscal challenges posed by the digital economy, mainly related to the use of intangibles. In particular they underline the crisis of the traditional tax systems and the necessity of undertaking a modernization path.

[11] Leadbeater C., June 1999, *New Measures for the New Economy*. The author focuses mainly on the analysis of the knowledge economy, intended as a set of new sources of competitive advantage.

These four features explain the valuable function played by the intangibles in the wealth creation process: firm's competitors will find hard to imitate them while, on the other side, firm's customers will properly value them, as declared by Professor David J. Teece (1998)[12].

The rise of the intangibles poses, on the other side, some critical challenges for those attempting to evaluate them. These challenges are the direct consequence of the firm-specific and immaterial nature of the intangibles, making them difficult to measure, quantify and value. This implies that it is not possible to identify a common and standardized approach for the intangibles' valuation but there is the necessity to adopt an highly-specific and firm-focused approach.

The first challenge is represented by the limits of the financial statement accounting in providing a precise description of the intangible assets. The most important measure of this critical issue is provided by the gap between the value of the company's tangible assets recorded on its balance sheet and its stock market-value. This gap can be numerically calculated by utilizing the market-to-book ratio, the ratio between the market and the book value of equity. The numerator, representing the market value, is including the value of the intangibles internally developed by the company, while the denominator, being the accounting book value, is excluding it. In this way the ratio shows the importance and the scale of the intangible assets, assuming higher values for the companies operating in service and high-tech industries. For example, in the case of Microsoft, only the 7% of the stock market-value is represented by physical assets, while all the residual 93% is connected to the intangibles.

The second challenge is represented by the diverging nature between accounting systems and intangibles. The accounting systems are in fact slow moving and historically based, being not appropriate in dealing with uncertainty, volatility and change. On the other side the nature of the intangibles is subject to rapid change and evolution. Lev and Zarowin (1999) suggest that the problem is not the level of investment in intangibles but the rate of change they produce. According to the two authors the investments in immaterial assets can lead to relevant and unpredictable changes in the business performance, changes that the traditional accounting schemes find difficult to track.

[12] See *Special Issue of the California Management Review*, Summer 1998 on Knowledge and The Firm. Already in 1986, with his book "*Managing Intellectual Capital*", David Teece identified the imminent advent of a new type of economy, based on digital resources and on intellectual property. Already at that time Professor Teece indicated how firms could exploit technological innovation and protect their intellectual property, thus guaranteeing and accentuating their competitive advantage.

The last challenge posed by the intangibles is represented by the absence of an active market for them. The lack of a market benchmark implies that it is difficult to establish a reliable price for the knowledge assets, making them difficult to be traded. Also this situation has critical implications for the accounting, given that accountants would be in a much better position to value intangibles if there were more robust and open markets to trade these assets.

In order to contextualize the previous three challenges it is necessary to underline that the difficulty in valuing the intangibles can lead to five main costs: the risk of insider trading, the higher costs of capital, the misallocation of capital, the weakened incentives for knowledge workers and the increased volatility.

The risk of insider trading refers to the idea that insiders within a firm or subjects that are very close to it have a better positioning to properly evaluate the strength of intangible assets and of the internal capabilities than outsiders who lack specialist knowledge. The more a company bases its competitive advantage on the intangible know-how and the more difficult it becomes for the average outside investor to assess the true value of the know-how, exacerbating the information asymmetry between the insider traders and the ordinary external investors.

The second “cost” that can derive from the difficult assessment of the intangible value is represented by the higher cost of capital. The evidence in fact shows that the more one business relies on intangibles, the higher is the cost of capital in obtaining funds. This peculiarity can be understood by analyzing the situation on the perspective of the financiers, such as bankers or investors. When financiers provide funds to a company with a large amount of tangible assets, these are seen as a sort of security, reducing the perception of risk and the required rate of return. On the other side intangibles cannot be used as an appropriate collateral, given the difficulty in valuing and measuring them. As a consequence, businesses with more immaterial assets are perceived as riskier and for this reason financiers demand a higher rate of return.

The third critical “cost” is represented by the risk of misallocating the capital. This risk is connected to the lack of an objective value of the intangibles, allowing the company to manipulate it to obtain unfair advantages. The inefficient allocation of the capital occurs when the firm voluntarily overvalues the intangible in order to attract capital from the investors. This overvaluation attracts more resources to the detriment of other industries in which the value of assets is more transparent and genuine.

The weakened incentives for knowledge workers refer to the difficulty that knowledge employees normally have to objectively quantify their ideas and their human work contribution. Knowledge workers face the risk to give away their knowledge capital to their employers too cheaply, creating a distortion among the employees and the firm.

The last critical "cost" is represented by the increased volatility and uncertainty that the company can suffer in the capital markets as a consequence of an inadequate disclosure concerning the quality of the intangible assets.

From this analysis it emerges that the nature of the intangibles addresses relevant opportunities but at the same time critical issues. Their highly-specific nature is in fact a source of corporate differentiation and a vehicle for achieving economic growth and competitive advantage. But the same nature can be the cause of potential mismatch with the financial statements representation and it can be the origins of information asymmetries with critical players, such as financiers and employees. In this perspective modern companies are required to deeply analyze the two aspects, balancing them and intelligently relating with the intangible dimension.

Chapter II: The evolution of the tax systems

The advent of the digital economy has posed some relevant tax challenges, able to trigger the crisis of the traditional tax systems. These issues have required an update of the existing tax rules in order to better align the economic and fiscal side. This Chapter is going to follow the same "evolutionary" approach. The starting point will be the presentation of the traditional tax systems, describing their historical and philosophical groundwork. Subsequently, the chapter will focus on the relevant elements of inadequacy posed by the modern tax challenges, identifying in the BEPS Project the first solving answer.

The traditional systems of taxation

The traditional systems of taxation are associated to a set of fundamental pillars, defined by the OECD as "overarching principles of tax policy"[13]. These principles can be summarized in the following ones:

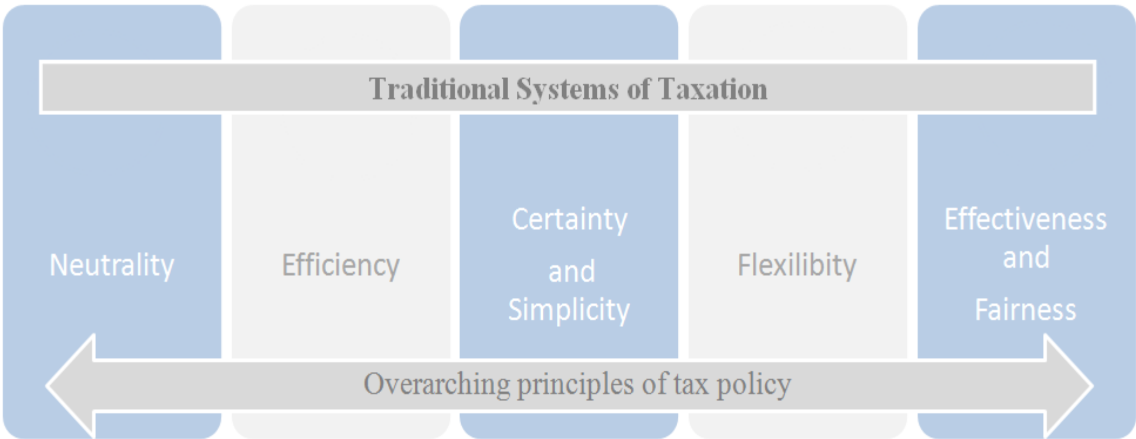

Figure 4: Traditional Tax Systems (own elaboration)

Taxation is characterized by *neutrality* when its imposition is equitable among the different players in the business landscape, without generating any kind of discrimination.

By meeting the neutrality principle, taxation results also *efficient*, meaning an optimal allocation of resources in the economic environment.

Certainty and simplicity are instead related to the necessity of having clear and easy to understand tax rules, in a way that taxpayers can properly recognize their obligations. The

[13] OECD, 2015, *Addressing the tax challenges of the digital economy- Action 1.* The "overarching principles of tax policy" have represented the basis for the 1998 Ottawa Ministerial Conference: since then, they are known as the Ottawa Taxation Framework Conditions (OECD, 2001).

clarity ensures in fact the avoidance of useless complexities that may incentivize aggressive tax planning activities.

The feature of *flexibility* requires a dynamic taxation, in order to keep pace with the technological and commercial transformations. By flexibility a double advantage is reached, namely meeting the revenue targets of the government and better adapting to external changes on a rapid basis.

The last two features are represented by *effectiveness and fairness*, according to which taxation should generate the right amount of tax burden at the right moment. The goal is clearly the one of escaping both double taxation or tax avoidance situations.

From the historical point of view, the first traces of the traditional tax systems may be found in the 20th century. This period is characterized by the liveliness of the tax studies, regarding the key principles and key concepts of tax levy, in addition to a more international dimension of the commercial and financial trades.

One of the most significant outcomes of the tax studies has been the conceptualization of the corporate income tax. Corporate income tax phenomenon was born in the US economy and it consisted in the possibility for the States to levy taxes on the firm's profits and not only on the portion distributed to shareholders[14]. At its origins the introduction of corporate income taxes was perceived "more as an expedient to increase State revenues than as part of an organic and rational tax reform plan" (Cosciani, 1986)[15]. Through this levy the local governments could find other sources of tax revenues beyond the traditional ones coming from individual taxpayers.

Moreover, the same governments could regulate some corporate situations not properly taxed, such as the profits allocated to accounting reserves. The lack of profit distribution to the shareholders and their consequent allocation to reserves showed the inefficiency of the schemes based on the individuals' income. The corporate income tax has eliminated this issue, taking shape as the simplest and most effective solution.

The corporate income tax phenomenon rapidly expanded worldwide and it progressively took a path of formalization, assuming the connotation of a an organic tax reform plan. In Italy the first studies are belonging to Benvenuto Griziotti, who first adopted the concept of "corporate

[14] Carpentieri L., Micossi S., Parascandolo P., 2019, *Tassazione d'impresa ed economia digitale.* In the Italian Law the corporate income tax was firstly introduced in 1954, through the Law 603 of 6th August 1954.
[15] Cosciani C., 1986, *Aspetti economici dell'imposta sulle società,* Quaderno dell'Associazione fra le società italiane per azioni, Roma, p.4

contributory capacity”.[16] According to Griziotti in fact the firm’s income generation function requires an autonomous and separated contribution to the national tax revenues. This contribution is independent from the shareholders’ one and it anchors on the corporate profits. In this way the firm abandoned the framework of being a mere collector of taxes due by its shareholders for becoming a self-standing taxpayer. According to Cosciani the corporate income tax can act as a valid instrument to properly shape the taxation system, avoiding unfair tax jumps and ensuring the progressivity principle. In addition Cosciani has described the corporate income tax as a mechanism to control the functioning of the economy, preventing situations of imperfect competition and unfair market power concentration.

On the other side, the development of international flows implied the birth of situations able to overcome the domestic boundaries of the Countries and characterized by an higher profile of complexity from the taxation point of view. The rise of a cross-border income entails that a multiplicity of jurisdictions may claim the right to tax that profit, generating what is called juridical double taxation. The double imposition of comparable taxes in two or more States on the same taxpayer raises up harmful effects in terms of incentives for cross-border movements of capitals and resources.

In order to overcome the double taxation issue it was necessary the definition of schemes able to properly allocate the taxing rights among Countries. The starting point was the identification of a list of criteria granting a legitimate power to tax to the jurisdictions involved in the cross-border situations.

The first international body that attempted to formalize these matters has been the League of Nations[17]. In the early 1920s the study was conducted by four economists: Professor Bruins, a Dutch monetary expert, Luigi Einaudi, who ultimately became the second President of Italy, Edwin R.A. Seligman, a relevant figure in the US public finance and Sir Josiah Stamp, a British tax expert who ultimately directed the Bank of England. They were appointed by the League of Nations with the purpose of giving a theoretical and practical vision of the international tax issues.

[16] Griziotti B., 1923, *Lezioni di scienza delle finanze*. Benvenuto Griziotti’s studies have mainly articulated in the field of public finance. Unlike many other authors, however, he assumed a more juristic approach rather than an economic one. In the tax field, Griziotti was in favor of levying tax on annuities and on the corporate income. He was also in favor of the introduction of a registration tax.

[17] The League of Nations was the first inter-governmental organization with the aim of enhancing human well-being. It was founded at the end of First World War, during the Paris Peace Conference of 1919. It became extinct on 19th April 1946 following the failure represented by the outbreak of Second World War and the birth, in 1945, of another international organization with the same purpose, the United Nations.

The work of the four economists has brought to the definition of the *economic allegiance* concept, permitting to design an international tax framework able to regulate both domestic and cross-border situations.

Economic allegiance is intended as the presence of economic connection between the income and the State entitled to tax it.

Its perimeter is outlined by four guidelines, associated to one of these possible factors:

- origin of wealth
- situs of wealth
- enforcements of the rights to wealth
- place of residence of the person entitled to consume the wealth

The analysis of the four economists has mainly focused on two of these factors, the origin of wealth and the place of residence of the subject consuming the wealth. The first aspect has been qualified as the *source criterion*, while the second as the *residence criterion*. These two principles represent real milestones of a State's jurisdiction to tax and they traditionally work as anchor points for all the tax systems. Consequently, a State may invoke a legitimate tax claim when it shows power over a certain territory or over a certain group of subjects. In the first case the State can levy a tax on the income sourced in its territory for a "territorial attachment"[18] (Beale, 1935) link, while in the second on the income belonging to its own residents for a "personal attachment link" (Schon, 2010)[19].
Under this perspective, situations involving domestic income show no complication profiles because both the attachment links are connected to a single State. As a consequence, an exclusive jurisdiction to tax that income is granted to the country. On the other side, when a transaction is able to cross the domestic boundaries, assuming an international respire, the two links may belong to a multiplicity of States, giving rise to a shared jurisdiction to tax and creating potential room for double taxation. In these critical situations, the definition of a set of rules governing the distribution of taxing rights among different countries is necessary. This explains the introduction of the OECD distributive rules, whose inspiring principle lies in the economic allegiance concept. For example, dealing with the business profits, OECD Model Tax Convention establishes that they, whatever the place of generation, are exclusively

[18] Beale J.H., 1935, *A treatise on the Conflict of Laws,* Vol.1, p.275, originally published by Baker, Voorhis & Co., New York. Beale's treatise ranks with Williston on Contracts and Wigmore on Evidence as one of the undisputed classics of twentieth-century American law.
[19] Schon W., 2010, *Persons and territories: on international allocation of taxing rights,* British Tax review, pp.554-562. A "personal attachment link" between the subject and the State is considered a sufficient source of economic allegiance, thus legitimately empowering the State to tax such income.

taxable in the state of residence, unless the company owns a permanent establishment in the State of income source.

The primary meaning of the permanent establishment concept is "a fixed place of business through which the business of an enterprise is wholly or partly carried on"[20]. Alternatively, when a physical place cannot be found, the permanent establishment may be however associated to an agent acting on behalf of the foreign enterprise. This person should conclude contracts for the firm, without any form of material interference by the principal.

It appears clear that the permanent establishment operates as a threshold for identifying the specific circumstances in which a foreign company can be regarded as "sufficiently integrated into the economy of a State to justify the taxation in that State" (Holmes, 2007 and Rohatgi, 2005)[21]. Therefore the permanent establishment represents a sufficient firm's economic presence in a certain Country and its concept perfectly integrates with the principle of the economic allegiance defined by the four economists: a business income can be taxed only if a strict economic link between that income and the territory exists.

The BEPS Project: the transition towards the modern tax systems

The "multinational enterprises as global value chains" and the "increasing importance of the intangibles" represent the key features of the digital economy that mostly have the capacity to exacerbate the Base Erosion and Profit Shifting (BEPS) risks. Eroding the taxable base and moving away the profits from the Country in which they have been generated towards more favorable tax jurisdictions are in fact favored by the ramification of the modern multinational companies around the world and the high mobility of the income associated to intangibles. The result of these unfair practices brings to a minimization of the group tax burden and opens to the double no-taxation issue.

BEPS activities represent a typical example of tax planning strategies largely adopted by multinational entities, where tax planning refers to the activity to identify and apply the best solution, among those permitted by law, to achieve the highest tax savings, maximizing the net utility of the group. In this way the companies that are able to exploit these opportunities may benefit an unfair tax advantage, at the expenses of the firms unable to cross domestic boundaries or refraining BEPS activities. These tax planning strategies show the capacity to

[20] OECD, 2017, *Model Tax Convention on Income and on Capital: Condensed Version 2017,OECD Publishing,* art.5(1) dedicated to Permanent Establishment.

[21] Rohatgi R., 2005, *Basic International Taxation,* Volume I: Principles, 2nd edition, Richmond Law and Tax Ltd, United Kingdom; Holmes K., 2007*, International Tax Policy and Double Tax Treaties,* IBFD Publications, the Netherlands

undermine the integrity of the traditional tax system, creating a "digital international tax gap" (Turina, 2018)[22] and to radically alter the regular competition among firms.

The first attempt to overcome these improper practices has taken form with the drafting of the BEPS Project by the OECD. In July 2013 OECD published the BEPS Action Plan, consisting in fifteen actions aiming at analyzing the matter on an international basis.

The BEPS Plan anchors on three fundamental Pillars:

- Consistency, intended as the pursuit to create coherence among the different national tax regimes to properly address the cross-border transactions;
- Substantial Profile, intended as the requirement to locate the taxable wealth in the place in which it has been generated;
- Transparency, intended as a form of information exchange for improving the legal certainty for the safeguard both of enterprises and national governments.

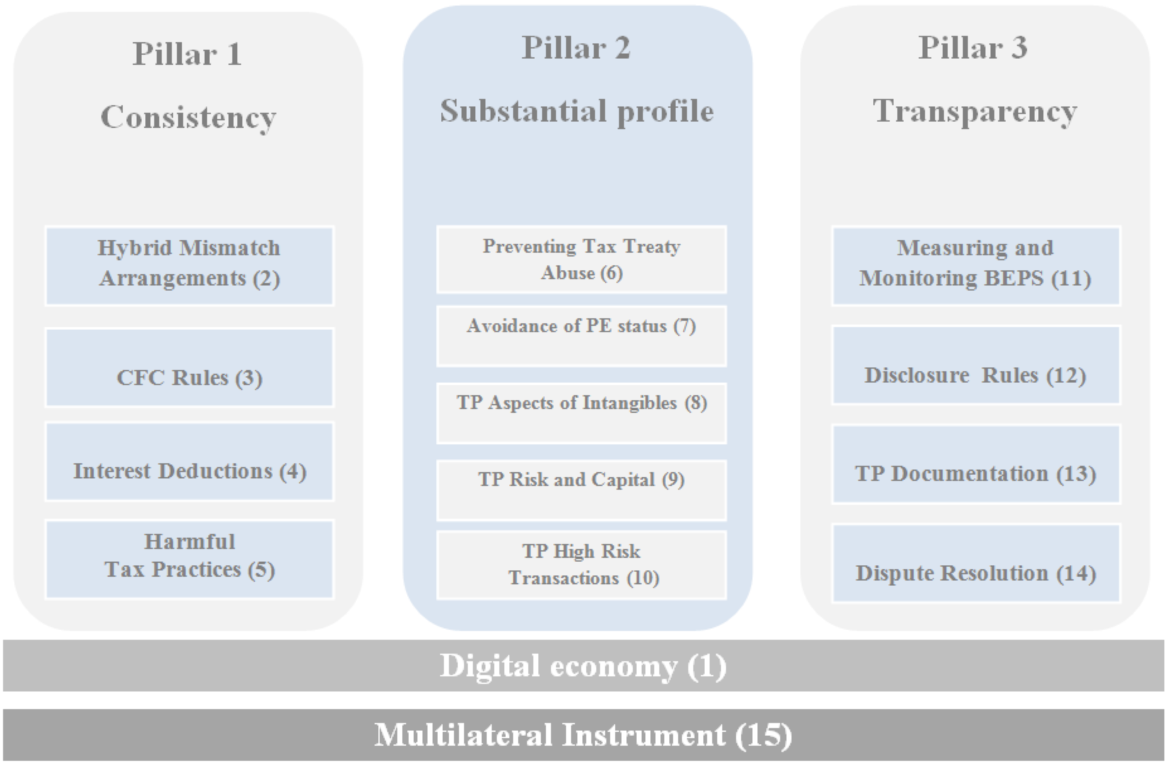

Figure 5: BEPS Project (own elaboration)

The groundwork of the BEPS Plan have a different nature: Action 1 "Digital Economy" has a more descriptive connotation, while Action 15 "Multilateral Instrument" owns a more practical approach. In fact the goal of Action 15 is to speed up the introduction of the most impacting anti-BEPS measures on the bilateral tax treaties. In this way the contracting States

[22] Turina A., 2018, *Which "source taxation" for the digital economy?,* Intertax, Volume 46, Issue 6 & 7

may avoid a time-consuming bilateral renegotiation and they may quickly synchronize their tax treaties with the contents of the BEPS Plan. Based on this analysis, a multilateral instrument is proposed, representing a completely innovative approach in the international tax landscape. Accepting this juridical tool ensures the capacity of keeping pace with the tax challenges occurring in the modern digital economy.

On the other side, the goal of Action 1 is providing a detailed description of the concrete situations belonging to the BEPS risks category. The understanding of these issues allows to adopt the specific anti-BEPS measures for granting the fairness and the neutrality of the taxation.

The following paragraph illustrates a set of specific tax challenges posed by the new economic framework dealing with the direct taxation, as described in the Action 1.

Action 1: Addressing the Tax Challenges of the Digital Economy

Action 1 plays the function of a descriptive groundwork for the BEPS Project. It in fact assumes the connotation of a connecting element between the economic and the fiscal side, accurately describing how the new economy is able to feed and accentuate the BEPS risks. The higher degree of innovation, digitalization, globalization and the increasing dematerialization of the income have strengthened the ability of the multinational groups to disseminate their activities around the world and, consequently, the possibility to separate the place of income generation from the place of income taxation. These transformations have triggered the crisis of the *territorial link* principle, revealing all the inadequacy elements of the traditional tax systems.

According to Action 1, these modern tax challenges are assuming a wider impact given that "the digital economy is increasingly becoming the economy itself"[23], making it difficult to separate it from the rest of the economy for fiscal purposes. These critical issues require a general and effective intervention, regarding both the tax preconditions and the allocation of the tax claims among different jurisdictions. The implementation of this approach, based on the anti-BEPS measures belonging to the three pillars, is strictly related to the understanding of the modern tax challenges. Action 1 summarizes them in:

a) taking unfair tax advantage through hybrid mismatch arrangements, excessive deductions or harmful tax practices;

[23] OECD, 2015, *Addressing the Tax Challenges of the Digital Economy- Action 1*. The complete reference may be found in the Executive Summary of the Action, p.11. See https://www.oecd.org/tax/beps/beps-actions/action1

b) avoiding withholding tax;
c) avoiding a taxable presence in the market country;
d) locating the income allocable to functions, assets and risks in the most favorable tax jurisdictions.

As visible in the *Figure 2* above, the first tax challenge is associated to the Pillar 1 of the BEPS Package, anchoring its resolution on the creation of an international coherent tax framework. On the other side the other three tax challenges are connected to the Pillar 2, requiring a substantial alignment between the place in which the wealth is created and the place in which it is taxed. A description of the four modern tax challenges is provided in the following section.

Taking unfair tax advantage through hybrid mismatch arrangements, excessive deductions or harmful tax practices

A multinational group may achieve an unfair tax advantage by exploiting certain *hybrid mismatch arrangements*, where an “hybrid situation” is intended as a lack of coordination between two domestic legal systems. The asymmetry between two different national jurisdictions offers the opportunity to escape the fair taxation, in the form of double non-taxation, multiple deductions on the same expenditure, deductions against which no tax is payable or long-term deferral of the tax itself. These unfair practices may be implemented through the use of certain strategies involving the use of an “hybrid instrument”. An instrument is qualified as “hybrid” when its categorization gives rise to a mismatch between two different legal systems. One jurisdiction may in fact classify it as a debt instrument, while the other as an equity one. In the first case an interest will be recognized, while in the second a dividend. This lack of symmetry poses relevant problems in terms of the taxable treatment of the payment associated to the instrument, when, like in the case of the European Union landscape, the intra-group dividends are exempted from taxation[24]. As a consequence, no taxation will occur in the jurisdiction that qualifies the instrument as “equity”, while the deduction of the interest will be granted in the other country.
Another way through which a multinational group gets an unfair tax advantage is by adopting *excessive deductions*. The erosion of the group taxable base may in fact derive from

[24] The exemption of the intra-EU dividends for a multinational group is granted by the 2011/96 EU Directive, so called Parent-Subsidiary or Mother-Daughter Directive. The exemption has been designed in order to eliminate the economic double taxation that would otherwise hit the dividend flow. In fact the same item of income would be taxed twice on the hands of two different taxpayers, the subsidiary and the parent.

maximizing the use of deductions for payments made to other group companies. These payments take primarily the form of interests, but also royalties or service fees are included. These strategies are particularly working when relevant mismatches exist between the taxation level of two different legal systems in which the multinational group is operating. The incentive of the organization will be minimizing the taxable base in a high-tax country and this purpose will be achieved by arranging an intra-group financial transaction between two group entities. In particular, the affiliate located in a low-tax jurisdiction will obtain a loan from an external financial intermediary and then it will lend the same amount of money to the subsidiary located in the high-tax country. In this way the flow of interests between the two companies will ensure a deduction of such costs, eroding the taxable base in the high-tax country.

A similar scheme may be organized in the case of the flow of royalties or service payments between two companies of the same multinational group. When in fact a company located in a high-tax country is using the intangible held by another affiliate in a low-tax jurisdiction, the payment of the royalty will bring to the deduction of such cost, limiting the taxation in the high-tax country.

Another relevant way through which a multinational group may obtain an unfair tax advantage is represented by the adoption of *harmful tax practices*. These strategies are supported by the mushrooming of many low-tax legislations around the world, designed to attract and maintain foreign investments.

Many Countries have in fact started to provide large tax benefits on the income produced by intangible assets located in their territory. These favorable tax regimes are named *IP Boxes* given their purpose of providing a reduced tax rate for the corporate income derived from the exploitation of intellectual properties.

The excessive adoption of these preferential regimes, in combination with the high mobility of the intangibles' income, may become vehicle of unfair tax advantages for a multinational group. In fact the group would have the incentive to choose the best allocation for its profits, generating an harmful tax competition among the countries.

Avoiding withholding tax

In general terms a multinational group is subject to a withholding tax in the situations involving outbound payments, such as royalties, dividends and interests. A reduced withholding tax or a complete exemption may arise in accordance with certain Tax Treaties between the jurisdiction of the payer and that of the recipient. These benefits are only granted

to the residents of the Contracting States.
The presence of favorable treaty networks around the world may incentivize a multinational group to implement artificial practices in order to participate in these favorable tax regimes. These aggressive tax planning strategies are known with the term of *treaty shopping*. *Treaty shopping* is a form of international tax avoidance and occurs when a taxpayer looks around in order to exploit the most advantageous treaties and their related benefits.
This strategy is possible by interposing shell companies in countries inserted in favorable tax treaty networks, for the sole scope of taking the tax advantage that would otherwise be guaranteed only to residents of the contracting country. This course of action produces a flourishing of mere "letter box" companies, without any economic substance. Their presence is detached from the economic environment in which they are formally inserted, lacking any operating connection.

Avoiding a taxable presence in the market country

The avoidance of the taxable presence in the market country is a very recurring tax challenge, primarily connected with the permanent establishment definition. The latter, as previously exposed, traditionally works as a threshold for granting power to tax of a Country over profits belonging to a non-resident company. If, however, the permanent establishment definition is not appropriate to the features of the current economic framework, opportunities may be created for initiating BEPS practices, in the form of artificial avoidance of the PE status.
For example, a company may try to minimize its tax burden by fragmenting its operations among multiple group entities in order to qualify them as "preparatory or auxiliary" activities, artificially falling in the exceptions to permanent establishment status.
The avoidance of the taxable presence in the market country also poses some broader fiscal challenges, going beyond BEPS. Today in fact modern enterprises are able to relate with customers in a remote way, without the necessity to be physically present in the territory, thanks to a website or other digital means. Reliance on automated processes and on physical presence are moving in a opposite direction because the more is the technological advance and the less is the necessity to be physically inserted in the territory.
The lack of physical presence produces a crack in the most important pillar of the traditional tax systems, the permanent establishment concept, traditionally anchored on the physicality requirement.
By avoiding a taxable presence in the market country, a multinational enterprise has therefore the capacity to earn revenues from customers without having a permanent establishment, thus

experiencing a significant tax relief.

Locating the income allocable to functions,
assets and risks in the most favorable tax jurisdictions

This tax challenge is moving around the concept of the principal company model[25]. This framework consists in the creation of a "centralized tax structure" (Valente, 2016), with the purpose of minimizing as much as possible the tax burden and, by consequence, maximizing the net profit of the group. The first step consists in identifying a principal company located in a Country with low or privileged fiscal legislation in order to shift the largest portion of the risks associated to its global value chain to this Country. The realization of this strategy requires the transfer of its own assets within the multinational group through a contractual basis. This juridical movement allows the group to widely reduce its own effective tax rate and, consequently, its own tax burden.

It emerges that the application of the principal company model can provide the best results if two conditions are satisfied. The first refers to the easiness in transferring the asset from one Country to another, while the second refers to the fact that the asset, object of the transfer, should be a significant "container" of income. In this way the group, by moving the asset, moves the income too. The more the income transferred in a low-tax Country and the less the taxation will be levied on the group.

The principal company model is particularly valuable when dealing with multinational entities transferring intangible assets within their group. In this context in fact both the previous conditions are widely satisfied: the easiness in transferring the asset is ensured by the worldwide articulation of the modern multinational enterprises and by the absence of a clear and univocal geographical localization for the intangibles, while the economic value of the asset transferred is ensured by the fact that today intangibles are increasingly becoming vehicles of growth and profit.

In this context therefore multinational entities can easily organize cross-border movements of intangible assets. Their related rights and returns can be contractually assigned and transferred to an affiliate of the multinational group that is located in a low or no-tax jurisdiction. In this way the income subsequently earned from these assets is associated to a reduced taxation for the presence of a preferential tax regime.

These transactions represent the most important example of transfer pricing in the modern economy. Their transfer is in fact involving two associated parties, the companies of the same

[25] Valente P., 2016, *Intangibili e determinazione dei prezzi di trasferimento,* Fiscalità e Commercio Internazionale 1/2016. For further information, consult Valente P., *Manuale del Transfer Pricing*, IPSOA, 2015.

group, and a price that is internally defined among them. This implies that the transaction does not reproduce the conditions at which the same would have occurred in a free-market context among two unrelated parties, therefore not satisfying the arm's length principle. But the most critical aspect dealing with the transfer pricing of the intangibles is that it is difficult to apply the Transfer Pricing Legislation, given the absence of comparable reference market benchmarks. This requires a strong attention by the tax legislator in order to ensure that the corporate profits are allocated in accordance with the value creation criterion, avoiding situations of unfair profit shifting and unfair erosion of the taxable base.

Figure 6 below summarizes the most important BEPS opportunities arising in the digital economy. The graph is a typical representation of a multinational entity structure, as visible from its large ramifications in at least four different Countries: the ultimate residence country, two intermediate countries and the final market country. The ultimate residence country, the market country and one of the two intermediate countries are assumed high-tax, while the remaining intermediate is assumed a low-tax one. The figure shows that the tax burden can be reduced in the high-tax jurisdictions by minimizing functions, assets and risks, shifting them towards low-tax jurisdictions. Other modern tax challenges are represented by the maximization of tax deductions to erode the taxable base, by the avoidance of withholding tax payments, by the adoption of preferential tax regimes on intellectual property and by the exploitation of certain hybrid mismatches. In the case of the market country a critical challenge may derive from the avoidance of the taxable presence.

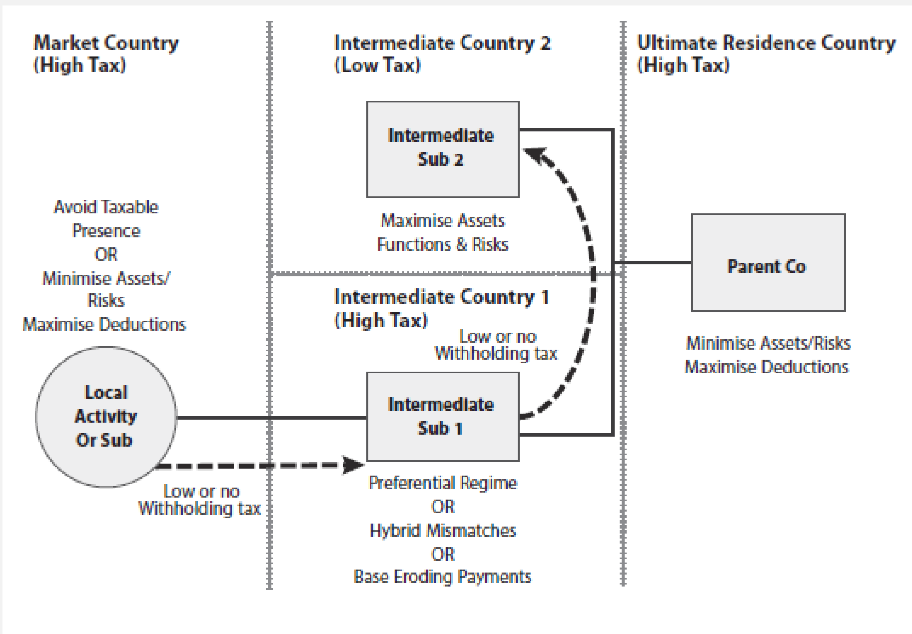

Figure 6: BEPS planning in the context of the income tax (OECD, 2015)

Chapter III: The three pillars of the BEPS Project

The Actions proposed by the BEPS Plan may be grouped in the three pillars of the Project, depending on their nature and their purpose. This section has the goal to provide an overview of the anti-BEPS measures belonging to Pillar 1 (Consistency) and Pillar 3 (Transparency), while a deeper analysis will be conducted for the Actions included in the Pillar 2 (Substantial Profile). An higher level of detail for the Actions in the second pillar may be explained in the light of their capacity to ensure a geographical alignment between taxation and value creation process. Their substantial approach allows to face the most critical tax challenges posed by the new economy, such as treaty shopping, PE status avoidance and transfer pricing.

Figure 7: focus on Pillar 1 (own elaboration)

Pillar 1: an overview

Action 2 defines a set of recommendations to neutralize the tax effects of the ***hybrid mismatch arrangements***. This Action follows a double-track approach, being based in two sections, respectively dedicated to the domestic and to the international framework.

In the first part OECD proposes a list of recommended changes to the domestic law. This is achieved by identifying a sort of "linking rules"[26] with the purpose of ensuring an alignment between the tax treatment of an instrument with the tax treatment received in the counterparty jurisdiction. Their application is based on a certain hierarchical order, distinguishing the primary rule from the secondary (or defensive) rule.

The primary rule places a limit on taxpayers' deductions, allowing countries to deny them at the occurrence of certain conditions:

- when the same item has not been included in the tax base by the recipient's jurisdiction
- or when it has been already subjected to deduction by the counterparty jurisdiction.

[26] OECD, 2015, *Neutralizing the Effects of Hybrid Mismatch Arrangements- Action 2*. The neutralization of hybrid mismatches is required by their negative impact on competition, transparency, fairness and efficiency. See http://www.oecd.org/tax/beps/beps-actions/action2

The secondary rule exercises its defensive function when it replaces the primary one, being its exact reverse. It reaches the same objective because the counterparty jurisdiction may include the payment in the taxable base or it may deny a deduction on the same item.

In the second part Action 2 approaches the *hybrid mismatch* issue according to an international perspective, mainly focusing on the tax treaty law. In this way it is prevented the use of hybrid strategies to achieve undue tax treaty benefits. Moreover, domestic law modifications proposed in the first section may not be obstructed by the international tax treaties.

Action 3 refers to the ***CFC Rules***, intended as the answer to the risk that taxpayers with a controlling ownership interest into a foreign company may arrange profit shifting activities towards that subsidiary. By proposing this anti-BEPS measure, OECD has tried to collect many previous domestic experiences developed over time by individual countries, with the additional aim of keeping the pace with the evolution of the actual international business landscape.

The CFC Rules designed by the Action 3 are based on six building blocks consisting in:

- definition of a CFC, underlining the foreign and subsidiary nature of the firm involved;
- CFC exemptions and threshold requirements, anchoring the application of the CFC rules to the presence of a significant lower taxation than that connected to the parent jurisdiction;
- definition of income to which CFC Rules are applied, not necessarily the whole income of the CFC;
- computation of CFC income, based on the rules of the parent jurisdiction;
- attribution of CFC income to shareholders, tied with the relative ownership stake;
- prevention and elimination of double taxation, in order not to hurt the investment decisions.

In this way, the share of the CFC's subject income attributable to each shareholder is included in the domestic taxable base.

Action 4 seeks to define a limit for the ***interest and other financial payments deductions***, identifying a "best practice approach"[27]. Such approach is not applied to royalties. The rule starts from the definition of a fixed ratio, that restricts the entity's net interest deductions to a fixed percentage of its EBITDA. The corridor between 10% and 30% is suggested as the quantitative benchmark for such ratio, keeping into account the specificities of the country in which the firm is located.

The adoption of a single ratio, common to all the country's firms, may pose some relevant drawbacks given that the debt exposure is not the same for all the multinational groups. The leverage in fact is related to the economic sector in which the group belongs and to the specific group's policies. The drawbacks derive from the fact that the common application of the fixed ratio rule would cause a tax constraint: groups which have a net third-party interest/EBITDA ratio above the benchmark fixed ratio would result unable to deduct the totality of their net third-party interest expenses.

In this context a supplementary criterion may allow the overcoming of the homogenous fixed ratio. Through this rule an entity is able to deduct its own net interest expense up to its group's net third-party interest/EBITDA ratio, in the cases in which this is higher than the benchmark fixed one. This criterion is known as the group ratio rule.

Alternatively the fixed ratio rule can be supplemented by an asset-based ratio approach. One example is the equity escape rule, according to which the fixed ratio rule does not apply if an entity is able to show that its equity/total assets is equal or exceeding the group's one. Passing the equity escape test means a whole deduction of the exceeding borrowing expenses, while failing to pass it forces to apply the fixed ratio rule.

Action 5 is directed to solve the ***harmful tax practices*** and turns out to be the refinement of the Report "Harmful Tax Competition: an Emerging Global Issue", launched by OECD in 1998. The necessity to realign taxation of income with the concrete activities that generate it has led to the formulation of a "nexus approach"[28]. This approach subordinates the enjoyment of preferential regimes associated to the IP income to the carrying out of a required

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[27] OECD, 2017, *Limiting base erosion via interest deductions and other financial payments- Action 4*. Action 4, starting from the consideration that money is mobile and fungible, aims at contrasting BEPS practices concerning the use of debt. One of these practices consists in concentrating debt in the high-tax jurisdictions, in order to exploit the deductible nature of interests. A confirmation of this practice may be found in the text of Action 11, "Measuring and Monitoring BEPS". See http://www.oecd.org/tax/beps/beps-actions/action4

[28] OECD, 2015, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance- Action 5*. The reference is visible in the Executive Summary of the Action, p. 9. See http://www.oecd.org/tax/beps/beps-actions/action5

"substantial activity"[29]. Therefore, the corporate taxpayer, in order to benefit of the IP Box proposed by a certain Country, has to effectively manage in that Country the economic activity that the regime wants to promote.

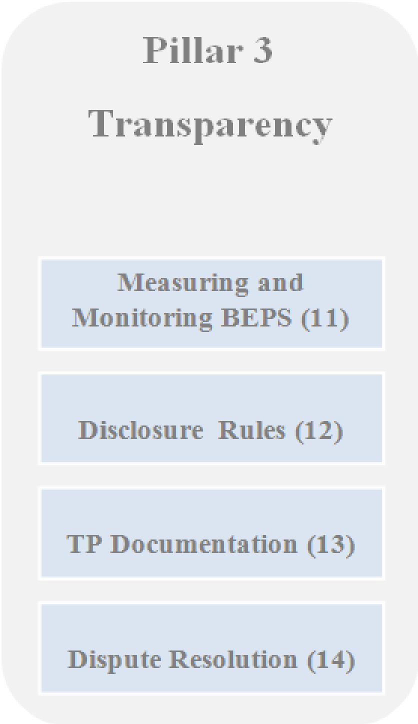


Figure 8: focus on Pillar 3 (own elaboration)

Pillar 3: an overview

Action 11 is based on the finding that BEPS effects are considerable, making necessary the adoption of certain indicators for ***measuring and monitoring*** them. The most relevant BEPS effects take the shape of**:** tax revenue losses, distortion of the competitive landscape in favor of multinationals adopting aggressive fiscal practices, excessive use of debt as source of financing and alteration of the foreign direct investments.

BEPS activity is analyzed through a set of five indicators, based on different sources of data and different quantitative metrics. These are:

- the profitability of the MNE subsidiaries located in low-tax countries is greater than the group's average profitability on a global scale;
- significant tax advantages are perceived by large multinational groups compared to only-domestic firms, in the form of a lower effective tax rate;
- the distribution of foreign direct investments (FDI) is concentrated where many other investments are located;
- the geographical separation of value creation from the relative taxation is particularly visible in the case of intangibles;
- the recourse to debt as a source of finance is more concentrated in high-tax countries in order to leverage the "deductible" nature of the interests.

Action 12 anchors on the conviction that, when a timely, complete and detailed information on aggressive tax planning practices is not provided, relevant challenges should be faced by

[29] OECD, 2015, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance- Action 5*. For example, the granting of IP Boxes should be subordinated to the conducting of research and development (R&D) activities. This means that income deriving from intellectual property is subjected to a favorable tax regime, only if the taxpayer has substantially performed R&D activities in the territory granting the IP Box.

the tax authorities. In order to solve this issue, the Action introduces a "modular framework"[30], based on a set of mandatory ***disclosure rules***. These rules are designed with the goal to ensure the access to a relevant flow of information for tax administrations, permitting a quick understanding and answer to the main tax risks posed by multinationals. This disclosure regime should indicate: who shall report, the information to be reported, the time frame of the reporting and the consequences of the non- reporting. The effectiveness of disclosure rules is subordinated to the achievement of two interconnected features, transparency and deterrence. When in fact an aggressive tax planning approach shall be transparently disclosed, the taxpayer may think twice before adopting it.

Action 13 develops a set of rules regarding ***Transfer Pricing Documentation***, by proposing a common template through which multinational groups should improve transparency for domestic tax authorities. Corporate taxpayers should provide a description about the places in which they have allocated the income-generating activities and in which the consequent taxes have been paid. This disclosure allows the domestic tax administrations to properly assess the transfer pricing risks and takes the form of a "three-tiered approach"[31] consisting in:

- a master file, a document summarizing the group's global business activity and the transfer pricing policies, made available to all the relevant tax authorities;
- a local file, focusing on the material intra-group transactions that have occurred in a specific country;
- a Country-by-Country Report, addressed to each State in which the multinational group runs its business, describing the amount of revenues, the profit before taxes and the taxes paid and accrued.

Action 14 is focused on the ***dispute resolution*** mechanisms, strengthening the mutual agreement process (MAP) proposed by article 25 of the OECD Model Tax Convention. The mutual agreement process consists in a mechanism through which the tax authorities of the Contracting States may find an agreement regarding the interpretation and the application of a certain tax treaty, minimizing the risks of useless uncertainty or harmful double taxation on the taxpayer. The improvement of the dispute resolution schemes is perceived as a

[30] OECD, 2015, *Mandatory Disclosure Rules- Action 12*. Such modular framework is mainly designed for all those countries without mandatory disclosure rules in order to design a regime that fits their need to obtain information on aggressive tax planning practices. See http://www.oecd.org/tax/beps/beps-actions/action12

[31] OECD, 2015, *Transfer Pricing Documentation and Country-by-Country Reporting- Action 13.* With regard to Transfer Pricing Documentation, OECD however states that its preparation should not lead to excessive compliance costs for the multinational group. See http://www.oecd.org/tax/beps/beps-actions/action13

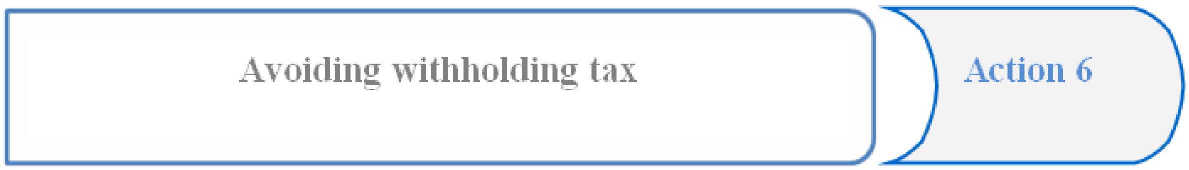
fundamental part of the BEPS work, with the purpose of modeling an international tax system capable of sustaining the economic growth.

Figure 9: focus on Pillar 2 (own elaboration)

Pillar 2: substantial profiles

In this section, a more detailed and specific description of the Pillar 2 tax challenges will be provided. The choice of this level of analysis is motivated by the need of obtaining an effective knowledge of these issues. Their theoretical content works as a reference network on which the Google case will be inserted at the end of this dissertation.

Action 6: Preventing Treaty Abuse



According to ***Action 6*** the BEPS nature of the ***treaty abuse*** strategies can be found in their capacity to jeopardize the tax revenues of a certain country. In particular the action aims at solving the critical issues posed by the adoption of *treaty shopping* practices. In this context, the measure should counter the granting of treaty benefits, such as reduced or null withholding tax in the State of income source, in inappropriate circumstances, resulting from an artificial deception of the corporate taxpayer. The question is addressed by proposing a three-pronged approach based on following fundamental pillars:

- the requirement for the Contracting States to insert a clear statement in which they declare to give up tax evasion or tax avoidance strategies in order to escape from the fair tax burden;
- the introduction of a specific anti-abuse rule, the limitation-on-benefits rule (LOB Rule), in the future versions of the OECD Model Tax Convention;
- the introduction of a more general anti-abuse rule, the principal purpose test rule (PPT Rule), in the future versions of the OECD Model Tax Convention.

The LOB Rule belongs to the historical tradition of US tax treaties and takes the form of a specific anti-abuse rule. In accordance with this rule, treaty benefits are available only to those entities that are recognized as "qualified persons"[32]. A certain taxpayer assumes the "qualified" nature when, going beyond the satisfaction of the residence requirement, is able to cross a set of reference targets, dealing with the legal nature, ownership and general activities of the enterprise. The overcoming of these conditions discloses the existence of a sufficient and substantial link between the taxpayer and its State of residence, permitting the participation in the tax benefits created by the treaties of its own country.

On the other side, the PPT rule seeks to bypass the limits arising from the exclusive application of the LOB Rule by adopting a more generic approach. This rule covers a broader range of situations and bases its analysis on the principal purpose of transactions or arrangements.

The PPT Rule focuses on the possibility for a Contracting State to deny the benefits associated to a certain tax treaty. This situation may occur when a transaction or arrangement aims at merely taking advantage from the most favorable provisions of a treaty. Only in the case in which such practice results coherent with the object and the purpose of the treaty involved, benefits will be granted.

The new anti-abuse rules arise from the modern evolution of the beneficial ownership concept. This concept was firstly introduced in the 1977 OECD Model Tax Convention and it aimed at preventing unfair situations in the field of passive income's taxation[33]. In particular, its main objective was to avoid the grant of a reduced-source tax by a given treaty, in the case in which the facilitated subject was not the real recipient of the income. The beneficial ownership concept works as the traditional safeguard against the treaty shopping practices, while the LOB and PPT rules represent more modern and stronger contrast tools, thanks to their focus on well-defined aspects.

[32] OECD, 2017, *OECD Model Tax Convention, Entitlement to benefits*. Restriction of treaty benefits to a resident of a Contracting State who is a "qualified person" is described under Article 29. See https://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm

[33] Passive income is the outcome of an investment and it is generally subject to the application of a withholding tax. Typical examples are dividends, interests and royalties. Passive income shall be distinguished from the active income, which instead derives from a working or business activity. Passive income is typically subject to the application of a particular type of tax, the withholding tax, working as a mechanism to tax the income of non-resident taxpayers.

Regarding the concrete implementation of the three-pronged approach, OECD has underlined the necessity to accommodate a certain "minimum standard"[34] of the proposed legislative instruments. Besides to the adoption of the clear statement in which the Contracting States refuse any form of unfair tax practices, the minimum level should incorporate the combination of LOB and PPT rule, or a PPT rule alone or a LOB rule with some supplementary measures. Coherently with the other OECD's recommendations of the BEPS Plan, the inclusion of these new anti-abuse rules in the landscape of the bilateral treaties is ensured and facilitated by the adoption of the multilateral instrument.

Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

Action** 7* counteracts the unfair practice of ***artificially avoiding the PE status. This goal is achieved by introducing a set of modifications to art.5 of the OECD Model Tax Convention, as visible from the textual and conceptual differences emerging in the 2017 version, compared to the 2014 one. These transformations are necessary in light of the advent of the digital economy and the consequent changes of the relative business models.
The main interventions have regarded the fourth, fifth and sixth paragraph of article 5, while the general definition of the permanent establishment as a "a fixed place of business"[35] by which a company runs its activity has remained untouched.

The fourth paragraph is dedicated to the exemptions from the permanent establishment status, while the other two paragraphs deal with the *agency permanent establishment* concept. The latter concept introduces a very peculiar type of permanent establishment, capable of moving away from the traditional definition. This particular form of permanent establishment is materialized in the activities of a dependent agent, instead excluding those of an independent agent.

[34] OECD, 2015, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances- Action 6.* Action 6 is configured as one of the four minimum standards of the BEPS Project. The others are defined by Actions 5,13 and 14. See http://www.oecd.org/tax/beps/beps-actions/action6

[35] OECD, 2017, *OECD Model Tax Convention, art.5(1).* Article 5 lists a series of "physical places" that constitute a permanent establishment, such as: a place of management, a branch, an office, a factory, a workshop, a mine or any other place of extraction of natural resources, a building site with a duration of more than twelve months. The analysis of Article 5 requires a combination with Article 7, which allocates the taxing rights regarding business profits among different jurisdictions. Article 7 is in fact one of the OECD Distributive Rules contained in the OECD Model Tax Convention (from article 6 to 21).

More specifically, art.5(4) has been adjusted because its previous wording (as in the 2014 version) was leaving room to many unfair tax avoidance practices and for the necessity to update its text to the current transformations of the economy. For example, the previous version of the article was excluding from the PE status all the activities with an auxiliary and ancillary nature, in particular the ones performed for the sole purpose of "storage, display or delivery of goods"[36]. But in the actual economic landscape these latter processes are increasingly growing their importance, representing critical value-adding activities in the core business of a modern firm[37]. Therefore, categorizing them as simple and subordinated activities of support is something of anachronistic and reductive.

These aspects can be confirmed by observing the entrepreneurial activity of an online selling firm, whose business model anchors on proximity and quick delivery to customers. In this context, the retention and management of a large local warehouse play a fundamental role in the value-creation process, for the possibility of improving the storing and the distribution of goods.

These new business models features have constrained the OECD to modify art.5(4) in the 2017 version, granting the exclusion from the permanent establishment definition only to those storage, display and delivery activities that continue to be merely of "preparatory or auxiliary character"[38]. As a consequence, with reference to the former example, no exemption could be possible and the permanent establishment status would be recognized.

The modifications brought to art.5(5) and art.5(6) are instead moving, as said in the introductive part, around the concept of the *agency permanent establishment*.

Art.5(5) of the 2014 version associated the existence of the *agency permanent establishment* to the fulfillment of two conditions: a person empowered to act on behalf of the foreign enterprise and with the authority to conclude contracts in the name of the company.

In a complementary way, art.5(6) excluded the presence of an *agency permanent establishment* in the case in which the contractual activity of the enterprise in the foreign State was conducted by a mere "broker, general commission agent or any other agent of

[36]OECD, 2014, *OECD Model Tax Convention,* art.5(4)
[37] A confirmation of the growing importance emerges from the analysis of the value chain proposed by Michael Porter in his work "*Competitive Advantage: Creating and Sustaining Superior Performance*". In such model in fact both the internal and external logistics were classified as primary activities, on par with the productive operations, the marketing and sales and the post-sale services.
[38]OECD, 2017, *OECD Model Tax Convention*, art.5(4)

independent status"[39]. An agent may be qualified as independent when it does not suffer any control regarding the manner in which the work is performed, even if it maintains a level of responsibility to his principal for the results of its activity.

The textual formulation of the fifth and the sixth paragraph allowed multinational entities to adopt unfair tax practices in order to artificially circumvent the PE definition. One of these strategies was identified in the *commissionaire arrangements*, consisting in those contractual schemes whereby taxpayers could substitute subjects operating as distributors in the foreign territory by commission agents. The unfairness of the situation resulted from the possibility of transferring profits outside the territory in which they were generated, without a real and substantial modification in the activities carried out in that geographical place.

From a juridical point of view in fact a *commissionaire arrangement* is qualified by the presence of a person appointed to sell the products owned by a foreign enterprise in a certain territory. Such sale transactions should be performed on behalf of the principal but spending the name of the commission agent. Since the name of the foreign company was not spent, one of the basic conditions of art.5(5) of the 2014 version was not met, creating a loophole to the agency permanent establishment concept. Consequently, the most relevant tax relief was connected to the possibility for a multinational entity to distribute and sell its own products in foreign countries without suffering any taxation on the consequent profits. In addition, since the person concluding the transaction was not the owner of the products involved, no tax claim could be made on that subject for the income of the operation. The commission agent resulted in fact only taxable on the compensation received for the services provided.

The wording of art.5(6) left room to other tax avoidance strategies, connected to the figure of the *closely related agent*. The agent's close relationship to an enterprise is associated to the beneficial interests of the parties involved. When in fact one of the two controls directly or indirectly more than the half of the beneficial interest in the other or when the beneficial interests of both are possessed by a third common party, such close relationship materializes. These features posed relevant tax issues when the close relationship of the agent was combined with its independence status. The independent nature was in fact enough to ensure the possibility for a multinational group to operate and realize profits in a foreign country without constituting a permanent establishment in that territory, even though the agent was closely related to the company.

[39]OECD, 2014, *OECD Model Tax Convention*, art.5(6)

All these issues required the necessity to update the text of the art.5(5) and art.5(6) in order to properly address the transformations brought about by the advent of the digital economy, weakening the capacity of multinational groups to avoid a taxable presence in the market country.

Moving in this perspective some critical changes have been introduced in the art.5(5) and art.5(6) in the 2017 OECD Model Tax Convention.

In particular art.5(5) has introduced a new set of conditions dealing with the *agency permanent establishment* status. Coherently with the 2014 version, it has remained unchanged that the agent should operate on behalf of the foreign enterprise, with the purpose of concluding or leading contracts to their conclusion. The main modifications have instead consisted in proposing a broader set of characteristics for the involved contracts: these latter may be signed in the name of the foreign enterprise (coherently with the 2014 version) or they may have as object the transfer of ownership, the granting of the right to use some specific resources or the provision of certain services.

These regulatory interventions have allowed to overcome the issues posed by the commissionaire arrangements, since spending the name of the foreign enterprise is one possible, but not anymore essential, condition. When in fact the agent concludes contracts on behalf of the foreign company in order to achieve certain goals such as transferring the ownership, granting a right to use a certain resource or providing a certain service, as it occurs in the situations of commissionaire arrangements, a permanent establishment is recognized, even if such contracts are not signed in the name of the foreign company.

Modifications of art.5(6) have instead regarded the concept of the closely related independent agent. Art.5(6) confirms in fact that paragraph 5 shall not apply when the person operating on behalf of the foreign enterprise assumes an independent nature, excluding however the case in which the subject "acts exclusively or almost exclusively on behalf of one or more enterprises" [40] with which a close relationship is established. In this last case the person will constitute an *agency permanent establishment* for its principal.

[40] OECD, 2017, *OECD Model Tax Convention, art. 5(6)*

Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation

Locating the income allocable to functions, assets and risks in the most favorable tax jurisdictions

Actions 8-10

Actions 8-10 of the BEPS Plan represent the tax rules proposed by the OECD to face the challenges posed by the **modern transfer pricing practices**. As a consequence of the modern economy advent, their impact is assuming a wider significance for the economic organizations and for the tax authorities. Globalization has in fact laid the groundwork for an exponential growth of the volume and value of the intra-group exchanges, requiring the identification of a specific set of rules to deter the adoption of unfair tax practices. Moving in this perspective, the overall purpose of Actions 8-10 is to ensure an alignment between the allocation of income within the entities of the multinational group and the location of the activities generating that economic value. In this way, these Actions aim at limiting the practice of locating the income allocable to functions, assets and risks in the most favorable tax jurisdiction.

The common pillar of the Actions 8-10 is represented by the arm's length principle, intended as the "cornerstone of the transfer pricing rules"[41]. This principle is willing to face the situations of internal transactions in which multinational groups apply a *transfer price*, intended as "the price established in a transaction between related parties, that may be different from the market price" (Arnold, 2016)[42]. In fact the arm's length principle moves from the assumption that the fair taxable situation should imply the application of the price that would have been charged in comparable free-market transactions between two unrelated parties. When these conditions are not fulfilled, adjustments to the profits may be needed for tax purposes, ensuring a proper allocation of profits to the place in which the value has been originated.

This rule package shows an high profile of interaction between its components and only a combined application will permit to achieve the purpose for which it is defined. Even if all the three Actions cover the transfer pricing topic, each of these develops a specific facet.

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[41] OECD, 2015, *Aligning Transfer Pricing Outcomes with Value Creation*, Actions 8-10.
See http://www.oecd.org/tax/beps/beps-actions/action8-10

[42] Arnold B., 2016, *International Tax Primer*, 3rd edition, published by Kluwer Law International BV. According to the author, when the transaction involves two independent parties, their conflicting interests usually ensure that no artificial manipulations occur in setting the price. On the other hand, if the parties are related, the absence of conflicting interests creates greater room for maneuver with reference to price.

More precisely:

- Action 8: Intangibles and Transfer Pricing
- Action 9: Risk Analysis and Transfer Pricing
- Action 10: High-Risk Transactions and Transfer Pricing

The content of these Actions has proved to be of particular importance, since it has guided the drafting of the new version of OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[43]. This "innovative value" is exposed in the following sections.

Action 8: Intangibles and Transfer Pricing

Locating the income associated to intangible assets in the jurisdiction offering the most attractive tax benefits is one of the most important BEPS practices adopted by the modern enterprises. The contractual movement of the intangibles within the multinational group generally occurs at non-arm's length prices, causing a misalignment between transfer pricing outcomes and the value creation process. These unfair opportunities are made possible thanks to the elusive nature of the intangibles, mainly deriving from:

- the absence of a specific geographical location
- the tough task of getting a quantitative assessment at the time of their contractual transfer
- the presence of information asymmetries between the taxpayers and the tax authorities in relation with their valorization
- the possibility of articulating certain contractual schemes with the purpose of transferring hidden or not identified intangibles, escaping from the appropriate recognition and the consequent money compensation.

[43] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are the result of a long evolutionary path. The first version dates back to 1979 when the document presented the three traditional methods for determining arm's length conditions: Comparable Uncontrolled Price (CUP Method), Cost Plus Method and Resale Minus Method. The 1995 version added two other methods, known as the income ones, but only usable in the last instance: they were the Profit Split Method and the Transactional Net Margin Method (TNMM). With the 2010 version the hierarchical structure has been eliminated, equating the five methods to each other. The choice of a method rather than another must depend on the specific situation involved. The 2017 version, the most recent one, shows instead all the updates connected to the contents of the BEPS Project in the matter of Transfer Pricing.

The rules proposed by Action 8 are willing to provide a set of solving tools to these tax challenges. The work mainly moves around four key areas, each one of these is associated to a specific Section, in a logical order.

The four sections address the following relevant aspects:

A. identification of the intangibles, through a complete and clear definition of their nature;
B. separation between the formal and the substantial dimension, by distinguishing the legal ownership concept from the "development, enhancement, maintenance, protection and exploitation of intangibles"[44] functions, known as DEMPE activities;
C. description of some specific transactions dealing with the transfer and the use of intangibles;
D. guidelines for fulfilling the arm's length principle in the situations having intangibles as object.

Section A: Identifying intangibles

The resolution of the harmful tax challenges posed by the modern transfer pricing processes requires to start from a precise definition of the *intangible concept*. This step plays a fundamental role for classifying an item as intangible and for driving all the subsequent phases involved in the determination of the right price for the transfer or the use of the immaterial resource.

The *intangible concept* should have a proper extension, avoiding either too tight or too wide definitions. Aiming at reaching this purpose, the OECD has anchored the *intangible definition* on three fundamental elements[45]:

- absence of physical or financial asset nature;
- capability of being owned or controlled for the utilization in commercial operations;
- possibility to remunerate its use or transfer with the compensation that would be charged in comparable circumstances involving independent parties.

[44] OECD, 2015, *Aligning Transfer Pricing Outcomes with Value* Creation, *Actions 8-10*
[45] OECD, 2017, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. See https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm. In particular see Chapter VI, the one dedicated to Intangible Assets and Transfer Pricing.

The adoption of a well-balanced definition ensures that the transfer pricing analysis in the case of intangibles is firmly based on the arm's length principle. On the other side, too narrow or too broad definitions would cause distortions to such principle.

Another relevant feature of the OECD *intangible definition* is that its perimeter is able to go beyond the typical accounting classifications. This implies that the transfer pricing analysis and the accounting schemes do not always bring to the same categorizations: a resource considered intangible in the transfer pricing analysis may not be so in an accounting perspective.

A typical example may be provided by looking at the research and development expenses, whose role is critical for the internal creation of intangible assets. These costs may in fact, in compliance with the accounting standards, be expensed in the Income Statement of the firm, instead of being capitalized in the Balance Sheet. Even if their lasting utility is not classified among the company's assets from an accounting point of view, their economic function shall be recognized for the transfer pricing scope. In conclusion, the recognition of a certain item as an intangible for the transfer pricing purposes can originate from its accounting nature, even if "it will not be determined by such characterization only"[46].

Not only the accounting framework is overcome by the OECD definition, but also the legal and contractual one. In fact the presence of a legal protection over the intangible asset or the contractual separate transferability are not considered as mandatory conditions for recognizing an intangible in the transfer pricing context.

Transfer pricing analysis requires the assumption of some further classifications inside the i*ntangible concept.* The first is dealing with the distinction between *marketing intangibles* and *trade intangibles*, while the second is willing to identify the special category of the "unique and valuable intangibles"[47].

The definition of *marketing intangible* is based on the marketing and promotional value of the resource for the firm's products, having the purpose of nurturing and addressing the customers' purchase behavior. The "marketing" qualification plays a critical role also for the *trade intangible* definition, given that the latter category includes all the intangibles excluded from the former one.

[46] OECD, 2017, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*
[47] OECD, 2017, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. The concept of unique and valuable intangibles will be repeated several times in the course of dealing with the actions dedicated to transfer pricing. It is therefore extremely useful to define it from the beginning, as it occurs in Action 8.

In the group of the *unique and valuable intangibles* OECD identifies all the intangibles sharing two fundamental features: lack of comparability to other assets belonging to other similar players, namely their uniqueness, and the strong involvement in the business value generation, namely their high-value potential.

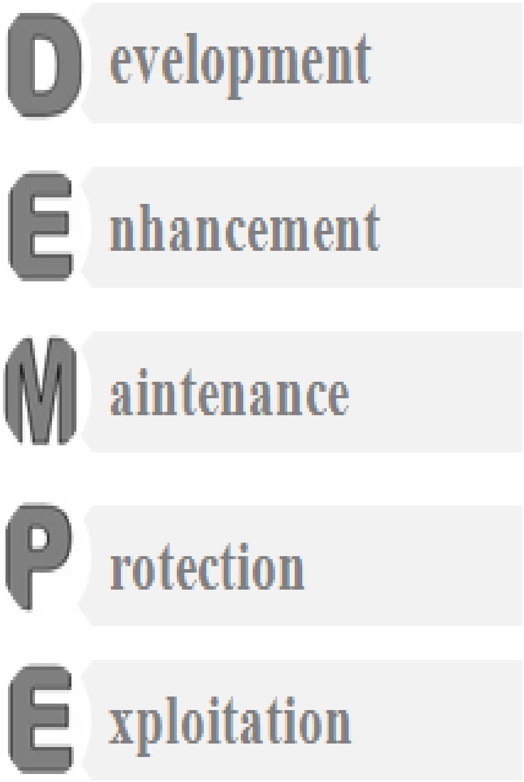
The conclusive part of the Section A shows a different nature with respect to the more theoretical first part. It aims in fact at providing a set of concrete examples in which the *intangible concept* is fulfilled, such as in the case of brands, patents, know-how, trademarks and trade secrets. On the other side, situations involving group synergies or market specific features cannot qualify as intangibles in the transfer pricing framework, for their impossibility of being owned, controlled or transferred. Nevertheless, these characteristics may affect the determination of the arm's length conditions and they should be used in the transfer pricing analysis "to improve the comparability degree of the transactions"[48] (Valente, 2015).

Section B: Distinguishing the legal ownership concept from the DEMPE functions

When the transfer pricing is involving the intra-group movement of an intangible asset, a crucial element is represented by the necessity to identify which entities should participate in the distribution of the profits associated to the use of that resource. The resolution of this issue is provided by the Section B of the BEPS Action 8. This Section, moving from the *intangible concept* previously exposed, assesses the concrete activities played by the multinational group's companies as the key points on which to anchor the allocation of the *intangible related profits* among the different firms.

In particular a relevant separation between the formal and the substantial dimension is achieved, by distinguishing the legal ownership and the economic ownership concepts. The founding principle consists in the assumption that the returns yielded by the intangible should be distributed not only to its juridical owner, but also to all those subjects that, in accordance with a functional analysis, have significantly contributed to the economic value of such resource.

[48] Valente P., 2015, *Transfer Pricing: criticità nella remunerazione dei beni intangibili,* Il Fisco 13/2015. For further information, see Valente P., *Manuale del Transfer Pricing*, IPSOA, 2015



As declared by Lagarden, "economic ownership is linked to the notion of economic fairness"[49], underlining its willingness to ensure a fair remuneration for all those economic parties that have concurred to the creation and development of the involved intangible. The economic ownership may be recognized when a certain entity of the multinational group runs functions, uses assets or assumes risks that are associated to the following types of activities: developing, enhancing, maintaining, protecting and exploiting the intangible. These are known as DEMPE activities.

Figure 10: DEMPE activities (own elaboration)

The definition of the economic ownership concept has caused that the legal ownership and the contractual conditions of the intangible operate only as a starting reference point. They in fact set the general framework of the transactions occurring between related parties but at the same time they require an integration of the legal ownership concept with more substantial considerations. This deeper level of analysis may be reached by focusing on the functions performed, the assets used and the risks assumed by all the contributing entities. For example, in the case of an internally generated intangible, if the juridical owner, besides holding the legal title, does not participate in any way in the DEMPE activities, it will not be recognized any portion of the "intangible related return"[50] (Verlinden, 2019) other than the arm's length remuneration, if existing, for the legal title.

[49] Lagarden M., 2014, *Intangibles in a Transfer Pricing Context: where does the road lead?*, International Transfer Pricing Journal. The author supports the economic ownership concept with concrete examples. If one transaction partner participates with valuable contributions to a certain intangible or a IP item (for example by financial funding, risk bearing or providing personnel), such partner assumes the economic ownership (co-ownership) of the intangible involved.

[50] Verlinden I., 2019, *Grappling with DEMPEs in the Trenches: Trying to give it the meaning it deserves,* Intertax, Volume 47, Issue 12

OECD proposes to summarize the transfer pricing approach in the case of intangibles through a six-step analysis, consisting in:

1.	Adopting a specific approach in order to identify the intangibles involved and the economically significant risks connected to the transaction
2.	Focusing on the juridical dimension, in particular on the legal ownership of the intangible and on all the relevant contractual conditions dealing with the rights, obligations and risks contractually assumed by the associated parties
3.	Performing a functional analysis in order to identify the parties playing functions, using assets and assuming risks in relation with the DEMPE activities
4.	Determining whether the juridical dimension and the functional analysis bring to coherent conclusions and ensuring that the assumption of economically significant risks is supported by the ability to control them and by the financial capacity to bear them
5.	Delineating the actual key features of the transaction involving entities of the same multinational group
6.	Determining, if possible, the arm's length prices associated to the intra-group transaction and ensuring a fair share of the profits deriving from the intangible to all the parties entitled to get it

Figure 11: six-step analysis (own elaboration)

The introduction of the six step analysis represents the most visible impact of the BEPS Project on the OECD Transfer Pricing Guidelines. These changes have caused a detachment of the 2017 Transfer Pricing Guidelines from the previous version, dated 2010.

In particular, the definition of the economic ownership concept, intended as a "fair remuneration" for those performing the DEMPE activities, has become the vehicle to focus on the real economic substance of the transactions, allowing an alignment between the transfer pricing outcomes and the value creation processes.

Three fundamental signals of participation to the economic value of the intangible are:

- performance and control of functions;
- use of assets;
- assumption of risks.

The first aspect relates with the necessity that each enterprise of the multinational group should be rewarded with an arm's length remuneration for the ***performance or control*** of one or more DEMPE functions. This requirement becomes particularly relevant when the legal owner has opted for the outsourcing of certain DEMPE activities to some associated companies. In this case in fact all those group's entities involved in the performance or even the control of the outsourced functions should be appropriately and fairly compensated.

The amount of the remuneration should have a proportional dependence on each entity's value of contribution. For example, merely financing the development of an intangible shall give rise to a lower compensation than that deriving from both financing and controlling such development. In the same logic the highest remuneration will be recognized to the company that funds, controls and physically performs such development.

The second aspect refers to the requirment that a fair compensation should be granted to all those group members that ***use assets*** for the implementation of DEMPE functions. The employed resources may be in the form of other intangibles, physical assets or funding. Regarding the latter possibility, a group entity may significantly participate to the economic value of an intangible by providing all the necessary financial resources, without being constrained to perform or control the associated activities.

The funding contribution can be seen as a risk-taking activity in which the financing party assumes the financial risk, namely the risk of losing its funds. As a consequence, the funder should expect consistency between its remuneration and the level of risk accepted.

The third aspect identifies the ***assumption of risks*** as another important factor for the determination of the arm's length remuneration. In particular, any group member that accepts to take certain risks associated to the DEMPE activities shall be appropriately rewarded. Moving in this perspective, Action 8 identifies a set of risks, such as the risks associated to the development and to the operational performance of intangibles, to the obsolescence of knowledge resources or to the infringement of the legal rights belonging to intangibles.

In accordance with Action 8, the group entities accepting the assumption of risks should, besides incurring all the costs, implement all the actions made necessary to face the occurrence of the risk. If the assumption of the risk and the guarantee of such liability are not allocated to the same entity, the need of a transfer pricing adjustment emerges: the costs are distributed to the party formally assuming the risk, while an appropriate compensation will be granted to the entity substantially facing the materialization of the risk.

<u>Section C: specific transactions dealing with the transfer and the use of intangibles</u>

The movement of an intangible within the perimeter of a multinational group can assume two alternative forms. An intangible or its rights may be in fact shifted among the group members or in alternative the use of an intangible may be related to intra-group sales of the firms, both of goods or services.

Regarding the first type of transactions, identifying the specific nature of the transferred intangibles or of their rights is considered the starting point for performing the transfer pricing analysis. If only a specific portion of the rights is shifted, on the base of some geographical or time restrictions, an understanding of such limitations is required. In a complementary way, this approach will permit to recognize the extent of the remaining rights transferred.

In addition to the general case described above, such class of transactions also includes other two more specific intra-group arrangements. They consist in:

- transferring a combination of intangibles;
- transferring intangibles or related rights in combination with other business transactions.

Shifting a combination of intangibles triggers two relevant transfer pricing issues. The first is that important value-impacting consequences may arise. It can occur in fact that some intangibles are more valuable when associated to other immaterial resources than when taken on their own. The issue is overcome by organizing a transfer pricing analysis that succeeds in considering all the effects of the economic and legal interaction between the combined intangibles.

If instead the connection among certain intangibles is so high that they constitute a sort of unique asset, the transfer of one of them necessarily entails the juridical movement of the other. This issue is countered by adopting a transfer pricing analysis that is capable of identifying all the intangibles contractually shifted in the sale process.

Transferring intangibles or related rights in combination with other business transactions constitutes an unique contractual package. The degree of interaction between the two key transactions affects how the transfer pricing analysis will be performed. In particular, if the two may be separated, each of them will be distinctly analyzed for verifying the consistency with the arm's length principle. Otherwise, in the case of no segregation, the arm's length prices will be determined aggregately.

Regarding the second typology of transactions, namely the use of an intangible in relation with the intra-group sales, no intangibles or associated rights are transferred. In these operations the contribution of the intangible plays a fundamental role for the value of the goods or the services that are the object of the controlled transactions. The evaluation of such intangible's nature shall be considered as the anchor point for conducting the comparability analysis and for choosing the most appropriate transfer pricing methodology for the controlled transaction.

Section D: guidelines for fulfilling the arm's length principle when intangibles are involved

Transfer pricing analysis shall have the final objective of determining the arm's length conditions for the intra-group transactions, regardless of whether they take the form of a transfer or a use of an intangible resource. Such analysis should be performed by considering the options that are "realistically available"[51] in the associated transaction, where such options are intended as the natural reflection of the involved parties' perspectives. A proper balancing between the interests of the two involved group entities allows in fact to properly determine the arm's length price, avoiding situations of prevalence that could bring to unfair outcomes for the counterparty.

When the intra-group transaction becomes a vehicle to transfer certain intangibles or related rights, the calculation of the arm's length price should derive from the application of two suggested methods: the Comparable Uncontrolled Price (CUP) method[52] or the Profit Split Method. The choice between the two methods is driven by the presence of reliable comparable uncontrolled transactions.

[51] OECD, 2015, *Aligning Transfer Pricing Outcomes with Value Creation*, *Actions 8-10.* The reference to the "realistically available options" wants to act as a guarantee for safeguarding the interests of both parties involved.

[52] According to the CUP Method, the fair price can be obtained by observing similar or identical situations between unrelated parties. The CUP method consists in finding a comparable that can be both internal or external. Internal comparable involves analyzing a transaction between one group's company and an external part, such that the independence of the parties is fulfilled. On the other side, an external comparable consists in finding benchmarks externally to the corporate group.

If they exist, the CUP method is applied, otherwise the Profit Split Method[53] is preferred.

On the other side, when the intra-group transaction does not transfer any intangible, but it involves the use of an intangible to arrange certain business transactions (sale of goods or provision of services), the arm's length price shall appropriately reflect the contribution of the intangible. The nature of such contribution affects the choice of the transfer pricing method, privileging the Profit Split Method when the contribution is so unique and valuable that no reliable comparable benchmarks exist.

The fulfillment of the arm's length principle occurs when the conditions of the transactions properly represent the value of the intangible involved. In fact, the higher the value of the intangible, the more the price should be. The valuation of the intangible should be anchored on the analysis of certain critical features that show a strict link with the value of the resource. In particular, the following characteristics of the intangible should be regarded: intrinsic nature, availability of legal protection, geographical coverage, temporal extension and potential for future enhancement.

With reference to nature, the most important feature is represented by the focus on the exclusivity. When in fact an intangible grants exclusive benefits to its holder, relevant advantages arise. Its holder may in fact prevent the use of that resource to other subjects, thus enjoying a strong power and influence on the market.

The availability of legal protection is classified as a relevant feature because the larger its extension and duration, the higher the benefits the entity should expect from the exploitation of the intangible.

Geographical coverage is instead related to the aspect that an intangible with a global scope is perceived largely more valuable than one characterized by certain geographical restrictions.

The temporal extension of the intangible may be thought as the combination of two fundamental reference parameters: its useful life and its stage of development. The longer the time in which an intangible produces utility, the more its value grows. On the other hand, intangibles with a more consolidated life experience succeed in generating higher value for the firm.

[53] The Profit Split Method states that the global taxable income of the related entities engaging in the same business line is allocated among them in proportion to the their contributions to generating the income. The most important feature of this method is that it is applied on the overall profit of each specific operating line. One possible "profit allocation" criterion is represented by the "cost to cost", dividing the profits among companies on the base of the costs level.

The potential for future enhancement consists in the possibility of having the right to access to the improvement of the intangible, through revisions and updates. Such participation allows to hedge the obsoloscence risk, keeping the pace with the innovations introduced by competitors.

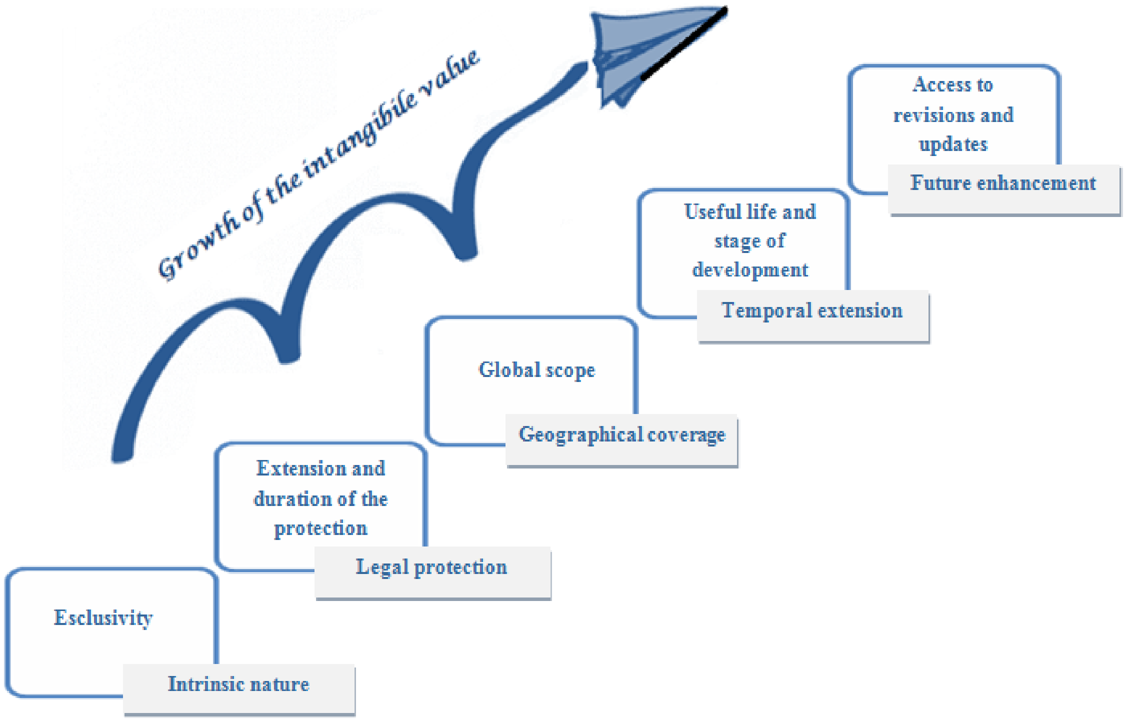


Figure 12: growth of the intangible value (own elaboration)

The conclusive part of Section D approaches the matter in a more specific way. In particular, it provides useful guidelines for meeting the arm's length principle in the following concrete cases:

- transactions involving intangibles whose value is largely uncertain at the time of the transfer
- transactions involving hard-to-value intangibles (HTVI)

When the intra-group transaction involves the juridical movement of an intangible whose value is highly uncertain at the time of the transfer, additional questions for determining the arm's length conditions arise. The uncertainty in the valuation may be solved by adopting a set of useful techniques, such as that based on the anticipated benefits. This latter aims at fixing the price of the transaction on the base of the projected future benefits and it properly works when a certain degree of reliability is recognized in such estimations. This occurs when making forecasts about the future is relatively simple. Otherwise, other valid solutions are represented by adopting some price adjustment clauses or some deferral payment structures in the contract. In this way it is possible to face some subsequent developments that might result difficult to predict in advance.

When the object of the intra-group transfer is represented by hard-to-value intangibles, some relevant information asymmetries arise between tax administrations and taxpayers. These asymmetries occur because hard-to-value intangibles are resources characterized by some critical features, difficult to be completely understood by external parties. Among these, the most important are the lack of reliable comparables at the time of the transaction and the high degree of uncertainty regarding their projected cash flows and, consequently, their valuation. This weakness of information mainly causes an incapacity for tax authorities to evaluate whether the "the differences between projected results used to set the transfer pricing (ex-ante) and the actual results (ex-post)"[54] (Schmidtke, Sidher, 2015) are the result of unexpected changes or faulty transfer pricing. In order to overcome this issue, a presumptive approach is adopted: if some material differences between the forecasts used to set the price of the transaction and the actual results arise, tax authorities may assume that the transfer pricing is not coherent with the arm's length principle, justifying a set of adjustments. Being a presumption, taxpayer may rebut it by demonstrating that the differences have derived from some unforeseeable developments or that the impact on the compensation of the hard-to-value intangible does not cross the 20% threshold.

Action 9: Risk Analysis and Transfer Pricing

Action 9 represents the natural continuation of Action 8, confirming the need for the intra-group price to correctly reward each group member participating in the associated transaction. In particular Action 9 decides to focus its attention on the risk assumption matter, perceiving it as a fundamental component for setting a fair compensation. Risk is intended as a natural price to pay for having the opportunity to enjoy the earnings of a entrepreneurial activity. Its existence derives from the possibility of suffering unexpected situations, such as lower returns or larger amounts of required resources.

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[54] Schmidtke R., Sidher S., 2015, *Hard-to-Value Intangibles,* Deloitte. The authors propose a set of characteristics typical of the HTVI. Among these it is possible to list: the partial development of the intangible at the time of the transfer, the lack of expectation of using the intangible for commercial purposes for a significant period of time, the crucial role for the development of another HTVI, a completely new expected exploitation and therefore not easy to be forecast, the intra-group transfer for a lump sum and the use or the development in combination with a Cost Sharing Agreement. According to the authors, HTVI typically possess one or more of these features.

The relevance of the risk in the business landscape requires the implementation of a six-step analysis, composed by the following subsequent phases:

1.	Specifically identifying the economically significant risks
2.	Focusing on the juridical dimension, in particular evaluating the contractual allocation of the economically significant risks
3.	Performing a functional analysis in order to analyze which of the associated parties substantially assume the economically significant risks previously identified
4.	(a) Combining and interpreting the outcomes arising from steps 1-3 in order to identify which associated parties have actually assumed the risks (b) Determining whether the assumption of the risks is supported by the ability to control them and by the financial capacity to bear them
5.	Running this step only if it is verified that step 4(b) is not fullfilled. In such case, allocating the risks to those entities that have the control and the financial capacity to assume them
6.	Pricing the transaction, properly compensating the risks assumed by the group members involved

Figure 13: six-step risk analysis (own elaboration)

Risk analysis moves from the first step consisting in the identification of the economically significant risks. Risks are intended as the effects of the uncertainty on the corporate goals and they are incorporated in all the business decisions: the acceptance of certain risks grants the possibility to participate in the profit allocation process. In the transfer pricing landscape, the economically significant risks are those that are connected with the commercial and financial relations of the group entities and may originate from external or internal sources.

The identification of the economically significant risks is followed by the implementation of a double-level analysis, considering both the legal and the substantive aspects of the transaction involved.

The focus on the juridical dimension is based on the evaluation of the contractual allocation of the economically significant risks, where the contract takes the connotation of an "ex ante agreement"[55]. Such agreement identifies in advance the consequences of the ex post materialization of the risk. In particular it determines which parties should bear the costs in the case of negative outcomes in exchange for the possibility of participating in the benefits deriving from positive outcomes.

Once completed the study of the juridical features of the risk allocation, a functional analysis shall be performed, with the purpose of evaluating the substantial and concrete conduct of the parties involved, in terms of the economically significant risks assumption and management.

The following step, the fourth one, provides a sort of summary result. It in fact combines and interprets the outcomes arising from the previous phases in order to identify which parties have substantially assumed the economically significant risks. The complications emerge when the effective conduct of the parties is not consistent with the contractual allocation of the risks. In such cases, the assumption of risk in the transaction should be anchored on the actual conduct of the parties, rather than on the contractual conditions which are not in practice applied. After the assessment of risk-taking, another consideration fits into this fourth step. More precisely it consists in determining whether the assumption of the risk is supported by the ability to control it and by the financial capacity to bear it.

The control over the risk is associated to two fundamental features. The first consists in the capacity to take decisions regarding a risk-bearing situation, in the form of acceptance, abandon or waiver. The second instead refers to the capacity to decide about whether and how to respond to a certain risk manifestation.

In the other hand, the financial capacity to bear the risk is related with the availability of financial resources to sustain it. In specific terms, it regards the access to the necessary funding to assume the risk, to remunerate the risk mitigation services and to bear the costs in the case of risk materialization.

Verifying whether the assumption of risk is supported by the control over it and by the financial capacity to bear it, initialed as step 4(b), plays a fundamental role in the risk analysis

[55] OECD, 2015, *Aligning Transfer Pricing Outcomes with Value Creation*, *Actions 8-10*

proposed by Action 9. Its results are able to affect the structuring of the final phases of the analysis. If in fact step 4(b) is fulfilled, there is no need to conduct the fifth step, moving directly to the sixth and final one. The final step aims at pricing the intra-group transaction, properly compensating the risks assumed by the group members involved.

If step 4(b) is not respected, the fifth stage shall be further conducted, before moving to the final price-setting process. Such fifth stage consists in the allocation of the risks to those group entities that have the control and the financial capacity to assume them.

Action 10: High Risk Transactions and Transfer Pricing

Action 10 closes the transfer pricing rules package, dedicating its attention on some specific intra-group transactions. In particular the focus is posed on the low value-adding intra-group services and on the transactions involving commodities.

With reference to the first type of transaction, the rules start from the definition of low value-adding intra-group services. They are intended as those services that are provided by a group member on behalf of other members, having the following features:

- they do not belong to the core business of the company;
- they merely have a supporting nature;
- they do not involve the presence of some unique and valuable intangible;
- they are not associated to economically significant risks and they do not cause significant risks.

The arm's length remuneration of these intra-group services should be based on performing a three-step procedure, defined as a "simplified procedure"[56].

In the first step the entire group should determine, with an annual reference, all the costs that are associated to the carrying out of low value-adding intra-group services. This pool of costs should only exclude those showing an in-house nature, namely those that are supported by a group member for its own benefit.

In the second step the corporate taxpayer should remove from the pool all those costs that relate to services performed by a group member esclusively in favour of another individual member. This causes that in the pool remain all those costs tied to services supplied to a plurality of group entities.

[56] OECD, 2015, *Aligning Transfer Pricing Outcomes with Value Creation*, *Actions 8-10*

In the third step all the pool costs should be allocated among the members of the group in such a way as to adequately reflect the amount of benefits accruing from the services provided. The distribution of costs should be arranged by adopting a series of allocation keys, depending on the nature of the costs involved: the distribution of costs in the same category shall be made using the same allocation method.

Once concluded the costs allocation, the low value-adding service can be priced, applying a 5% profit margin on the cost incurred.

As described in the introductive part, Action 10 also aims at determining the arm's length price for the intra-group transactions involving the exchange of commodities[57], intended as fungible goods without significant qualitative differences. In these situations, Action 10 suggests the CUP method as the most appropriate method for the determination of the arm's length remuneration, adopting the *quoted prices* as the reference benchmarks. This choice is based on the fact that the *quoted prices* represent the prices at which the commodities are usually exchanged among independent parties, in a certain market and for a certain time interval. The application of the CUP method should be preceded by the analysis of the features of the involved intra-group transaction, in terms of physical features of the commodity and contractual terms. If the consideration of these features gives rise to certain differences with respect to the external benchmark transaction, some adjustments to the *quoted price* should be made.

The adoption of the *quoted price* and the actual conduct of the associated parties significantly affect the transfer pricing analysis conducted by the domestic tax authorities. If the behaviour is in fact consistent with the price determination date indicated by the taxable person, the national tax authorities must confirm the analysis of transfer prices at that date. Otherwise, the tax authorities may update such analysis to another date, consistent with the circumstances that would have involved independent parties.

[57] The word commodity has derived from the French word "commodité", which was used to express the convenience of holding fungible and easily negotiable goods, such as commodities. Commodities may be classified in the Soft or Hard Category. Soft Category includes all the commodities deriving from the agricultural and livestock sector, such as agricultural goods or meat. On the other hand, Hard Category contains all the commodities regarding energy and precious metals, such as oil and gas or gold, platinum and silver.

Modern fiscal challenges and BEPS Project

Modern fiscal challenges		Tackling Action	
Hybrid mismatch arrangements	PILLAR 1	Action 2	Granting symmetry among different national jurisdictions, in terms of taxable revenues and deductible expenses
Excessive deductions	PILLAR 1	Action 4	Limiting the amount of interest deductions by setting a critical threshold
Harmful tax practices	PILLAR 1	Action 5	Subordinating the enjoyment of favorable tax regimes to the existence of a supporting nexus
Avoiding withholding tax	PILLAR 2	Action 6	Preventing treaty abuse strategies through the introduction of LOB and PPT Rules
Avoiding a taxable presence in the market country	PILLAR 2	Action 7	Preventing the artificial avoidance of PE status by providing: ▪ changes to the exceptions of the PE status ▪ modifications to the agency PE status
Locating the income allocable to functions, assets and risks in the most favorable tax jurisdictions	PILLAR 2	Actions 8-10	Aligning transfer pricing outcomes with the value creation process, by defining: ▪ economic ownership concept ▪ participation to DEMPE activities ▪ risk analysis

Figure 14: modern fiscal challenges and BEPS Project (own elaboration)

Chapter IV: Facing the "broader direct tax challenges"

The introduction of BEPS Package has stimulated the birth of a completely new way of feeling and relating with international taxation issues. It should in fact be perceived not as an end point but a starting point, in order to conduct an increasingly in-depth analysis on the modern fiscal challenges. In this regard Anna Elphick has declared that "BEPS is more likely a journey rather than a defined response to a single issue"[58].

Modern fiscal challenges cannot be only reduced to the risks of BEPS strategies, as many other broader and deeper issues may emerge in the context of digital economy. The wide nature of these challenges is connected to their close link with the key features of the contemporary business models. Considering the tax perspective, the most important are represented by: the remoteness, the user participation in the value creation and the reliance on digital means. These characteristics are relevant because they permit modern enterprises to enlarge the scale of their cross-border operations without physical presence, spreading them on a global basis and segregating them from the customers' market. From the tax point of view these business transformations are identified as "elements of discontinuity"[59] (Turina, 2018), requiring a specific understanding of the deeper fiscal challenges associated with each of the previous key features.

In specific terms, going beyond BEPS, the three broader fiscal challenges, are represented by:

- nexus with the territory
- relevance of data
- characterization of the income.

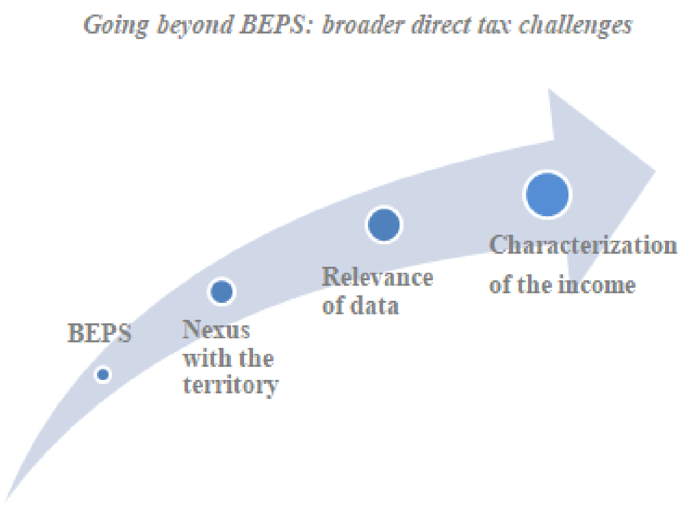

Figure 15: broader direct tax challenges (own elaboration)

[58] This quotation is taken from a speech dated 2016, during the Mazars International Tax Conference. Anna Elphick is the responsible for all tax matters in Asia and Africa for Unilever Plc.

[59] Turina A., 2018, *Which "source taxation" for the digital economy?,* Intertax, Volume 46, Issue 6 & 7. In particular the author has identified the remoteness as the key element of discontinuity from a tax policy perspective.

The first issue, the ***nexus with the territory***, is directly connected with the factor of the ***remoteness***. Today in fact modern enterprises are able to conduct their business without being physically inserted in the territory in which they operate. The technological advances brought by the advent of the digital economy have not changed the profile of core activities that a firm should carry on in order to generate profits, but the way in which they perform them. The management of all the traditional activities in the value chain should be supported by the ability to seize the opportunities offered by the new technologies, such as the possibility to expand the volume of customer information, to accelerate the speed of analysis and to reach customers with greater ease. All these innovative transformations have allowed modern enterprises to grow their customer base with a lower level of local presence than that was required in the pre-digital age. As a consequence, the "territorial attachment link"[60] (Beale, 1935) has suffered a strong weakening.

The second issue, the ***relevance of data***, is tied to the ***user participation in the value creation***. The improvement of information and communication technologies has in fact allowed companies to collect and utilize information from customers in the form of data on a worldwide basis. The stronger user participation works as a corporate revenue-enhancing tool but at the same time it raises the issue about how the value derived from the data analysis should be allocated and, consequently, taxed. The relevance of data originates a dual fiscal challenge, both when the enterprise has a permanent establishment in the territory and also when it does not have it. The presence of a permanent establishment in the territory in which the users are located is in fact not a sufficient condition to levy a tax on the value created by the user participation. Even more so, when a permanent establishment is missing, revenues rooted in the users' contributions may not be appropriately taxed.

The challenges regarding the allocation of value derived from the data analysis may also be caused by the possibility to split the most important activities in different jurisdictions. If for example the data are centered on the customers of one country but their study is performed by using a technology developed in another country, some relevant tax issues may emerge in relation of how to allocate the consequent profits among the two countries. Other challenges may emerge when data are stored through cloud computing systems: in such case, determining the proper location of the associated income may be particularly difficult.

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[60] Beale J.H., 1935, *A treatise on the Conflict of Laws,* Vol.1, p.275, originally published by Baker, Voorhis & Co., New York. Beale's treatise ranks with Williston on Contracts and Wigmore on Evidence as one of the undisputed classics of twentieth-century American law.

The third issue, the ***characterization of the income***, is associated to the ***reliance on digital means***. In particular the creation of new digital products and new channels for delivering the digital services has raised questions about how to properly characterize certain transactions and how to tax their consequent payments. In fact a specific type of taxation corresponds to each specific classification of income, depending on whether the digital payments are treated as royalties, fees for technical services or business profits.

All these challenges raised by the digital economy show many overlapping points and have the capacity to affect the distribution of the profits within the multinational group and, by consequence, the taxing rights among different jurisdictions. For example gathering data from certain customers located in a certain jurisdiction may represent a signal of nexus with that territory, requiring an evaluation about whether the income associated to the use of those data is attributable to that nexus. In a similar prospective, the clarification of the income characterization may facilitate the identification of the appropriate tax treatment and it may indicate the jurisdiction in which the payer is located, creating a nexus with that territory. These examples underline how the relevance of the data and the characterization of the income may be strongly connected with the nexus concept.

These issues have been defined by the OECD as "broader direct tax challenges", given their pervasiveness and their capacity to hit direct taxation. The broadness of their nature is willing to highlight their capacity to go beyond the BEPS risks, thus requiring more radical and innovative interventions. This situation can be explained by analyzing two critical aspects, both related to the purpose of the BEPS Project. The first is that the measures recommended in three pillars of the BEPS Plan were thought to close certain gaps and loopholes emerging in the tax systems in order to eliminate situations of tax avoidance and double no-taxation. The second is that the pillars of the BEPS Project were not designed with the scope of radically modifying the existing systems of taxation, but only with the purpose of updating them to the current economic transformations. The BEPS Project in fact, despite its innovative capacity, keeps itself tied to the traditional concepts of taxation, maintaining reliance on the residence versus source paradigm and adopting a balancing definition for the permanent establishment threshold. This nature of the BEPS Project is confirmed by Brauner, who declares that "the BEPS Project has decided to take a conservative yet evolutionary approach, working towards increasing source taxation, yet maintaining the fundamental structure of the international tax regime intact" (Brauner, 2019)[61]. These features are concretely visible in the fact that none of the BEPS pillars measures were designed to completely address the digital economy changes

[61] Brauner Y., 2019, *Taxing the Digital Economy Post-BEPS, Seriously*, Intertax, Volume 46, Issue 6 & 7.

that would have required a radical detachment from the traditional tax systems. For example, no substantial measures were devised to face the circumstances in which the company operates in a foreign market without having a physical presence or to solve the issue of attributing the profits connected to the collection and the use of data.

The following two sections aim at presenting the position of the OECD and of the EU on the broader tax challenges, reaching the conclusion that only a shared and multilateral solution is the most suitable in the international landscape.

The OECD position on the broader tax challenges

The OECD position on these matters is constantly evolving. Its historical path may be subdivided in two key phases: the first one originates from the identification of the broader tax challenges and proposes an initial framework to the problem, while the second represents a refining phase aimed at reaching a consensus-based solution on an international scale.

The first phase: the assessment of the three initial options

When the OECD began to deal with the issue of digital economy taxation, it was like opening a Pandora's box, where the digital sector represented only the "major problem that could no longer be kept inside the box"[62] (Dourado, 2018). But at the same time a precise focus on the digital economy transformations became an instrument to question the entire structure of the traditional tax systems. This approach was pursued by a new subsidiary body within the Committee of Fiscal Affairs, named Task Force on the Digital Economy (TFDE), created in September 2013. This body was originally established with the purpose of identifying the main tax issues connected with the modern economy and of proposing a first set of solutions by September 2014. Subsequently, following the recognition of the broader tax challenges, the TFDE was instructed to analyze some potential addressing tools.

In specific terms, TFDE focused on the following three options:

- the definition of a new nexus with the territory, based on the significant economic presence;
- the imposition of a withholding tax on certain types of digital transactions;
- the introduction of an equalization levy.

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[62] Dourado A.P., 2018, *Digital Taxation opens the Pandora box: the OECD Interim Report and the European Commission Proposals*, Intertax, Volume 46, Issue 6 & 7. The author states that revisiting the digital sector represents an opportunity to discuss the entire structure of international tax system. Starting from this premise, the essay analyzes the path undertaken in the post-BEPS era. In particular the focus is on the adoption of unilateral measures by certain jurisdictions. While on one hand these measures may undermine the international cooperation efforts, on the other they have the positive effect of exerting pressures on international coordination.

The content of these options range from theoretical to practical. The *significant economic presence* has in fact the theoretical purpose of identifying the existence of a nexus with the territory on virtue of which a taxable presence may be recognized. On the other side instead the impositions of a withholding tax or an equalization levy hit concretely the digital transactions involved.

With reference to the first proposed option, the *significant economic presence*, it represents a tool to modify the *permanent establishment* concept, traditionally anchored on the fixity requirement. Such update has been made necessary because "the fixity requirement can easily be avoided by enterprises that operate within the digital economy and benefit from its advantages" (Gomez Requena, 2017)[63]. Unlike the traditional approach, the new taxing threshold aims at weakening the physical presence requirement in order to identify a set of factors able to represent a new nexus with the territory, ensuring in this way a legitimate taxation at source. These factors are willing to demonstrate the "significant economic presence" of the foreign firm in the territory, implying the existence of a purposeful and regular interaction with that country. Action 1 of the BEPS Plan identifies such taxable presence when the company is able to:

- overcome a certain revenue threshold for the remote transactions;
- design and utilize a certain number of digital tools to create and nurture a "purposeful and sustained interaction with customers"[64];
- develop and maintain an active involvement of its users in the key business relationships.

Among these factors, that associated to revenues may be considered as the basic one, even if not enough, if used in isolation, for identifying a nexus with the territory. This requires its combination with the other two factors in order to qualify for a significant economic presence.

With reference to the two more "practical" solutions, the imposition of a *withholding tax* or of an *equalization levy*, the focus should be conducted on how they are structured and how they connect with the significant economic presence concept.

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[63] Gomez Requena J.A. , 2017, *Adapting the Concept of Permanent Establishment to the Context of Digital Commerce: From Fixity to Significant Digital Economic Presence,* Intertax, Volume 45, Issue 11. The author resumes a rhetorical question by Garcìa Novoa (2001): if basing the idea of PE on a physical link has sense in an economy based on the exchange of tangible goods, why not consider a new nexus in accordance with the dematerialization of the modern economy?
[64] OECD, 2015, *Addressing the tax challenges of the digital economy- Action 1.* In particular see Chapter VII, "Broader direct tax challenges raised by the digital economy and the options to address them".

From the structural point of view, the TFDE proposes to apply the withholding tax on the payments made by the local customers for those digital products or services that are delivered by the foreign enterprise through digital means. Concretely, a certain percentage of the price would be subject to deduction and deposited in the coffers of the State by the selling firm or by the customer itself or by the company responsible for managing the electronic payments.

On the other side, the equalization levy should be applied in order to tax the sales transactions that are concluded remotely with in-country customers. Its structure could be tracked back to the excise duty model, being enforced on the gross value of the goods and services supplied to customers and being paid by the latter. An alternative and more innovative form of equalization levy may be the one imposed on data and other local customers contributions. This solution would be the most appropriate in order to tax the value implicitly related in the relationships with own users.

Considering the link between these options and the economic presence concept, it is possible to observe that a withholding tax could be seen as an enforcing tool to comply with the taxation derived from the existence of the economic nexus, while the equalization levy could be perceived as an alternative to attribute the income to such nexus with greater ease.

When OECD analyzed the three options above mentioned, a relatively cautious application of them was suggested. What in fact the OECD advised was primarily the implementation of the BEPS pillars measures, considering their uniform and multilateral application as the best tool to align the location of taxable profits with the location of the value creation processes. For this reason, at the time in which the Action 1 Report was approved (2015), such options did not assume the form of agreed international standards. They in fact only represented additional safeguarding tools which each country could introduce in its own jurisdiction, provided that the existing tax treaties and other international obligations were respected.

The first phase of the OECD fight against the broader fiscal challenges ended with a reference to a subsequent period of in-depth analysis and elaboration, which should have led to interim conclusions in 2018 and to a global shared conclusion among the Inclusive Framework[65] members by the end of 2020.

[65] The Inclusive Framework on BEPS allows to the participating countries to work with OECD and G20 for developing and implementing international standards on BEPS. At the date of December 2019, it grouped 137 Members. The composition of the Inclusive Framework reflects a significant economic and geographical diversity. Its regional composition shows the following percentages: 26% from Americas, 22% from Western Europe, 19% from eastern Europe and Central Asia, 18% from Africa and 15% from Asia-Pacific.

The second phase: from the three proposals to the Unified Approach

The second phase has represented and still represents a phase of intense work for the achievement of a consensus-based solution on a global scale. It has started from the assumption that the broader fiscal challenges are "chiefly related to the question of how taxing rights on income from cross-border activities in the digital age should be allocated among countries"[66].

More concretely, such second phase began when the TFDE activity was substantially renewed at the request of the G20 Finance Ministers. In particular the TFDE, through the BEPS Inclusive Framework, was mandated to conduct an in-depth analysis on the tax challenges posed by the digital economy, having to deliver an interim and final report, respectively by 2018 and 2020.

In the Interim Report, dated March 2018, the broader fiscal challenges related to the allocation of taxing rights have been connected to three key factors of the digital business models. The first, the *scale without mass*, affects the distribution of the taxing rights by creating a limitation to the countries entitled to tax a certain business income. The second, the *high reliance on intangibles*, is instead responsible of easily moving the associated profits and of concentrating the taxing rights in the more favorable jurisdictions. The third, the *data and user participation*, instead causes that digitalized businesses may benefit from user-generated contents without having a relevant taxable presence in the territory in which the users are located.

Conscious of the tax impact of these issues, the TFDE and Interim Framework have further intensified their work since the delivery of the Interim Report. This phase of combined efforts has brought to a set of proposals regarding the modifications to both the profit allocation and nexus rules, as summarized in the Policy Note of January 2019. The three proposals aim at enlarging the amount of taxing rights for the user and market jurisdictions, going also beyond the arm's length principle. Their presentation is included in the first pillar of the work, consisting in:

- the user participation proposal
- the marketing intangibles proposal
- the significant economic presence proposal.

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[66] OECD, 2019, *Addressing the tax challenges of the digitalization of the economy- Public Consultation Document* . See https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf

The *user participation proposal* is based on the consideration that relevant tax issues may arise from the active involvement of the firm's users. The value generated by their participation is in fact not properly captured in users' jurisdictions under the existing tax systems, traditionally anchored on the physical requirement of the taxable presence. Consequently, the proposal seeks to propose new territorial nexus rules so that the users' jurisdiction may levy a tax on the profits arising from the active user base. In this way a better alignment between the profit allocation outcomes and the value creation would be achieved, ensuring a fair taxation.

The mechanics of the user participation proposal should follow a series of steps, moving within the residual profit split methodology. The first phase should identify the residual profit generated by the business, namely the income that remains after remunerating the routine activities for their ordinary contribution with an arm's length compensation. The residual profit can in fact be perceived as "the value created in markets that is not recognized under the existing profit allocation rules"[67]. Successively, a certain proportion of such profit should be attributed to the users' participation activities and then such proportion should be attributed to the different jurisdictions in which the firm has its own users. In this way users' jurisdictions are entitled to tax the portion of profits allocated to them, regardless of the traditional link existence, founded on the physicality of the taxable presence.

The *marketing intangibles proposal* lies on the assumption that an "intrinsic functional link"[68] between marketing intangibles[69] and the market jurisdiction exists. Such link may manifest in two ways, depending on the type of marketing intangible involved. For example, in the case of a brand name, the link is visible when the intangible assumes a relevant position in the minds of the clients located in a specific market jurisdiction. On the other hand, in the case of durable customer relationships, the link emerges when these derive from an active and fruitful interaction with the customers of the market jurisdiction.

The mechanics of the marketing intangibles proposal shows some common features with those of the user participation proposal, since both rely on the residual profit split methodology for distributing profits on which the local jurisdictions have a legitimate taxing

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[67] OECD, 2019, *Programme of Work for to develop a consensus solution to the tax challenges arising from the digitalization of the economy* . See https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf

[68] OECD, 2019, *Addressing the tax challenges of the digitalization of the economy- Public Consultation Document*

[69] The marketing intangibles proposal requires to remind the difference between marketing and trade intangibles, as provided by the Section A of BEPS Action 8. Marketing intangibles are those with a marketing or promotional value for the firm's products, while the trade intangibles are a residual category, thus all those that are excluded from the previous category.

right. This means that, after identifying the residual income attributable to marketing intangibles[70], a certain portion of it will be taxed by all those market jurisdictions having a strict link with the marketing intangibles considered. Also in this case the physical requirement of the taxable presence would be overcome.

The *significant economic presence proposal* incorporates the same concept already presented in the Action 1 Report but in addition it provides a practical application based on the fractional apportionment method. The proposal confirms that a significant economic presence can be attributed to the combined presence of three factors, *revenue-based*, *digital* and *users-based factors*.

Revenue-based factors move from the idea that, if a company overcomes a certain level of revenues for the remote transactions with customers in a foreign country, a significant economic presence shall be recognized to that firm. Interaction with clients and collection of revenues are in fact the clearest signal of the existence of a nexus between the enterprise and the territory.

Digital factors should be perceived as the tools through which an enterprise succeeds in running its business in a foreign country, attracting and properly addressing the demand of local customers. In the category of these factors it is possible to include a local domain name, a local digital platform and local payment options.

User-based factors are intended to measure the contact between the firm and its local customers, indicating a significant economic presence when monthly access to digital platforms or the number of contracts concluded or the amount of data collected exceed a certain threshold.

As mentioned above, the mechanics of the significant economic presence proposal relies on the fractional apportionment methodology. The latter is different from the residual profit split because it does not make any distinction between the routine and the residual income. In accordance to this method, a non-resident enterprise characterized by a significant economic presence in a certain jurisdiction would be assigned a fraction of the overall profitability of the multinational group. Such fraction is determined by applying certain allocation keys associated to fundamental business factors.

[70] The marketing intangibles proposal applies the residual profit split methodology. This implies that the identification of the residual income attributable to marketing intangibles should be conducted by performing two steps. The first consists in isolating the total residual income from the routine one, while the second in allocating a certain portion of it to the use of marketing intangibles.

The identification of the three Pillar One proposals has represented a fundamental step in the path towards a shared solution. In particular, the Inclusive Framework has underlined the necessity to build a consensus solution based on the commonalities of the three proposals. A significant number of common points between the three alternatives could indeed be traced, such as their purpose of overcoming the arm's length principle in order to relocate the taxing rights to the users' or market jurisdictions by virtue of a new territorial nexus, completely unsealed from the physical presence requirement or their purpose of constructing a tax system characterized by simplicity and stability.

These considerations have allowed the Inclusive Framework to launch a new Programme of Work, dated 28 May 2019. It aimed at synthesizing the commonalities of the three proposals through the architecture of a Unified Approach resulting from the OECD Secretariat[71] activity by January 2020. Such approach was perceived as the only viable option in order to reach a consensus solution by the end of 2020.

After delineating its own scope, the Unified Approach defines new nexus and profit allocation rules capable of overcoming but at the same time reconciling with the traditional schemes of taxation.

With reference to the *scope*, the Unified Approach focuses on broadly defined consumer-facing enterprises, namely those businesses that make interaction with customers a key element for selling consumer products or digital services.

The innovative action of the Unified Approach is clearly visible with reference to the *nexus and profit allocation rules.* A new typology of territorial nexus is in fact provided, even if the traditional one, based on the physical presence requirement, is not completely abandoned. The new nexus has the purpose of setting up a new form of taxing right capable of detaching from the physical requirement of the permanent establishment. Therefore a taxable presence will be identified in the overcoming of a certain revenue threshold, the latter being a strong signal of interaction with the territory.

The choice between the new and the traditional nexus depends on the type of income involved, in accordance with the new three tier profit allocation mechanism. This mechanism has indeed the purpose of placing an income in one of the following categories:

[71] The main function of the OECD Secretariat consists in providing an operational support to the OECD activity, ensuring a practical contribution to the priorities identified in the OECD Council. It carries out the work of the OECD. It is led by the Secretary-General and composed of directorates that interact with policy makers in each country. The OECD Secretariat employs 3300 people, including economists, lawyers, political analysts, digital experts, statisticians and sociologists.

- Amount A, that is a share of the residual profit allocated to a certain local jurisdiction by virtue of a new taxing right, based on a new nexus rule;
- Amount B, that is a fixed portion of income associated to the compensation of certain baseline or routine activities and allocated to the territory by virtue of a traditional nexus;
- Amount C, that includes "any additional profit where in-country functions exceed the baseline activity compensated under Amount B"[72], by virtue of a traditional nexus with the territory.

The determination of the ***Amount A*** relies on the residual profit split methodology, where profit refers to the group's total income. Successively a separation between the routine and the residual income should be conducted, remunerating the ordinary activities with an agreed share of profit. Ultimately, the residual income, excluding the portion associated to other factors such as trade intangibles, should be distributed among the eligible local jurisdictions, adopting an allocation key based on sales.

The innovative scope of the Amount A is reconciled with the existing rules through the definition of the ***Amount B and C***. The latter remain in fact anchored on the traditional physical nexus and are designed in order to prevent situations of tax disputes. In particular Amount B is thought for standardizing the remuneration for those group entities that perform baseline activities, such as marketing or distribution. On the other side Amount C is thought for better aligning the taxable profit for a certain jurisdiction with the real contribution of the firm in such territory.

"Taking the Unified Approach forward"[73] will play a connecting role between the three Pillar One proposals, becoming the basis for negotiating a well-defined and mutually agreed solution among the Inclusive Framework members by the end of 2020. It is necessary to precisely outline its boundaries in order to avoid problems of legal certainty. When in fact certain measures propose blurred taxing rights, too much room for unilateral action is left to individual countries. These latter, driven by the desire to increase their revenues, could activate excessive taxation policies at source, discouraging the foreign investments. On the other side, it is necessary to develop a mutually agreed solution because the birth of unilateral

[72] OECD, 2019, *Secretariat Proposal for a "Unified Approach" under Pillar One- Public Consultation Document.* See https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

[73] OECD, 2020, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to address the tax challenges arising from the digitalization of the economy.*
See https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps.htm

measures by single countries may generate relevant fiscal distortions, radically altering the "tax competition in the world"[74] (Andersson, 2017).

The EU position on the broader tax challenges

The following section describes the EU position on broader tax challenges[75]. In the first part it is presented the attempt of the EU to develop a common line for taxing digital economy through the definition of two proposals for directives. In the second part, however, all the criticisms related to this approach are highlighted, explaining the need to put the issue in a more international forum, that of the OECD.

The EU's attempt to adopt a common line for taxing digital economy

A close interplay exists between the European Union and the OECD on broader tax challenges. In particular the European Commission acts in strict contact with the OECD for the purpose of developing an internationally agreed solution, realizing that the wide scope of these challenges requires equally broad solutions, characterized by the multilateralism and the mutual sharing[76].

Despite this shared purpose, the European Union has nevertheless tried to develop its own common line in order to adapt tax rules to the transformations of the digital era. This choice has been motivated by the fact that EU noted the fight against broader tax challenges within the OECD would have taken a long time, because of the complex nature of such challenges. This intent roots in the request of the EU Leaders to constitute a "fair and effective EU tax system for the unique digital market"[77], expressed in September 2017. The definition of an own common line should urge the Member States to act on the problem, pending the achievement of a global scale solution. Furthermore, the unity of a shared action aims at avoiding competitive distortions within the unique market, safeguarding one of the EU key pillars. For these reasons, in December 2017, the ECOFIN Council welcomed the path taken by the EU, while still interpreting it as a preliminary step towards an international solution.

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[74] Andersson K., 2017, *Taxation of the Digital Economy*, Intertax, Volume 45, Issue 10. The author underlines that the division of tax revenues among countries is at the heart of the digital economy taxation. Moreover, he states that the measures proposed for taxing the digital sector are able to affect the way in which the pie of tax revenues is divided and at the same time they may have macro-economic consequences among countries in the world.

[75] For an historical description of the EU position, see https://www.consilium.europa.eu/it/policies/digital-taxation.

[76] In this respect, the European Union has recently stated (2020) that the global nature of digitalization requires an equally comprehensive solution (Zdravko Marić, Finance Minister of Croatia, Croatian Presidency of the Council from 1st January to 30th June 2020).

[77] European Commission, 2017, *Communication from the Commission to the EU Parliament and the Council.* https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf

In this climate of strong interest on the subject, in March 2018, the European Commission has provided an important contribution through the definition of two proposals for directives, respectively the number 147 and 148 of 2018.

Proposal for Community Directive number 147 of 2018 aims to update the notion of permanent establishment by introducing the concept of ***significant digital presence***. This concept acts as a new taxable link in favor of a Member State on the basis of certain criteria. Such parameters should be adapted to the business model involved, in order to measure the "fingerprint of an enterprise"[78] in a certain territory. A significant digital presence in a EU Member State is recognized when one or more of the following criteria is met:

- the revenues generated by the provision of digital services in a given jurisdiction exceed EUR 7.000.000 in a single tax period;
- the number of users for a certain digital service in a Member State overcomes 100.000 in a single tax period;
- the number of commercial contracts for the provision of digital services is above the 3.000 threshold in a single tax period.

Among the most favorable aspects of this proposal, the most definitely relevant one refers to the possibility of taxing the economic value resulting from digital interaction with customers in the exact place where it is generated. On the other hand, with reference to the criticalities of the proposal, the main uncertainties are linked to the assessment of the chosen threshold parameters. According to Confindustria in fact the purely quantitative nature of such parameters may generate a proliferation of taxable presences, "therefore pushing towards greater legal uncertainty and risk of double taxation"[79]. For these reasons, Confindustria suggests identifying a significant digital presence not only on the basis of quantitative consumption parameters but also of qualitative indicators capable of representing the real intention of the company to establish itself in a given market, through investments in a local digital interface, in a local domain name or in marketing strategies related to the territory.

In a complementary manner, Proposal for Community Directive number 148 of 2018 aims to provide a practical tool for the taxation of the digital firms, by proposing a common ***tax on digital services*** whose distribution has occurred within the EU boundaries. Such levy on

[78] European Commission, 2018, *Proposal for Community Directive number 147.* The concept of significant digital presence is described in Chapter II, article 4. Article 5 is instead dedicated to the profits attributable to or in respect of the significant digital presence.
See https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf

[79] Confindustria, 2018, *Iniziative europee per la tassazione dell'economia digitale- Contributo alla Consultazione Pubblica indetta dal Ministero dell'Economia e delle Finanze*

digital services is envisaged as a temporary measure, pending the development and the adoption of an internationally agreed solution.

In specific terms, such tax on digital services should be imposed on those revenues arising from activities in which users play a fundamental role and for which the risk of dissociation between the place of generation and taxation of value is typically higher. Some examples of digital services that would fall within the scope of this tax are represented by:

- sales of targeted advertising to users of a specific digital platform;
- provision of brokering services through an interface that facilitates interaction between clients and their related business negotiations;
- sale of data generated by information obtained from users.

For the purposes of tax on digital services, an enterprise should be regarded as a taxable person when it overcomes the two following thresholds:

- total worldwide annual revenues over EUR 750.000.000 and
- at least EUR 50.000.000 of these obtained within the European Union.

The tax on digital services would consist of 3% of the turnover obtained by the multinational company in the territory of the Member State and its application would ensure a large flow of revenue in the coffers of the EU Countries.

The first threshold, intentionally defined on a world-wide scale, is finalized to hit mainly the large corporate taxpayers, thus excluding the small and local enterprises. Such a high revenue threshold could in fact be intercepted only by large companies, with well-established market shares and a series of highly branched network effects among users.

On the other hand, the second threshold is designed with the aim of including in the scope of taxation all those companies with a "significant fingerprint"[80] in the territory of the EU. This threshold is intentionally set at the Union level in order to neutralize the possible different sizes of markets within the EU.

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[80] European Commission, 2018, *Proposal for Community Directive number 148.* The main features of the tax are presented in the following articles: art.3 (taxable revenues), art.4 (taxable person) and art.8 (rate). See https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf

The imposition of a tax on digital services also raises important critical issues[81]. The first relates to the fact that, since it is applied to revenues and not to profits, such tax could result particularly harmful for those enterprises that are placed at an embryonic phase of their life, moment in which revenues and profit margins may follow two different paths.

The second issue is instead linked to the fact that such tax, since it is not included among those traditionally covered by international conventions on the basis of the OECD Model, may not recognize a credit for payments of taxes executed abroad.

The need to refer the matter back to OECD

Following the proposal for an European digital service tax, commonly called *web tax*, a period of intense dialogue began. Despite the economic and fiscal value of the proposal, the discussions ended with a stalemate due to the lack of unanimous approval by all the ECOFIN Council members. It is fundamental to remind that unanimity is required with regard to fiscal policies. At least two factors have caused the braking of the proposal.

The first concerns the opposition of those EU Countries that are called "fiscally aggressive countries"[82], since they offer preferential tax systems, such as Ireland, Netherlands, Luxembourg, Malta and Cyprus. Among the tax advantages provided by these countries, the most relevant are:

- very low corporate tax rate, such as the Irish one at 12.5%[83];
- willingness to grant specific tax treatments to certain multinationals, the so-called tax ruling, such as the one between Apple and Ireland;
- the inclusion in favorable tax treaty networks, such as the case of the Netherlands.

The low taxation of these States collides against the higher taxation of other EU members, such France, Italy and Spain. This imbalance triggers numerous repercussions from the point of view of income allocation. It occurs in fact that, on the one hand, the low-tax countries succeed in attracting a large number of corporate profits while, on the other side, the high-tax countries suffer a drastic reduction in the taxable material. The ability of low-tax States to entice a large quantity of foreign investments, together with their small geographical size,

[81]Critical profiles are also presented by Ruth Mason and Leopoldo Parada in their essays *Digital Battlefront in the Tax Wars (2018)* and *The Legality of Digital Taxes in Europe (2020).* In particular they focus on the potentially discriminatory nature of the tax, given its high-revenue triggers and its narrow scope (sale of advertising, brokering services through an interface, sale of data). These features would cause a disproportionate application, mainly at the expenses of foreign large companies belonging to the three disfavored digital sectors.
[82]OCPI, 2020, *L'Unione Europea e le eccessive differenze nella tassazione dei profitti tra Paesi*
[83]A complete list of the statutory and effective rates of the EU countries is available on: https://osservatoriocpi.unicatt.it/cpi-Nota%20tassazione%20europea.pdf

means that they lose little revenue due to a reduced taxation compared to what they recover through aggressive fiscal policies.

The second factor is instead strongly connected with the commercial relations between EU and US. The imposition of a digital service tax would in fact affect the so-called “web giants”, mainly US high-tech multinationals, commonly synthesized under the acronym GAFA[84]. The need to protect the dominance of the own high-tech in the European territory has prompted US President Donald Trump to threaten a fiscal war in the form of compensatory customs measures. This reaction was therefore intended as the natural counter-response to the intention of some EU Countries to apply a web tax on digital services provided by US multinational companies.

As the US represents a key trading partner for many EU countries, the risk of incurring a tax war on exports would result particularly heavy, thus adequately explaining the slowdown in approving the European web tax. The will to preserve commercial activities with the US is fully evident in the behavior of Germany, which has shown itself to be particularly lukewarm towards the introduction of a taxation on digital turnover: the application of heavy duties on its exports of cars to US would have in fact been too much detrimental to the country’s balance of trade.

The opposition of EU “fiscally aggressive countries”[85] and the trade issue with the US have decreed the failure to find a common line to tax the revenues of web giants within the EU territory. The rejection of such tax, defined as an “opportunity missed”[86] by the Commissioner for Economic Affairs Pierre Moscovici, highlights the presence of very divergent fiscal policies among the Member States and urges the EU to put back the matter in the hands of the OECD.

In fact the adoption of a global consensus-based and multilateral solution, mediated through the OECD, would be the most suitable option in the international arena. Referring the matter back to OECD would also allow to open a negotiating table with the US, thus cooling the path of fiscal war.

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[84] The term GAFA includes: Google, Amazon, Facebook, Apple. The term was coined for the first time by Eric Schmidt, Phil Simon and Scott Galloway with the purpose of underlining an exponential growth in the technological field. The four US giants are also known as the Big Four.

[85] OCPI, 2020, *L’Unione Europea e le eccessive differenze nella tassazione dei profitti tra Paesi*

[86] These words have been pronounced following the non-approval of the digital service tax in the ECOFIN Council, on 12th March 2019.

But it is also true that pursuing this internationally accepted formula, which is based on appreciable principles of tax uniformity and equity, is very difficult for some reasons.

On the one hand, the governments of the European countries most convinced of the need for this tax, such as France, Italy and Spain, have strongly expressed their position with some national regulations involving the introduction of a web tax. The Italian version of the web tax requires a 3% levy on digital revenues for all those companies with total revenues exceeding EUR 750 million and digital revenues in the Italian territory of at least EUR 5.5 million. This measure is part of the Italian legislator's intention to update the national tax system to the modern fiscal challenges, as seen in the integration of the permanent establishment concept introduced by Law 205/2017. According to article 162 of the Italian TUIR, a permanent establishment may also be associated to "a significant and continuous economic presence in the territory of the State constructed in such a way as not to result in its physical consistency in the territory itself"[87].

On the other hand the explicit threats of retaliation by the Trump's administration are hanging over European exports to United States. This climate of commercial tension has provoked numerous complexities in the negotiations, opening a real hunt for compromise.

A compromise seemed to be reached at the beginning of 2020 when France and Italy had agreed to suspend the collection of the web tax until the conclusion of negotiations in OECD, scheduled for the end of 2020. But the situation has recently precipitated, in June 2020, when the US decided to leave the negotiating table.

The tear has resulted from a letter with final tones sent by the US Treasury Secretary, Steven Mnuchin, to his French, Italian and Spain peers[88].

The document has stressed the inadequacy of 2020 as a year to continue negotiations by indicating that the priority of governments around the world should be the resolution of the economic problems arising from the outbreak of Covid-19. In particular the letter highlights that US opposes "the adoption of measures that focus only on digital companies and that fall mainly on US companies"[89]. The intimidating tones of the letter become evident when it

[87] Art.162 TUIR, as emended by Italian Law 205/2017. The complete article is available on: https://www.brocardi.it/testo-unico-imposte-redditi/titolo-iii/capo-i/art162.html

[88] The complete text of the letter is available at: https://www.corriere.it/esteri/20_giugno_20/ecco-lettera-usa-governi-europei-guerra-web-tax-rottura-vicina-5b7047e0-b335-11ea-8839-7948b9cad8fb.shtml

[89] Department of US Treasury, 2020, *Letter sent by US Treasury Secretary*

states that the US will react to the adoption of web taxes with "appropriate measures of equal amount"[90].

This choice has been seized with regret by the European Commission, asking the US to re-enter in the negotiating table within OECD. The shared OECD approach continues in fact to be considered the first pick by the EU but if this proves to be impossible, the European Council has already stated its readiness to resume talks on a European web tax.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 12, 2020

His Excellency
Bruno Le Maire
Minister of Finance of the French Republic

Her Excellency
María Jesús Montero
Minister of Finance of Spain

His Excellency
Roberto Gualtieri
Minister of Finance of the Italian Republic

The Right Honorable
Rishi Sunak
Chancellor of Exchequer

Dear Ministers:

We have worked closely with your countries over the last three years on a bilateral and multilateral basis, including at the Organisation for Economic Co-operation and Development (OECD), to preserve and renew an international consensus on the taxation of multinational enterprises in a rapidly changing global economy. During that process, the United States has consistently made clear that we object to the adoption of measures

Figure 16: extract of the letter sent by US Treasury Secretary (Corriere, 2020)

[90] Department of US Treasury, 2020, *Letter sent by US Treasury Secretary*

Chapter V: The Google Case

This chapter is dedicated to the analysis of the Google case. This choice is motivated in the perspective of providing a real and concrete application to the modern fiscal challenges brought by digital multinationals. Among these, the Google's fiscal strategy, adopted for many years before the recent abandonment, announced in early 2020, represents perhaps one of the most comprehensive examples of BEPS risks and broader fiscal challenges associated with conducting a business on an international scale.

The chapter frames Google as one of the so-called *Silicon Six,* namely the six US multinationals that more than others leverage tax avoidance strategies to maximize their profits. Subsequently, the specific strategy of Google, defined *Double Irish with a Dutch sandwich*, is analyzed, observing the jurisdictions involved and the tax advantages related to them. The chapter continues with the identification of the modern fiscal challenges associated to Google's strategy. The last section is dedicated to the description of the main regulatory interventions, inspired and guided by the innovative scope of the BEPS Plan, which have decreed the recent rejection of this strategy by Google.

The Silicon Six: USD 100 billion global tax gap

The term *Silicon Six* has been coined to group the most important digital multinationals on a global scale, whose geographic localization is situated in the American area of the Silicon Valley. The link between this area and technology has always represented a strong blend, allowing the Silicon Six to become real web giants. The following multinational enterprises belong to the Silicon Six group: Amazon, Apple, Google, Facebook, Netflix and Microsoft. These enterprises exhibit a dominant influence on many consumer markets, such as the leadership of Google in digital advertising or that of Amazon in the data management field.

The economic dimension of these enterprises is enormous inside the international landscape. In October 2019, the combined market capitalization of the Silicon Six was of nearly USD 4.5 trillion, representing the 15% of the total value of the world broadest financial market, the New York one. Their overall value overcame that of economies such as Germany, UK, France or the whole of Africa, being only exceeded by US, China and Japan.

In addition to their enormous economic value and the ability to dominate the markets, a further common feature, in the tax field, unites the Silicon Six. All these multinationals seek in fact to exploit the existing gaps in the international tax system to develop aggressive tax avoidance strategies, with the aim of maximizing their profitability. The attempt of dodging the payment of taxes whenever and wherever they can causes that "none of the Six is an exemplar of responsible tax conduct"[91].

The elusiveness of their tax conduct may be found in two types of fiscal gaps, occurred in the period 2010-2019:

- the one between their cash taxes paid and the expected headline rates of tax, overall equal to USD 155.3 billion;
- the one between their cash taxes paid and the current tax provisions booked, overall equal to USD 100.2 billion.

The assessment of the two gaps requires to know the overall amount of cash taxes paid by the six multinationals over the period considered. These values should then be contextualized to the corporate profits earned in the same period of time. With regard to cash taxes paid and the profits made by Silicon Six in the period 2010-2019 the data were as follows:

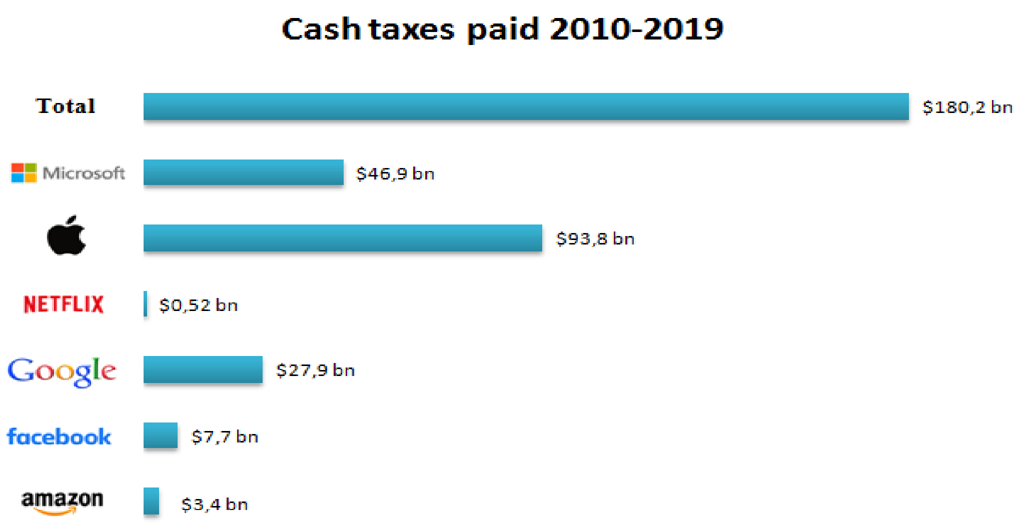

Figure 17: cash taxes paid by the Silicon Six in the period 2010-2019 (own elaboration)

[91] Fair Tax Mark, 2019, *The Silicon Six and their $100 billion global tax gap*. The Fair Tax Mark certification scheme was launched in February 2014. It aims to identify companies which fairly meet their tax obligations, paying the right amount of taxes when and where due. In a parallel way, the goal is also that of recognizing those organizations lacking a fair tax conduct.

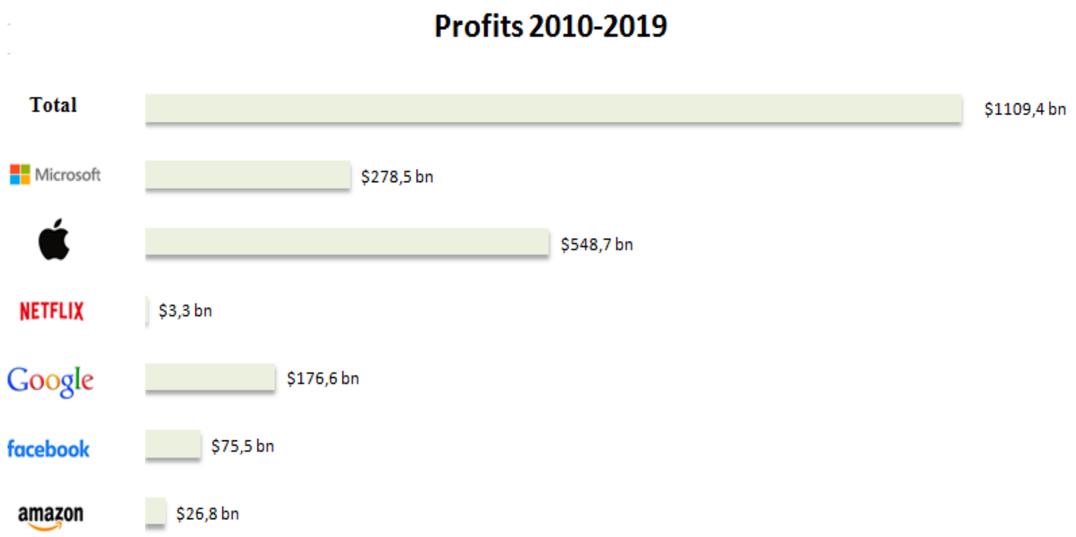

Figure 18: profits by the Silicon Six in the period 2010-2019 (own elaboration)

The first gap, the one between the cash taxes paid and the expected headline rates of tax, is intended as the difference between the expected overall taxes and the paid overall taxes. The first value is calculated by applying the US headline rate, around 30.24%, to the total profits of the period. The rate used is lower than 35% to reflect the lowering of the corporate profit tax rate following the introduction of the Tax Cuts and Jobs Act in the US jurisdiction, at the end of 2017. This application has led to a total of expected taxes equal to USD 335.5 billion, far beyond the USD 180.2 billion of taxes paid. The difference, equal to USD 155.3 billion, has represented a large gap.

The analysis may be deepened by determining the weight of cash taxes paid in terms of corporate profits for each company of the Silicon Six, as visible in the following graph:

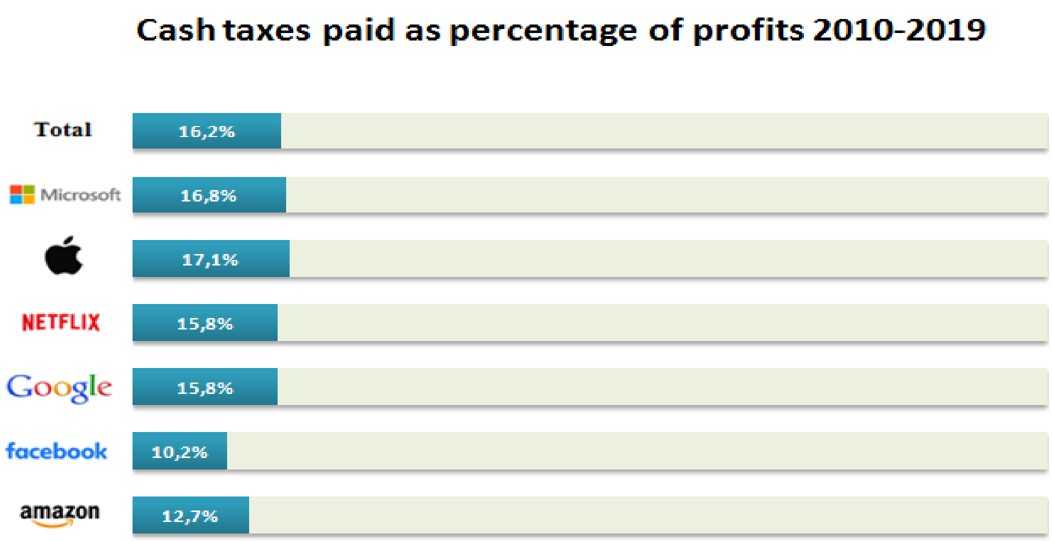

Figure 19: cash taxes paid as percentage of profits in the period 2010-2019 (own elaboration)

The chart shows how the total amount of taxes paid by the Silicon Six in the period 2010-2019 has been around 16.2% of their total profits, well below the federal headline rate. Moreover it turns out that each of the six enterprises has paid an amount of taxes on profits widely lower than that it would have been expected.

The gap associated to the cash taxes paid remains even if the comparison term is changed. In fact the expected taxes, rather than being anchored on the US headline rate, could be based on the average statutory rate across the OECD members, that is around 23.7%. Such value, applied to the overall profits of the Silicon Six, would determine an amount of expected taxes equal to USD 262.9 billion, with a deviation from those paid of USD 82.7 billion.

In a complementary way the second gap, the one between the cash taxes paid and the current tax provisions booked, confirms the elusive nature of the tax conduct of each of the six enterprises. In particular the total value of current tax provisions for the period 2010-2019 amounts to USD 280.4 billion, representing the 25.3% of the overall profits. Cash taxes paid deviate from the booked ones for an amount of USD 100.2 billion, demonstrating that the accounting and fiscal dimension do not always go hand in hand.

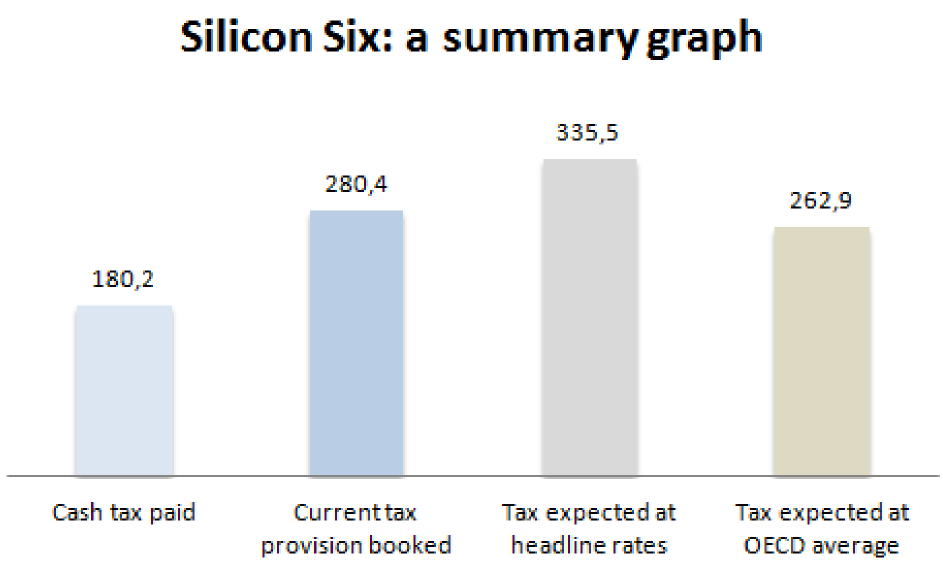

Figure 20: a summary graph (own elaboration)

The international nature of Google's tax avoidance strategy: the tax jurisdictions involved

In the period going from 2010 to 2019 the US multinational Google, headquartered in Mountain View (California), realized revenues for USD 647.7 billion and profits for USD 176.6 billion[92]. The amount of cash tax paid was USD 27.9 billion, representing the 15.8% of the overall profits, well below both the US headline rate and the average OECD rate. The Google's tax dodge has been possible by the adoption of a tax avoidance strategy with strong international connotations. The study of this tax conduct allows again to find many of the modern fiscal challenges previously analyzed, with the advantage of contextualizing them within a real business activity operating in the international framework.

Google's tax avoidance strategy, defined *Double Irish with a Dutch sandwich*, represented a sophisticated tax engineering scheme. This strategy belonged to the category of the tax planning activities, able to exploit the gaps in the international tax landscape, while remaining always in the wake of legal.

At the basis of the scheme was the willingness to move a large portion of the profits associated with Google's intangibles into the tax heaven of the Bermuda Islands, where no taxation is applied to corporate income. The international nature of this strategy resulted from the fact that at least five geographical areas were taken into account from a fiscal point of view:

- United States
- Ireland
- Netherlands
- Rest of Europe
- Bermuda Islands.

With regard to the ***United States***, prior to the introduction of TCJA at the end of 2017, the tax system was particularly strict on the business profits. The federal headline rate was 35%, one of the highest on a world scale. This meant that the big US multinationals had the incentive to shift profits elsewhere, taking advantage of their high international ramification. In addition the US tax system, prior to the TCJA, was a worldwide system, implying that all domestic-source income, as well the foreign-source income of resident corporations could be taxed. In order to avoid double taxation issues, tax credits were recognized to resident companies for

[92] Fair Tax Mark, 2019, *The Silicon Six and their $100 billion global tax gap*. For a graphical representation, see Figures 17, 18 and 19 of this dissertation.

offsetting the taxes already paid abroad on the same income. Moreover, the tax claim on income generated abroad through a controlled foreign company was activated only when profits were repatriated, that is to say distributed in the form of dividends. Since the repatriation of profits was subject to the high US taxation, multinationals preferred to keep them parked abroad, somewhere with a privileged taxation. This trend is confirmed by the FED, according to which "by the end of 2017, U.S. MNEs had accumulated approximately $1 trillion in cash abroad"[93] (Smolyansky, 2019)

With reference to ***Ireland***, the country has always represented a favorable business climate. Among the most important tax advantages associated with the current Irish tax system it is possible to identify the reduced taxation of corporate profits and the numerous facilities for investments in research and development. As regards the first aspect, there is a single rate of 12.5%, among the lowest in Europe, on all profits of companies, including those of subsidiaries controlled by non-resident enterprises. In terms of the second aspect it is granted the possibility of deducting the investments made to support research and development or to acquire know-how.

An additional tax advantage that characterized the Irish tax system was due to the fact that a domestic law allowed companies to be set up under Irish law but with a tax residence in another country. This provision represented a great fiscal opportunity for US multinational groups that were determined to move their profits to offshore countries, where the taxation is traditionally low, if not totally missing. The tax avoidance strategy consisted in creating a company legally based in Ireland, but with a fiscal residence in one offshore legislation, such as Cayman or Bermuda Islands, from where it was managed and controlled. In this way the profits were essentially channeled into a tax heaven, although in the perspective of the US tax authorities they remained tied to the Irish territory, where the legal seat had been formally established.

The latter advantage is today no longer offered by the Irish tax system because it has been removed from the legislative landscape. In fact, since 1st January 2015, the tax avoidance strategy previously exposed is not anymore usable for all those companies that stabilize from scratch in Ireland, while for those already present at the time of the legislative amendment an

[93] Smolyansky M., 2019, *U.S Corporations' repatriation of offshore profits: evidence from 2018,* FEDS Notes. According to the author's estimates, U.S. firms repatriated USD 777 billion in 2018 as a consequence of the TCJA. Repatriation was particularly strong in the first half of 2018, when USD 510 billion were brought back to the US territory. Taking a more historical view, a similar phenomenon occurred in 2005 when USD 312 billion were repatriated as a consequence of the Homeland investment Act of 2004 (also known as "tax holiday"). Such Act provided in fact a temporary one-year reduction in the repatriation tax rate.

additional time was granted until 2020 in order to review their organization. This decision has been the product of numerous international pressures, mainly exercised by US and EU, supported by the innovative principles of the BEPS Plan.

The reference to the ***Netherlands*** is necessary because this country is traditionally associated with a favorable tax system. The most relevant advantages regard the tax treatment of dividends and the outgoing royalties. Dutch tax treaties have in fact the peculiar feature of eliminating withholding tax on dividends paid by a foreign subsidiary to a Dutch parent company. Moreover, the Dutch fiscal discipline does not apply withholding tax on outgoing royalties by choice. In this way, the tax exemption of outgoing royalties makes the Netherlands an extremely attractive country for tax planning of profits associated to intangibles. Another important tax advantage offered by the Dutch tax system is that of the Participation Exemption, or PEX. It provides that no tax is levied on any economic benefit associated with the participation, such as capital gains. This facilitation covers investments with at least 5% of capital in resident or non-resident subsidiaries and it is applied only when the assets of the subsidiary are not 90% or more of a real estate nature.

The last two geographical areas mentioned above, the ***Rest of Europe*** and the ***Bermuda Islands***, represent two antithetical economic and tax systems. The rest of Europe definition is deliberately broad and aims to encompass all the major developed European economies, such as Germany, France, Italy and Spain, excluding Ireland and Netherlands mentioned above. From the economic point of view, these countries share the feature of being markets in which US web giants typically sell their digital products, thus representing the place where users are located and where value is created. On the other side, from the fiscal point of view, they show high levels of taxation, with tax rates generally over 25%. From the latter aspect it follows that many US multinationals have the incentive to move the economic value generated in these developed European countries towards areas of the world with low or zero taxation, commonly denominated tax havens.

Among the tax havens, Caribbean area is certainly one of the most famous in the world, within which Bermuda Islands are located. The antithesis between Bermuda Islands and the Rest of Europe aggregate takes place in both economic and fiscal terms. From the economic point of view in fact the value that is generated in the Bermuda Islands is almost null, since these do not represent typical market jurisdictions in which to establish profitable relationships with users. From the fiscal point of view, however, the advantages are enormous for the complete absence of taxation on corporate income. This latter divergence entails the incentive for the US multinationals to shift income to the Bermuda Islands, eroding the taxable base of the Rest of Europe countries. The antithesis is manifested in the fact that economic value is created in a place other than where it is taxed: profits deriving from the interaction with German, French, Italian and Spanish customers are in fact subject to taxation, even if null, overseas, in the Bermuda Islands.

The core of the strategy: Double Irish with a Dutch sandwich

Once presented the main features of the tax jurisdictions involved in the Google's tax avoidance strategy, it is possible to analyze in detail its articulation. The core of the strategy consisted in the realization of a refined tax engineering scheme, called *Double Irish with a Dutch sandwich*. The main objective was to shift intangible-related profits from major European markets to a tax haven, through a triangulation system whose summits were Ireland, Netherlands and Bermuda Islands. The absence of a specific geographical location and their difficult valuation at the time of a contractual transfer made the intangibles easy to move and, with them, the associated profits.

The central structure of the strategy was based on the ***Double Irish arrangement***. This was the direct consequence of that Irish law which allowed the setting up of companies under Irish law but with a tax residence in another country. Taking advantage of this law meant for Google the opportunity to create a company with legal seat in Ireland but with tax residence in an offshore country, where profits were moved to reduce or nullify the tax burden. For these reasons Google had created ***Google Ireland Holdings ("Ireland Holdings")***, legally established in Dublin but whose headquarters was located in Hamilton, in the Bermuda Islands. Since such company was officially registered under the Irish law, the shift of profits to the Bermudian territory was not formally visible in the perspective of US tax authorities.

But the name Double Irish arrangement indicates the presence of two Irish companies. In fact, alongside *Ireland Holding*, Google had created another company in the Irish soil: ***Google Ireland Limited ("Ireland Limited").*** The latter company was, however, completely different from the previous one because it had a real economic structure to operate in the market and because it was taxable under the Irish fiscal law. This firm was particularly important because it was the reference point for all sales of digital products made by Google in the major European markets.

The tax avoidance strategy also provided for a Dutch company to be involved between the two Irish companies: this firm was called ***Google Netherlands Holdings BV ("Netherlands***

Holdings BV"), resident in Netherlands. Its interposition was designed in order to benefit from the advantages related to the Dutch tax system, in particular with regard to outgoing royalties.

Figure 21: graphical synthesis of Double Irish with a Dutch sandwich strategy (own elaboration)

The strategy was articulated in a series of successive steps:

1. Through specific contractual agreements the US parent company of Google sold the rights to exploit its technology to its subsidiary Google Ireland Holdings, against a fee payment. Ireland Holdings could exercise these rights worldwide except the US. In particular the most relevant market was represented by the EMEA Area (Europe, Middle East and Africa).
2. Ireland Holdings, which had purchased the license, sublicensed it to another group company, Google Netherlands Holdings BV. This company proved to be completely devoid of assets, staff or actual activities, placing itself therefore like a simple vehicle of intermediation.
3. Netherlands Holdings BV granted the same intellectual property to the affiliate Google Ireland Limited, which was actively operating in the market.
4. Ireland Limited, using the intellectual property received, sold advertising on the search engine for all customers outside the US, becoming a real billing center for at least 80% of total Google's sales. All revenues from advertising contracts signed in the EMEA Area, for example in Italy, were in fact held by Ireland Limited. When in fact an Italian customer decided to buy some advertising spaces in Google, its payment flowed to Ireland Limited and was not taxed in Italy, as Google did not have a permanent establishment in the Italian territory. In reality the multinational of Mountain View owned the Italian branch Google Italy Srl, whose social object was "the provision of consulting services and assistance in support of sales, in the

marketing sector"[94]. Since the activity of this branch was formally declared of auxiliary character to the sales, the permanent establishment status and the application of the Italian taxation could not emerge.

5. Once all profits relating to advertising sales had reached Ireland, a very low tax rate of 12.5% was imposed on them. In addition, Ireland Limited had to pay royalties to Netherlands Holdings BV for the grant of the intangible. Such high-value royalties represented costs which lowered the tax base, further reducing the tax burden.
6. After being remunerated by Ireland Limited, Netherlands Holdings had to pay, in its turn, royalties to Ireland Holdings, fiscally resident in the Bermuda Islands, in order to compensate the intellectual property received. The first flow of royalties, the one entering in Netherlands from Ireland, was not subject to withholding tax as permitted by Double Tax Treaty between Ireland and Netherlands, signed on 11th February 1969. On the other hand, the second, moving from Netherlands to Bermuda through Ireland Holdings, was exempted from withholding tax as a typical advantage of the Dutch tax system on outgoing royalties, even if directed to a tax haven. The only charge, although extremely low, was a fee applied in the Netherlands for triangulation services[95].
7. In this way, the wealth hooked to the intangibles, in the form of royalties, was conveyed to the Bermudian tax haven[96], where it was completely exempted from taxation.

[94] Il Sole 24 Ore, 2017, *Google fa pace (dopo un anno) con il Fisco italiano: pagherà 306 milioni di Euro*.
[95] Netherlands Holdings BV paid to Ireland Holdings the 99.8% of what received from Ireland Limited, implying a tax burden only on the 0.2% of the royalty flow. The usage of royalties as deductible costs allowed an almost complete erosion of the Dutch taxable base.
[96] According to the estimates of Oxfam (2016), the Bermuda Islands are in the first place in the ranking of the most aggressive tax havens in the world, also before Cayman Islands. Their aggressiveness derives from: zero tax on corporate profits, no withholding tax, no participation in international tables, little transparency and serious cases of tax avoidance.

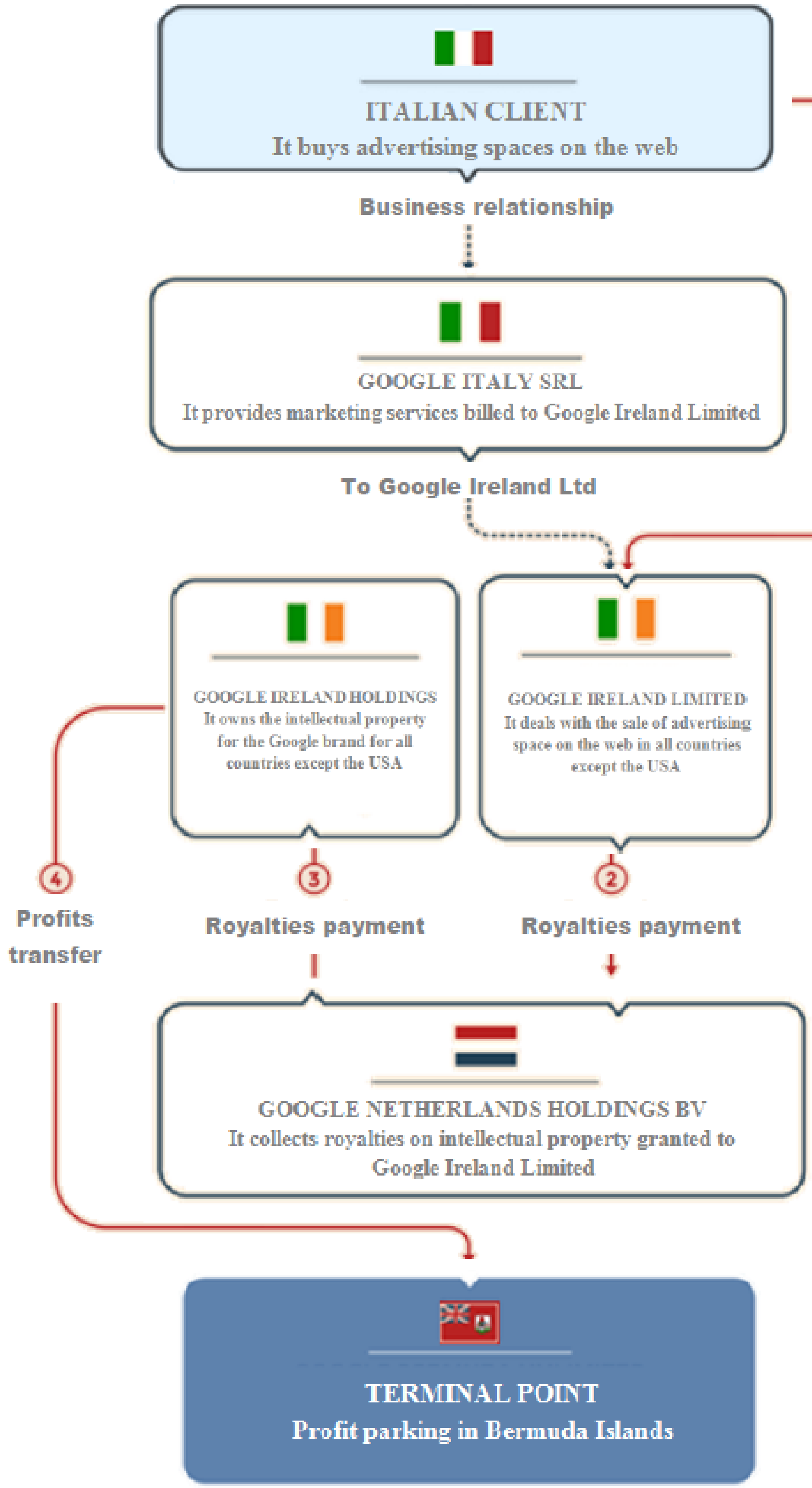

Figure 22: Google's tax avoidance strategy (own reworking from Sole 24 Ore)

The triangulation between Ireland, the Netherlands and the Bermuda Islands was extremely profitable for Google. According to an indiscretion by Reuters in fact Google was able to move EUR 21.8 billion (USD 24.5 billion) to Bermuda in 2018, up from EUR 19.9 billion in 2017. The use of this tax-avoidance scheme allowed Google "to enjoy an effective tax rate in the single digits on its non-US profits, around a quarter the average tax rate in its overseas markets"[97].

The large reduction in the tax burden on intangibles' revenues generated outside the US market resulted from the combination of four significant tax advantages:

- the application of the Irish tax system, with a rate of 12.5%, on profits from the sale of advertising in other markets where taxation would have been higher (as in Italy, where the IRES rate at that time would have been 27.5%[98]);
- the use of royalties as cost elements capable of reducing the tax base of subsidiaries included in the tax avoidance scheme;
- the Dutch tax system which did not apply withholding tax on outgoing royalty flows;
- the benefits offered by the tax haven of Bermuda Islands, where corporate income was exempted from taxation.

The first tax advantage, namely the *application of the favorable Irish tax*, was linked to the fact that Google avoided taxation at source in the jurisdictions in which its users were located. Google in fact did not formally constitute any permanent establishment in the market jurisdictions, exploiting the remote nature of its business. However, if a careful analysis is carried out on the Italian market, one of the largest for Google, it can be noted that in the Italian territory Google had a branch, named Google Italy Srl, based in Milan. The risk of incurring the permanent establishment status, however, has meant that Google has officially qualified this branch as a mere sales support in Italy, thus falling outside the permanent establishment definition. In this way the profits obtained from the market jurisdictions, such as Italy, were only taxed in Ireland.

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[97] Sterling T., 2019, *Google to end "Double Irish, Dutch sandwich" tax scheme,* Reuters

[98] According to art.73 of the Italian TUIR, the passive subjects of IRES (Imposta sul Reddito delle Società) are: corporations, cooperatives and mutual societies with residence in the Italian territory; public or private entities, other than companies, as well as trusts, resident in the territory of the Italian State which have as their exclusive or principal object the conducting of commercial activities; public or private entities, other than companies, as well as trusts, resident in the territory of the State, which do not have as their object the exercise of commercial activities; any other company or entity, including trusts, regardless the legal personality requirement, not resident in the territory of the State. The current rate, since 2017, is 24%.

The second tax advantage, the one connected to the *use of royalties as erosive elements of the taxable base*, was particularly relevant because it allowed Google to reduce the tax burden in the two European summits of the triangulation, Ireland and Netherlands. This occurred because the outgoing royalties were classified as costs, thus lowering the taxable wealth. In addition the payment of royalties from Ireland Limited to Netherlands Holdings BV was exempted from the withholding tax, pursuant to the Double Tax Treaty between Ireland and Netherlands.

The third tax advantage, linked to the *non-application of the withholding tax on the outgoing royalties* moving from Netherlands to Bermuda Islands passing through Ireland Holdings, was a typical feature of the Dutch tax system. If the same royalties had been paid by Ireland Limited to Ireland Holdings, there would have been an international flow between Ireland and Bermuda Islands that would have been subject to withholding tax. For these reasons Netherlands Holdings BV was interposed between the two Irish companies, thus avoiding the taxation of royalties directed to the tax haven.

The last tax advantage, the one granted by the Bermudian legislation, was the pivot of the entire strategy because the *complete exemption of corporate income taxation* was a benefit of enormous value.

Figure 23: the stages of the Google's tax avoidance strategy
(own reworking from Sole 24 ore)

The modern fiscal challenges associated with Google's tax avoidance strategy

In Google's tax avoidance strategy many of the modern fiscal challenges may be identified. The analysis is conducted by distinguishing BEPS risks from broader fiscal challenges.

The reference to BEPS risks requires an understanding of the ultimate purpose of the strategy, consisting in the intention of shifting the intangibles-related profit, earned outside US, into the Bermudian tax haven. Google aimed in fact at ***locating the income associated with intangible assets in the most convenient tax jurisdiction*** through the implementation of a series of intra-group transactions. The latter formally presented themselves as contractual arrangements concerning Google's intangibles but were essentially geared to ensuring the income shift in the offshore jurisdiction. Google's strategy offered numerous recalls with the *principal company model*[99] (Valente, 2016), where the principal company could be identified in Ireland Holdings. Ireland Holdings in fact, having bought the legal ownership of Google's intangible property from the US parent, could collect all profits in the form of royalties and direct them to Bermuda, where it was fiscally resident for the Irish tax authorities. The attribution of profits only to the company which held the legal ownership of the intangible was certainly a form of tax avoidance since the firms with the economic ownership entitlement were completely excluded from the remuneration scheme. For example, the companies of the Google group that were established in the US and that performed many of the DEMPE functions, such as the development and the enhancement of the intangible, were not attributed any share of profits for remunerating their contributions: all profits earned outside US revolved in fact around the legal owner, Ireland Holdings. Another critical aspect, always with reference with the intra-group transaction between the US parent and Ireland Holdings, was related to the price at which the intangibles were transferred. Since the transaction took place between two affiliated companies, there was every incentive to lower the price in order to reduce the revenues of the US company and, consequently, its taxable base. In this way less taxes were paid in the US, where the taxation was typically higher. The room for maneuver on the determination of the *transfer price* was made possible by the nature of intangibles, whose objective assessment is difficult, if not impossible.

[99] Valente P., 2016, *Intangibili e determinazione dei prezzi di trasferimento*, Fiscalità e Commercio Internazionale 1/2016. For further information, consult Valente P., *Manuale del Transfer Pricing*, IPSOA, 2015.

Google's tax avoidance strategy aimed also at ***avoiding a taxable presence in the market country***. The example can be found in the Italian market, where the multinational of Mountain View was established with a branch declared of simple support to the sales, thus avoiding the *permanent establishment status*. However, the Italian tax authorities had many doubts about the real nature of this settlement. In particular the Milan Guardia di Finanza's tax unit considered that Google had masked the true role of the Italian branch, generating a real corporate fiction. The tax litigation, opened by Italian Fiamme Gialle after 2015, was based on a careful analysis of the functions actually performed by Google Italy Srl in the Italian territory. According to the findings of the Guardia di Finanza, the Italian branch of Google had operated with very different roles from those officially declared and especially with a permanent establishment. This belief was linked to the fact that contracts with Italian customers, formally referred to Ireland, were instead prepared and edited by Google Italy Srl, to be sent and only signed by Ireland Limited. Subsequently they were sent back to the Milanese branch, from where they were then delivered to Italian clients. The Guardia di Finanza therefore considered that Google had operated for years in Italy with a not declared permanent establishment, as not officially constituted. For these reasons the Italian tax authorities asked the US multinational for compensating the loss of tax revenue related to the tax avoidance strategy. After a path of difficult negotiations, Google agreed to settle its position with a payment of EUR 306 million[100], clearing also an old dispute relative to the period 2002-2006.

Google's strategy was designed in a way to generate another substantial BEPS risk, that of ***avoiding the withholding tax*** that otherwise would have hit the income shift towards Bermuda. The presence of Netherlands Holdings BV was designed for escaping this imposition, operating as a crucial hub for the royalty flow. Through the Dutch company, royalties could enter the Netherlands without suffering any Irish withholding tax, leveraging the tax advantages provided by the Double Tax Treaty between Ireland and the Netherlands. This Convention was particularly favorable because it eliminated, with no restrictions, any form of taxation at source on the royalty flows between Irish and Dutch jurisdiction. Its article 10 declared in fact that "royalties arising in one of the States and paid to a resident of the other State shall be taxable only in that other State"[101]. Such wording thus conferred an exclusive power to tax for the State of residence, effectively avoiding any form of double

[100] Il Sole 24 Ore, 2017, *Google fa pace (dopo un anno) con il Fisco italiano: pagherà 306 milioni di Euro*
[101] Double Taxation Treaty between Ireland and the Netherlands, 1969. The Tax Treaty was signed on 11th February 1969 at the Hague. The reference is visible in art.10, dedicated to cross-border royalties. See https://www.revenue.ie/en/tax-professionals/documents/double-taxation-treaties/n/netherlands.pdf

taxation that would have increased the tax burden. This facilitation was also extremely attractive as it was free from any restrictive conditions, such as that of the beneficial owner or the more modern LOB and PPT Rules. The Convention stated in fact that any entity, even if it had simply been interposed with the purpose of subsequently transferring royalties to the real beneficial owner, would have benefited from this tax advantage. This left ample room for *treaty shopping practices*, carried out through the creation of merely interposed firms, the conduit companies, completely empty of economic substance but only aimed at capturing the tax benefits promoted by the Convention. Since the royalties had their source in Ireland, these shell companies were typically established in the Dutch territory: Netherlands Holdings BV was one of these. The channeling of royalties in the Netherlands was necessary in order to move them to the Bermuda Islands without taxation. In fact the Dutch tax system, for its colonial past, did not levy any withholding tax on the outgoing royalties, even if their "ultimate beneficial owner"[102] (Peters, 2012) was located in a tax haven. The final result of this strategy was that the royalties from Ireland to Bermuda, passing through the Netherlands, did not suffer any withholding tax.

Google's tax conduct was also characterized by the presence of the three modern fiscal challenges associated with the first pillar of the BEPS Plan. In particular an *asymmetrical tax treatment of royalties* emerged in the jurisdictions involved, assuming the connotations of an ***hybrid mismatch arrangement***. For example, in the Irish and Dutch jurisdiction royalties were treated as deductible expenses respectively for Ireland Limited and for Netherlands Holdings BV, while they were not taxed as revenue in the Bermuda Islands, with reference to Ireland Holdings.

Given that the amount of royalties involved in the scheme was particularly relevant, another BEPS risk, retrievable in the Google's strategy, was the one associated with the ***excessive deductions*** issue. As a result both Ireland Limited and Netherlands Holdings BV could experience a *significant erosion of their taxable base*, widely reducing the tax revenues of both Ireland and Netherlands.

The Google's tax avoidance strategy was also based on the widespread use of ***harmful tax practices***. For example, the purpose of transferring intangibles-related profits to the Bermuda Islands was simply the one of participating in the *favorable tax regime* offered by the tax

[102] Peters J., 2012, *Netherlands: Independent Dutch Royalty Conduit Entities and their benefits for multinational enterprises.* The author aims to highlight the traditional characteristics of Dutch Royalty conduit entities, explaining why the "Holland Routing" is common to many tax planning strategies of many multinational enterprises involving royalty flows.

haven. This advantage occurred without the US multinational having a real and substantial nexus with such territory: Google's intellectual property was not developed in Bermuda, yet its associated economic value was taxed there.

But the criticalities associated with Google's tax conduct were not only limited to BEPS practices, as the broader fiscal challenges could also be found. In fact the increasing *remote nature* of Google's business model has laid the foundations for changing its ***nexus with the territory***, weakening its level of physical presence in the market jurisdictions. At the same time, the *high reliance on new digital means* widened the range of services offered, making the ***characterization of the income*** a variable of primary importance. In addition, commonly to many other modern enterprises, Google greatly increased the ***relevance of data*** collected by customers. An higher *involvement of users* was crucial for *value generation*, although with some tax distortions. The need to mitigate these distortions resulting from interaction with users has prompted many market jurisdictions in which Google has no taxable presence, such as Italy, to develop proposals for the introduction of the so-called web tax.

The modern fiscal challenges associated with Google's tax avoidance strategy

Hybrid mismatch arrangements	BEPS PILLAR 1	Asymmetrical tax treatment of royalties in the jurisdictions involved: deduction in the Irish and Dutch jurisdiction, no taxation in the Bermudian one
Excessive deductions	BEPS PILLAR 1	Due to the deductibility of royalties, a significant erosion of the taxable base of both Ireland Limited and Netherlands Holdings BV occurred
Harmful tax practices	BEPS PILLAR 1	Participation in the Bermudian favorable tax regime without having a real nexus with that territory: intellectual property was not developed in Bermuda, yet its associated value was taxed there
Avoiding withholding tax	BEPS PILLAR 2	By channeling royalties through Netherlands Holdings BV, no application of withholding taxes in the royalty flow moving from Ireland to Bermuda
Avoiding a taxable presence in the market country	BEPS PILLAR 2	For example, the branch in the Italian market jurisdiction was officially declared to be of mere support, thus artificially avoiding the PE status
Locating the income allocable to functions, assets and risks in the most favorable tax jurisdictions	BEPS PILLAR 2	A series of intra-group transactions assured the shift of intangibles-related income to the Bermudian tax haven. The elusive nature of the intangibles facilitated both the displacement of the associated profits and the discretional choice of the transfer price
Nexus with the territory	BROADER FISCAL CHALLENGES	The increasing remoteness of the business model has posed the foundations for changing the nexus with the territory, weakening the level of physical presence in the market jurisdictions
Relevance of data	BROADER FISCAL CHALLENGES	Significant increase in the value obtained from the involvement of users, although with some tax distortions
Characterization of income	BROADER FISCAL CHALLENGES	The high reliance on new digital means widened the range of services offered, making the characterization of the income a variable of primary importance

Figure 24: the modern fiscal challenges associated with Google's tax avoidance strategy (own elaboration)

The abandonment of the Double Irish with a Dutch Sandwich: the reasons

In the tax documents submitted at the end of 2019, Google announced that, from 2020, it would no longer adopt the strategy of the *Double Irish with a Dutch sandwich*. Officially the choice has been motivated by the requirement to simplify the corporate structure, with the aim of licensing the intellectual property directly from the US and not anymore from the Bermuda Islands. Actually, the reasons for the abandonment of such a profitable strategy must be broader, stemming from external rather than internal factors. Therefore the real explanation may be found in the joint process of adapting the different jurisdictions around the world to the modern fiscal challenges arising from the advent of the digital economy.

This section aims to analyze how the main regulatory interventions by the jurisdictions involved in the Double Irish with a Dutch sandwich are going to change many aspects of international taxation, forcing Google to abandon its strategy.

In particular, the main regulatory changes are the following ones:

- the US fiscal reform proposed by the Tax Cuts and Jobs Act (TCJA), entered into force in January 2018;
- the amendment of the Irish legislation, having the purpose of eliminating the possibility of setting up companies under Irish law but resident for tax purposes elsewhere;
- the new version of the Double Tax Treaty between Ireland and Netherlands, that will be effective from 1st January 2021;
- the decision of Dutch legislator to introduce a conditional withholding tax on royalties directed towards low-tax jurisdictions, from 2021 onwards;
- the update of the permanent establishment concept introduced by the Italian Law 205/2017, visible in the new version of article 162 of Italian TUIR.

The main objectives of the ***tax reform promoted by the TCJA*** have been that of facilitating the repatriation of the wealth generated elsewhere by multinationals and that of incentivizing US companies to run their business from the domestic territory.

The first goal has been achieved by mitigating the traditional *worldwide* nature of the US tax system. Prior to the TCJA in fact the United States generally taxed its corporations on their global income, namely both the domestic-source and foreign-source income. The foreign-source income, generated through controlled foreign companies, was taxed at 35% when returned to US, that is, when distributed in the form of dividends. In order to avoid double taxation, a tax credit for taxes paid abroad was granted, but up to the US tax rate. This imposition certainly did not favor the repatriation of profits, so that many US multinationals preferred to keep them parked abroad.

For these reasons, the TCJA has opted for changing the nature of the US tax system, transforming it into an hybrid between a *territorial and worldwide* one. The territorial nature has been introduced by offering two incentives to the return of earnings to the US soil. The first has been that the foreign profits of US multinationals are no longer be subject to US taxes when repatriated, thus granting a sort of 100% of dividend deduction. The second has consisted in the application of a one-time tax, payable in eight years, on the existing stock of not repatriated earnings accumulated abroad. This tax, applied regardless of whether the funds are repatriated, offers two preferential tax rates: 15.5% for earnings held in cash or cash equivalents form, 8% if held in all the other forms. The combined action of these two measures aims to move the US tax system towards a more territorial one, facilitating the return of financial resources within the US borders.

However, the shift towards a more territorial tax system owns some critical implications since US companies would be encouraged to move their business into low-tax jurisdictions, for paying few taxes at source and successively repatriating dividends in a fully exempted manner. In order to avoid these risks, the TCJA has proposed a set of measures acting as "guardrails"[103], thus incentivizing US firms to run their business from the domestic territory. These measures aim to achieve their purpose by reducing the tax burden for companies that decide to conduct their business from the US, instead increasing that of companies that prefer to shift their activities and consequent profits abroad.

The reduction of the tax burden for operations originated within the domestic borders is achieved substantially in two ways: the introduction of a new *tax on profits of US resident corporations*, with a flat rate of 21%, and the preferential taxation on the *Foreign Derived Intangible Income*, so-called FDII.

With reference to the first aspect, the *new Corporation Tax* works as a flat tax, "marking the abandonment of the progressive system previously adopted at federal level"[104]. The main

[103] Tax Policy Center, *How did the Tax Cuts and Jobs Act change business taxes?*
See https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-business-taxes
Particular attention should be paid to the "International Issues" section. This section deals with all the changes in the US tax system linked to Tax Cuts and Jobs Act reform adopting an international, not merely domestic, perspective.

[104] Mattia S., 2018, *Stati Uniti: un primo bilancio sulla riforma fiscale in vigore nel 2018,* Il Fisco 40/2018, p.3858-3862, section: Approfondimento Fiscalità Internazionale.

beneficiaries of this measure have resulted to be the large multinationals which traditionally, by virtue of their income bracket, were instead subject to a taxation around 35%.

On the other hand, the second measure has concerned a reduction in the tax burden on the *Foreign Derived Intangible Income*, namely the income that arises from exporting products or services attributable to US-based intangibles, such as patents, trademarks and copyrights. The objective has been clearly of encouraging US multinationals to conduct their worldwide business from the United States, keeping as much as possible intangible assets within the domestic borders. In this way intellectual property and the associated wealth remain legally and substantially inserted in the US territory, instead of being shifted towards more favorable tax jurisdictions. From the numerical point of view, the FDII is computed as a portion of the income attributable to a US company's intangible assets, where the latter consists in the income that overcomes the 10% deemed return on its depreciable tangible property. Within this excess income, the portion that refers to the sales of goods or services abroad is classified as FDII, benefiting from a reduced tax rate of 13.125%, instead of the ordinary 21%. In 2026 the FDII rate will increase to 16.83%.

In a symmetric way, the TCJA has introduced measures in order to make *profit shifting practices* less easy for US multinational groups. Among these, the most important is represented by the introduction of a minimum tax on GILTI, namely *Global Intangible Low-Taxed Income*. GILTI represents the income that is earned from intangible assets held abroad through the presence of foreign affiliates. Its numerical computation shows some common features with the FDII one. GILTI is in fact determined as the total income earned by a US company's foreign subsidiaries in excess of the 10% deemed return on tangible property held abroad. The tax is calculated by taking into account the possibility for a corporation to deduct the 50% of the GILTI and to claim a credit for the 80% of taxes paid or accrued abroad on GILTI. If the foreign tax rate is zero, the US will effectively levy a tax of 10.5% on GILTI, thanks to the 50% deduction. If instead the foreign tax rate equals or exceeds 13.125%, no tax will be applied in the US because of the 80% tax credit.

A numerical example can facilitate the understanding of the minimum tax applied on GILTI[105]. In particular the focus will be placed on how the value of foreign tax rate changes

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[105] Tax Policy Center, *What is Global Intangible Low-Taxed Income and how is it taxed under the TCJA?* See https://www.taxpolicycenter.org/briefing-book/what-global-intangible-low-taxed-income-and-how-it-taxed-under-tcja The numerical values of the proposed example may be found in the conclusive paragraph of the article above mentioned. The proposed example shows a dual purpose. The first is to provide a practical demonstration regarding the application of the GILTI tax. The second is to highlight the intrinsic nature of the tax, namely its primary objective of contrasting profit shifting practices towards low-tax jurisdictions.

the GILTI tax actually levied in the US. Supposing that a US corporation controls an affiliated company abroad, with a foreign tangible property valued USD 100 million and the foreign income USD 30 million:

- GILTI is equal to USD 20 million (30 million-10% times 100 million);
- taxable GILTI (after 50% deduction) is equal to 10 million;
- US tax on GILTI before tax credit is equal to the product between taxable GILTI and the US ordinary tax rate;
- taxes paid abroad on GILTI are equal to the multiplication between foreign tax rate and GILTI;
- available tax credit is the 80% of the taxes paid abroad;
- GILTI tax is the difference between US tax on GILTI before tax credit and the available tax credit;
- GILTI tax rate is equal to the GILTI tax over GILTI.

US ordinary tax rate	Foreign tax rate	GILTI	Taxable GILTI	US tax on GILTI before tax credit	Taxes paid abroad on GILTI	Available tax credit	GILTI tax	GILTI tax rate
21%	0%	20 mln	10 mln	2,1 mln	0 mln	0 mln	2,1 mln	10.5%
21%	12.5%	20 mln	10 mln	2,1 mln	2,5 mln	2 mln	0,1 mln	0.5%
21%	13.125%	20 mln	10 mln	2,1 mln	2,625 mln	2,1 mln	0 mln	0%
21%	14%	20 mln	10 mln	2,1 mln	2,8 mln	2,24 mln	0 mln	0%

Figure 25: GILTI tax (own elaboration)

The example shows that the amount of the GILTI tax is higher when the foreign tax rate is lower. Therefore its application mainly hits those US multinationals that move intangibles and associated profits in low-tax jurisdictions, such as tax havens. The minimum tax on GILTI and the reduced tax on FDII, by acting symmetrically, reach the same objective. GILTI acts in fact as a "stick to prevent companies from making investments in intangible assets overseas while FDII works as a carrot to provide an incentive for firms to hold intangible assets in their US affiliates"[106]. Both measures are designed in order to reduce the incentives to artificially

[106] Tax Policy Center, *How did the Tax Cuts and Jobs Act change business taxes?* The GILTI tax takes also the connotation of a CFC Rule, as it aims to counter the practices consisting in shifting profits towards controlled foreign companies located in favorable tax jurisdictions. It is important to underline that United States has been the first jurisdiction to introduce CFC Rules, already in the 1930s.
See https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-business-taxes

shift the intellectual property out of the US through the realization of intra-group transactions, thus ensuring a fairer taxation of corporate profits.

TCJA also disadvantages the profit shifting strategies with another tax, the BEAT, namely *Base erosion and anti-abuse tax*. Its purpose consists in countering the practices of multinationals of eroding taxable base in the US through the realization of deductible payments, such as interests and royalties, to group entities located in low-tax countries. The BEAT is applied only on corporations exceeding USD 500 million of gross receipts and on those that have made more than the 3% of their total deductible payments to foreign affiliates. The BEAT takes the form of an additional tax, since first the US company shall calculate its regular tax with the 21% fiscal rate, reducing the taxable base with the intra-group deductible payments. Successively, the corporation shall calculate the BEAT, using a lower rate than 21% (5% in 2018, 10% from 2019 to 2025, 12.5% in 2026 and beyond) but adding back the intra-group deductible payments to the taxable base. If the regular tax is lower than the BEAT, then the company shall integrate the difference: in this way the corporation will fully pay the BEAT.

As indicated above, the second major regulatory intervention that has forced Google to abandon its strategy has been a ***modification in the Irish tax legislation***. This amendment has had the purpose of eliminating an important tax benefit traditionally provided by the Irish system, namely the possibility of establishing companies under Irish law but considered to be tax resident elsewhere. Since 1st January 2015 in fact, according to Irish Finance Minister Michael Noonan, all the companies that decide to set up in Ireland from scratch will also be treated as tax residents. On the other side, companies that were already leveraging that advantage at the time of the legislative amendment, such as Google, were given an additional time until 2020 to review their organizational structure.

The abandonment of the tax avoidance strategy has been also caused by another significant regulatory change, that is the ***new version of the Double Tax Treaty between Ireland and Netherlands***. This new version has been signed on 13th June 2019 and it has entered into force on 29th February 2020. Its effective applicability is established from 1st January 2021, when it will replace the previous version dated 1969. The new version has been designed in order to remove some limitations of the previous one, which left ample room for unfair treaty shopping practices. The 1969 version, based on the 1963 OECD Model Tax Convention, was indeed very scarce in terms of anti-abuse rules, both generic and specific. For example, with reference to international flows of royalties, the exemption from taxation at source was not subject to the *beneficial ownership clause,* thus encouraging the proliferation of mere interposed shell companies. Now instead the new version aligns with the 2017 OECD Model Tax Convention, granting the exemption from the withholding tax on royalty only to the beneficial owner, therefore emptying the function of conduit companies. Article 12 of the new Double Tax Treaty between Ireland and Netherlands in fact states, in the same way as the OECD Convention currently proposes, that "royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State"[107]. The term "beneficially owned" represents the main change from the 1969 version, a graft that greatly reduces the feasibility of treaty shopping.

Also in the Dutch legislative landscape some significant changes are going to happen. The most important relates to the decision of the Dutch legislator to introduce a ***conditional withholding tax on royalties directed towards low-tax jurisdictions***, from 2021 onwards. This choice aims to eliminate the convenience of Dutch sandwiches, otherwise used to move profits without taxation to tax havens. The conditional withholding tax will be levied on payments of royalties made by Dutch resident companies to other group entities located in designated low-tax jurisdictions, namely the jurisdictions with a statutory corporate tax rate of less than 9%. The same tax is also applied to all those abusive situations in which "artificial structures are put in place with the main purpose to avoid the Dutch withholding tax"[108]. The evaluation of the abuse situations will be conducted by the Dutch tax authorities, on the base of the facts and circumstances of each specific case. The rate proposed for this new withholding tax should be equal to 21.7%.

As mentioned in the previous list, some relevant regulatory interventions also originate from the Italian market jurisdiction. For example, the Law 205/2017 has emended article 162 of the Italian TUIR, ***updating the permanent establishment concept to the fiscal challenges*** posed by the digital economy. In particular this integration has been necessary in order to tax all those situations otherwise characterized by a presence "constructed in such a way as not to result in its physical consistency in the territory itself"[109]. Therefore, the ultimate purpose of

[107] Double Taxation Treaty between Ireland and Netherlands, 2019. The Tax Treaty was signed on 13th June 2019. The reference is visible in art.12, dedicated to cross-border royalties. See https://www.revenue.ie/en/tax-professionals/documents/double-taxation-treaties/n/netherlands-not-yet-in-force.pdf

[108] Pwc NL, 2019, *Withholding tax on interest and royalty payments to low-tax jurisdictions- Update.* The article lists all the low-tax jurisdictions in the world to which the conditional withholding tax on royalties will be applied. Among these: Anguilla, Bahamas, Bahrain, Belize, Bermuda, British Virgin Islands, Cayman Islands, Fiji, Guam, Guernsey, Isle of Man, Jersey, Kuwait, Marshall Islands, Oman, Qatar, Samoa, Saudi-Arabia, Trinidad and Tobago, Turks and Caicos Islands, United Arab Emirates, US Samoa, US Virgin Islands and Vanuatu. This list is updated annually on 1st October and it is applicable to the following year.

[109] Art. 162 TUIR, as emended by Law 205/2017

the measure has consisted in countering dissimulative practices aiming at artificially avoiding the PE status and, consequently, the taxable presence.

The common denominator of all these regulatory interventions is represented by the BEPS Project. Each of the measures provides in fact a concrete application to the OECD recommendations, mainly inserted in Pillar one and two of the BEPS Plan.

The tax reform promoted by the TCJA encourages in fact at locating the intellectual property in the US, taxing FDII on a preferential basis and introducing instead a tax on GILTI. In this way US multinationals have less incentives to move intangibles within the international articulation of their groups, despite the intangibles' easily transferable nature. Maintaining the legal ownership of intangibles in the US territory primarily means preserving the related profits within national borders, thus avoiding profit shifting towards more favorable tax jurisdictions. The reference is clearly to Actions 8-10 of the BEPS Plan, which aim at aligning taxation with the value creation process.

Always with reference to TCJA, the BEAT finds its inspiration in Action 4 of the BEPS Plan, with which it shares the objective of limiting the base erosion practices through the use of excessive deductions.

The amendment of the Irish legislation is intended to remove the link between Ireland and tax havens, avoiding the possibility for a multinational group to create companies formally Irish but with tax residence offshore. In this way harmful tax practices are limited, coherently with Action 5 of BEPS Plan.

The new version of the Double Tax Treaty between Ireland and the Netherlands and the introduction of a Dutch conditional withholding tax on royalties directed towards low-tax jurisdictions are instead moving in the perspective of eliminating the incentive to create Dutch shell companies, simply interposed to enjoy the advantages offered by the Dutch tax environment. These measures are in fact designed in order to reduce the withholding tax avoidance, coherently with what recommended by Action 6 of BEPS Project. In this way the function of the Netherlands as a gateway to tax havens results significantly jeopardized.

The update of the permanent establishment concept by the Italian legislator is instead designed in order to resolve all those situations in which taxpayers seek to conceal the presence of its own permanent establishment in Italy, endeavoring to provide a distorted image of the substantial circumstances[110].

Therefore, this measure shares with the Action 7 of the BEPS Plan the intent of preventing the artificial avoidance of the PE status.

The sum of all these regulatory interventions has represented an effective response to all the modern fiscal challenges associated with Google's tax avoidance strategy. These measures have weakened the elusive cornerstones of the strategy, thus forcing the US multinational to abandon it.

First, the tax reform proposed by the TCJA, favoring the repatriation of wealth in the US territory, has eliminated the incentive of keeping profits parked in low-tax jurisdictions. The same reform has also reduced the base erosion practices and it has increased the tax burden on the profits of intellectual property held abroad, thus encouraging Google to license its own technologies from the US.

The strategy has also been rejected because the Double Irish mechanism has lost its traditional function, as a result of the Irish legislative amendment. The possibility of creating companies under Irish law but with tax residence elsewhere was in fact something unique in the international tax environment, working as a backbone for the entire scheme.

In addition, the updated version of the Tax Treaty between Ireland and the Netherlands, together with the choice of the Dutch tax system to activate a tax on royalties directed to tax havens, have progressively emptied the traditional interposition function of the Dutch shell companies.

Ultimately, the Italian modification of the permanent establishment concept has weakened another cornerstone of Google's tax avoidance strategy, namely the one of avoiding the taxable presence in the market countries, for example by artificially circumventing the PE definition.

The coordination of all these measures, characterized by a strong international respire, has induced Google to reduce its BEPS practices, as visible from the abandonment of its *Double Irish with a Dutch sandwich* strategy.

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[110] Forestieri V., Salvini L., 2019, *Il nuovo articolo 162, 2° comma, lett. f-bis) del TUIR alla luce dello Strumento Multilaterale: il Legislatore italiano ha veramente introdotto una norma sulla stabile organizzazione virtuale?* In the article, the authors qualify the amendments made to article 162 as an anti-avoidance measure, aiming at preventing the artificial avoidance of PE status, rather than a new form of territorial nexus.

A coordination of efforts on an international scale

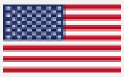
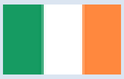
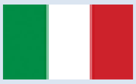
Jurisdiction involved	Type of regulatory intervention	Content of the intervention	Countered fiscal challenge
United States 	Tax reform promoted by TCJA 2018	*FDII and GILTI*	*Locating the income allocable to intangible assets in the most favorable tax jurisdictions*
		BEAT	*Excessive deductions*
Ireland 	Amendment to Irish tax legislation 2015	*Companies under Irish law are also Irish tax resident*	*Harmful tax practices*
	New version of the Double Tax Treaty with Netherlands 2021	*Beneficial ownership clause for exemption from royalty withholding tax*	*Avoiding withholding tax*
Netherlands 	Conditional withholding tax 2021	*Withholding tax on outgoing royalties towards tax havens*	*Avoiding withholding tax*
	New version of the Double Tax Treaty with Ireland 2021	*Beneficial ownership clause for exemption from royalty withholding tax*	*Avoiding withholding tax*
Italy 	Modification of art.162 TUIR	*Update of the permanent establishment concept*	*Avoiding a taxable presence in the market country*

Figure 26: a coordination of efforts on an international scale (own elaboration)

Conclusions

The modern fiscal challenges have highlighted all the inadequacies of the traditional tax systems. The innovative nature of the digital economy has been extremely powerful, forcing a necessary update in the field of international taxation. The growing intangible origin of the income has in fact laid the foundations for the circulation of a new form of wealth, much more geographically mobile than the previous one, traditionally associated to tangible resources. And, since tax law deals with wealth, a new wealth paradigm had to be necessarily accompanied by a series of new juridical paradigms to tax it. In addition, the current epidemiological crisis due to the Covid-19 has led to a strong acceleration of digitalization processes, intended as means for achieving the so-called "social distancing", stressing the need to identify appropriate responses to modern fiscal challenges.

This path of change, aimed at updating the traditional tax systems to the current economic transformations, has its own starting point in the BEPS Project, born within the OECD. BEPS Plan has represented an "unprecedented initiative in the field of international taxation"[111], anchoring on the assumption that only a "paradigm shift" would have allowed to adequately **tackle the modern fiscal challenges**. Therefore, the entry into the international scene of the BEPS Plan has brought a breath of innovation to the pre-existing framework of international taxation.

Now, five years after the definitive modeling of the BEPS Plan, the main road has been traced, oriented towards a well-defined goal: **taxing economic value in the place where it is generated**. The broad scope of this objective, however, requires a joint and shared international effort, fuelled by greater interest on international tax issues. In this sense, OECD has accepted the challenge of coordinating the different jurisdictions around the world towards the adoption of a *construens* approach. In fact, all the OECD proposals are based on the awareness that only an active and international cooperation among countries would grant the shaping of cross-border tax profiles suitable for the current economic transformations.

This process of adapting tax systems to the challenges posed by the modern economy certainly shows high-value intentions, aimed at achieving a fairer distribution of tax revenues around the world. An active coordination between the different national jurisdictions would in fact allow to eliminate the presence of harmful tax asymmetries that would otherwise offer wide loopholes to reduce the tax burden of multinational groups. Moreover, the contrast of

[111] Greggi M., 2013, *Coordinamento fiscale e doppie deduzioni internazionali nel quadro dell'iniziativa BEPS,* Rivista di Diritto Tributario Internazionale 3/2013

modern fiscal challenges would not be loaded on the shoulders of a single jurisdiction but it would be the shared purpose and effort on an international scale. Wealth in circulation is not infinite. Once created, it is distributed. But if certain areas of the world attract more wealth than what they should, such as the low-tax jurisdictions, other areas will irreparably lose taxable matter. Equity in taxation therefore means equity in the way in which wealth is distributed: economic value must be taxed where it is generated and at higher value must correspond to greater tax burden. As stated by the OECD Secretary General Angel Gurrìa on 5th October 2015, "the BEPS practices not only deprive the various States of valuable economic resources needed to engage the recovery train, but above all destroy citizens' confidence in the overall equity of the tax system"[112]. The creation of a fair tax system is also a priority of the current National Recovery and Resilience Plan of Italy. Fairness, simplicity and transparency of the tax system are in fact intended as "necessary gussets"[113] to support the achievement of the Plan's objectives.

The aspiration to an international fair taxation is certainly an ambitious objective of great value, but at the same time it is a long and time-expensive path. Such path is in fact based on a fragile balance, where the activation of international pressures may cause a sharp halt to the entire cooperation process, thus inhibiting the negotiation efforts.

For example, the frustration of countries most affected by BEPS practices may prompt them to take rapid and uncoordinated actions. These unilateral interventions would take the features of a mere *destruens* approach, aimed at removing the tax criticalities within the own territory, without participating in a broader plan to rethink international taxation. The adoption of unilateral measures would facilitate the introduction of provisions that are too flexible, nuanced and suited to the specific tax revenue needs of countries. In fact, in order to guarantee the right of sovereignty over the income generated in the territory of the State, they could assume such a discretionary nature as to weaken fiscal certainty. As evidenced by the testimony of Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration, unilateral and uncoordinated actions by countries have the capacity to replace the issue of non-taxation with the proliferation of uncoordinated legislative measures that will cause "excessive compliance costs for MNEs, as well as the potential for double or multiple taxation on the same income, undermining the existing consensus-based standards and replacing them

[112] Speech delivered by OECD Secretary General Angel Gurrìa on 5th October 2015 during the presentation of BEPS 2015 Final Report. The full speech is available on https://www.youtube.com/watch?v=dVRVfIz9c64.

[113] Corriere della Sera, 2020, *Linee Guida per la Definizione del Piano Nazionale di Ripresa e Resilienza,* published on 15th September 2020

with chaos"[114]. A weakening of fiscal certainty would lead to a lower knowledge regarding the tax burden associated with the conduct of a business, posing the entrepreneur in a position of greater uncertainty.

Taking a broader view, the lack of fiscal certainty could also undermine some of the fundamental rights associated with the modern and liberal society. For example, the weak knowledge of the tax burden associated with a certain investment choice could be configured as a violation of the right to freedom of economic initiative or the famous principle "no taxation without representation", according to which the collectability of a tax burden shall be subject to the actual knowledge by the taxpayer. "Metabolizing" the tax burden becomes in fact a fundamental condition to guarantee stable and programmable investments for the entrepreneur.

The introduction of uncoordinated measures, as declared by Pascal Saint-Amans, "has also the potential to encourage protectionist measures that would be detrimental to international trade"[115]. Their unilateralism could in fact trigger a series of compensatory trade measures, igniting a framework of political tension at international level. This situation has recently occurred when some EU countries, which are among the most affected by the BEPS practices, have decided to introduce their own taxation on digital turnover. Since the taxable persons of this tax were predominantly the large US multinational high-tech vendors in the European continent, the US has immediately classified such taxes as discriminatory. As a compensatory measure, moreover, President Trump has threatened the application of a series of duties on export of European products in the US territory, opening to a dangerous tax war.

These considerations highlight that the path taken, despite its noteworthy value, is certainly not easy and many obstacles are placed in its realization. But what really matters is that those that lead the way in this path, namely the OECD, are strongly supporting their conviction: a coordination of efforts on an international scale in order to globalize taxation, as the economy already is.

During the meeting of July 2020, as reported in a recent OECD Tax Talk, G20 Finance Ministers have in fact stated that "the failure to achieve a consensus-based solution would lead to a proliferation of unilateral measures, more uncertainty and trade disputes. We stress the importance to continue advancing the work on a global and consensus-based solution"[116].

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[114] See the complete testimony of Pascal Saint-Amans (2014) before the US Senate Committee on Finance at: https://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Pascal%20Saint-Amans.pdf .

[115] See the complete testimony of Pascal Saint-Amans (2014) before the US Senate Committee on Finance at: https://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Pascal%20Saint-Amans.pdf

[116] G20 Finance Ministers' Meeting, July 2020, see the OECD Tax Talk at: http://www.oecd.org/tax/beps/tax-talks-webcasts.htm

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